Ben S Bernanke: Developments in the financial markets

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 3 April 2008.

* * *

Chairman Dodd, Senator Shelby, and other members of the Committee, I appreciate this opportunity to discuss current economic and financial conditions and the actions the Federal Reserve has taken to stabilize financial markets and the economy.

Although the situation has recently improved somewhat, financial markets remain under considerable stress. Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and increased the amount of collateral they required to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices. Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises (GSEs), have reported substantial losses and writedowns, reducing their capital available to support increased lending. Some key securitization markets, including those for nonconforming mortgages, continue to function poorly if at all.

These developments in financial markets – which themselves reflect, in part, greater concerns about housing and the economic outlook more generally – have weighed on real economic activity. Notably, in the housing market, sales of both new and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall. Private payroll employment fell substantially in February, after two months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline. But the demand for labor has also moderated recently in other industries. Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee (FOMC) at the end of January. Inflation has also been a source of concern. We expect inflation to moderate in coming quarters, but it will be necessary to continue to monitor inflation developments carefully.

Well-functioning financial markets are essential for the efficacy of monetary policy and, indeed, for economic growth and stability. Consistent with its role as the nation's central bank, the Federal Reserve has taken a number of steps in recent weeks to improve market liquidity and market functioning. These actions include reducing the cost and increasing the allowable term of discount window credit to commercial banks; increasing the size of our Term Auction Facility, through which credit is auctioned to depository institutions; initiating a Term Securities Lending Facility, which allows primary dealers to swap less-liquid mortgage backed securities for more-liquid Treasury securities; and creating the Primary Dealer Credit Facility, which is similar to the discount window but accessible to primary dealers. Although these facilities operate through depository institutions and primary dealers, they are designed to support the broader financial markets and the economy by facilitating the provision of liquidity by those institutions to their customers and counterparties. With respect to monetary policy, at its March meeting the FOMC reduced its target for the federal funds rate by 75 basis points to 2-1/4 percent.

It was in this context of intensifying financial strains that, on March 13, Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funds became available.

This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.

To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The purpose of our action, as with our other recent actions – including our provision of liquidity to financial firms and our reductions in the federal funds rate target – was, as best as possible, to improve the functioning of financial markets and to limit any adverse effects of financial turmoil on the broader economy. We will remain focused on those objectives.

Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. I remain confident in our economy's long-term prospects.

Thank you. I would be pleased to take your questions.