

Ben S Bernanke: Semiannual Monetary Report to the Congress

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington, DC, 21 July 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress*.

Economic and financial developments in the first half of 2009

Aggressive policy actions taken around the world last fall may well have averted the collapse of the global financial system, an event that would have had extremely adverse and protracted consequences for the world economy. Even so, the financial shocks that hit the global economy in September and October were the worst since the 1930s, and they helped push the global economy into the deepest recession since World War II. The U.S. economy contracted sharply in the fourth quarter of last year and the first quarter of this year. More recently, the pace of decline appears to have slowed significantly, and final demand and production have shown tentative signs of stabilization. The labor market, however, has continued to weaken. Consumer price inflation, which fell to low levels late last year, remained subdued in the first six months of 2009.

To promote economic recovery and foster price stability, the Federal Open Market Committee (FOMC) last year brought its target for the federal funds rate to a historically low range of 0 to 1/4 percent, where it remains today. The FOMC anticipates that economic conditions are likely to warrant maintaining the federal funds rate at exceptionally low levels for an extended period.

At the time of our February report, financial markets at home and abroad were under intense strains, with equity prices at multiyear lows, risk spreads for private borrowers at very elevated levels, and some important financial markets essentially shut. Today, financial conditions remain stressed, and many households and businesses are finding credit difficult to obtain. Nevertheless, on net, the past few months have seen some notable improvements. For example, interest rate spreads in short-term money markets, such as the interbank market and the commercial paper market, have continued to narrow. The extreme risk aversion of last fall has eased somewhat, and investors are returning to private credit markets. Reflecting this greater investor receptivity, corporate bond issuance has been strong. Many markets are functioning more normally, with increased liquidity and lower bid-asked spreads. Equity prices, which hit a low point in March, have recovered to roughly their levels at the end of last year, and banks have raised significant amounts of new capital.

Many of the improvements in financial conditions can be traced, in part, to policy actions taken by the Federal Reserve to encourage the flow of credit. For example, the decline in interbank lending rates and spreads was facilitated by the actions of the Federal Reserve and other central banks to ensure that financial institutions have adequate access to short-term liquidity, which in turn has increased the stability of the banking system and the ability of banks to lend. Interest rates and spreads on commercial paper dropped significantly as a result of the backstop liquidity facilities that the Federal Reserve introduced last fall for that market. Our purchases of agency mortgage-backed securities and other longer-term assets have helped lower conforming fixed mortgage rates. And the Term Asset-Backed Securities

Loan Facility (TALF), which was implemented this year, has helped restart the securitization markets for various classes of consumer and small business credit.

Earlier this year, the Federal Reserve and other federal banking regulatory agencies undertook the Supervisory Capital Assessment Program (SCAP), popularly known as the stress test, to determine the capital needs of the largest financial institutions. The results of the SCAP were reported in May, and they appeared to increase investor confidence in the U.S. banking system. Subsequently, the great majority of institutions that underwent the assessment have raised equity in public markets. And, on June 17, 10 of the largest U.S. bank holding companies – all but one of which participated in the SCAP – repaid a total of nearly \$70 billion to the Treasury.

Better conditions in financial markets have been accompanied by some improvement in economic prospects. Consumer spending has been relatively stable so far this year, and the decline in housing activity appears to have moderated. Businesses have continued to cut capital spending and liquidate inventories, but the likely slowdown in the pace of inventory liquidation in coming quarters represents another factor that may support a turnaround in activity. Although the recession in the rest of the world led to a steep drop in the demand for U.S. exports, this drag on our economy also appears to be waning, as many of our trading partners are also seeing signs of stabilization.

Despite these positive signs, the rate of job loss remains high and the unemployment rate has continued its steep rise. Job insecurity, together with declines in home values and tight credit, is likely to limit gains in consumer spending. The possibility that the recent stabilization in household spending will prove transient is an important downside risk to the outlook.

In conjunction with the June FOMC meeting, Board members and Reserve Bank presidents prepared economic projections covering the years 2009 through 2011. FOMC participants generally expect that, after declining in the first half of this year, output will increase slightly over the remainder of 2009. The recovery is expected to be gradual in 2010, with some acceleration in activity in 2011. Although the unemployment rate is projected to peak at the end of this year, the projected declines in 2010 and 2011 would still leave unemployment well above FOMC participants' views of the longer-run sustainable rate. All participants expect that inflation will be somewhat lower this year than in recent years, and most expect it to remain subdued over the next two years.

Policy challenges

Monetary policy

In light of the substantial economic slack and limited inflation pressures, monetary policy remains focused on fostering economic recovery. Accordingly, as I mentioned earlier, the FOMC believes that a highly accommodative stance of monetary policy will be appropriate for an extended period. However, we also believe that it is important to assure the public and the markets that the extraordinary policy measures we have taken in response to the financial crisis and the recession can be withdrawn in a smooth and timely manner as needed, thereby avoiding the risk that policy stimulus could lead to a future rise in inflation.¹ The FOMC has been devoting considerable attention to issues relating to its exit strategy, and we are confident that we have the necessary tools to implement that strategy when appropriate.

¹ For further discussion of the Federal Reserve's "exit strategy" from its current policy stance, see "Monetary Policy as the Economy Recovers" in Board of Governors of the Federal Reserve System (2009), Monetary Policy Report to the Congress (Washington: Board of Governors, July), p. 34-7.

To some extent, our policy measures will unwind automatically as the economy recovers and financial strains ease, because most of our extraordinary liquidity facilities are priced at a premium over normal interest rate spreads. Indeed, total Federal Reserve credit extended to banks and other market participants has declined from roughly \$1.5 trillion at the end of 2008 to less than \$600 billion, reflecting the improvement in financial conditions that has already occurred. In addition, bank reserves held at the Fed will decline as the longer-term assets that we own mature or are prepaid. Nevertheless, should economic conditions warrant a tightening of monetary policy before this process of unwinding is complete, we have a number of tools that will enable us to raise market interest rates as needed.

Perhaps the most important such tool is the authority that the Congress granted the Federal Reserve last fall to pay interest on balances held at the Fed by depository institutions. Raising the rate of interest paid on reserve balances will give us substantial leverage over the federal funds rate and other short-term market interest rates, because banks generally will not supply funds to the market at an interest rate significantly lower than they can earn risk free by holding balances at the Federal Reserve. Indeed, many foreign central banks use the ability to pay interest on reserves to help set a floor on market interest rates. The attractiveness to banks of leaving their excess reserve balances with the Federal Reserve can be further increased by offering banks a choice of maturities for their deposits.

But interest on reserves is by no means the only tool we have to influence market interest rates. For example, we can drain liquidity from the system by conducting reverse repurchase agreements, in which we sell securities from our portfolio with an agreement to buy them back at a later date. Reverse repurchase agreements, which can be executed with primary dealers, government-sponsored enterprises, and a range of other counterparties, are a traditional and well-understood method of managing the level of bank reserves. If necessary, another means of tightening policy is outright sales of our holdings of longer-term securities. Not only would such sales drain reserves and raise short-term interest rates, but they also could put upward pressure on longer-term interest rates by expanding the supply of longer-term assets. In sum, we are confident that we have the tools to raise interest rates when that becomes necessary to achieve our objectives of maximum employment and price stability.

Fiscal policy

Our economy and financial markets have faced extraordinary near-term challenges, and strong and timely actions to respond to those challenges have been necessary and appropriate. I have discussed some of the measures taken by the Federal Reserve to promote economic growth and financial stability. The Congress also has taken substantial actions, including the passage of a fiscal stimulus package. Nevertheless, even as important steps have been taken to address the recession and the intense threats to financial stability, maintaining the confidence of the public and financial markets requires that policymakers begin planning now for the restoration of fiscal balance. Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in the costs of Medicare and Medicaid. Addressing the country's fiscal problems will require difficult choices, but postponing those choices will only make them more difficult. Moreover, agreeing on a sustainable long-run fiscal path now could yield considerable near-term economic benefits in the form of lower long-term interest rates and increased consumer and business confidence. Unless we demonstrate a strong commitment to fiscal sustainability, we risk having neither financial stability nor durable economic growth.

Regulatory reform

A clear lesson of the recent financial turmoil is that we must make our system of financial supervision and regulation more effective, both in the United States and abroad. In my view, comprehensive reform should include at least the following key elements:

- a prudential approach that focuses on the stability of the financial system as a whole, not just the safety and soundness of individual institutions, and that includes formal mechanisms for identifying and dealing with emerging systemic risks;
- stronger capital and liquidity standards for financial firms, with more-stringent standards for large, complex, and financially interconnected firms;
- the extension and enhancement of supervisory oversight, including effective consolidated supervision, to all financial organizations that could pose a significant risk to the overall financial system;
- an enhanced bankruptcy or resolution regime, modeled on the current system for depository institutions, that would allow financially troubled, systemically important nonbank financial institutions to be wound down without broad disruption to the financial system and the economy;
- enhanced protections for consumers and investors in their financial dealings;
- measures to ensure that critical payment, clearing, and settlement arrangements are resilient to financial shocks, and that practices related to the trading and clearing of derivatives and other financial instruments do not pose risks to the financial system as a whole; and
- improved coordination across countries in the development of regulations and in the supervision of internationally active firms.

The Federal Reserve has taken and will continue to take important steps to strengthen supervision, improve the resiliency of the financial system, and to increase the macroprudential orientation of our oversight. For example, we are expanding our use of horizontal reviews of financial firms to provide a more comprehensive understanding of practices and risks in the financial system.

The Federal Reserve also remains strongly committed to effectively carrying out our responsibilities for consumer protection. Over the past three years, the Federal Reserve has written rules providing strong protections for mortgage borrowers and credit card users, among many other substantive actions. Later this week, the Board will issue a proposal using our authority under the Truth in Lending Act, which will include new, consumer-tested disclosures as well as rule changes applying to mortgages and home equity lines of credit; in addition, the proposal includes new rules governing the compensation of mortgage originators. We are expanding our supervisory activities to include risk-focused reviews of consumer compliance in nonbank subsidiaries of holding companies. Our community affairs and research areas have provided support and assistance for organizations specializing in foreclosure mitigation, and we have worked with nonprofit groups on strategies for neighborhood stabilization. The Federal Reserve's combination of expertise in financial markets, payment systems, and supervision positions us well to protect the interests of consumers in their financial transactions. We look forward to discussing with the Congress ways to further formalize our institution's strong commitment to consumer protection.

Transparency and accountability

The Congress and the American people have a right to know how the Federal Reserve is carrying out its responsibilities and how we are using taxpayers' resources. The Federal Reserve is committed to transparency and accountability in its operations. We report on our activities in a variety of ways, including reports like the one I am presenting to the Congress today, other testimonies, and speeches. The FOMC releases a statement immediately after each regularly scheduled meeting and detailed minutes of each meeting on a timely basis. We have increased the frequency and scope of the published economic forecasts of FOMC participants. We provide the public with detailed annual reports on the financial activities of

the Federal Reserve System that are audited by an independent public accounting firm. We also publish a complete balance sheet each week.

We have recently taken additional steps to better inform the public about the programs we have instituted to combat the financial crisis. We expanded our website this year to bring together already available information as well as considerable new information on our policy programs and financial activities.² In June, we initiated a monthly report to the Congress (also posted on our website) that provides even more information on Federal Reserve liquidity programs, including breakdowns of our lending, the associated collateral, and other facets of programs established to address the financial crisis.³ These steps should help the public understand the efforts that we have taken to protect the taxpayer as we supply liquidity to the financial system and support the functioning of key credit markets.

The Congress has recently discussed proposals to expand the audit authority of the Government Accountability Office (GAO) over the Federal Reserve. As you know, the Federal Reserve is already subject to frequent reviews by the GAO. The GAO has broad authority to audit our operations and functions. The Congress recently granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act, including the loan facilities provided to, or created for, American International Group and Bear Stearns. The GAO and the Special Inspector General have the right to audit our TALF program, which uses funds from the Troubled Assets Relief Program.

The Congress, however, purposefully – and for good reason – excluded from the scope of potential GAO reviews some highly sensitive areas, notably monetary policy deliberations and operations, including open market and discount window operations. In doing so, the Congress carefully balanced the need for public accountability with the strong public policy benefits that flow from maintaining an appropriate degree of independence for the central bank in the making and execution of monetary policy. Financial markets, in particular, likely would see a grant of review authority in these areas to the GAO as a serious weakening of monetary policy independence. Because GAO reviews may be initiated at the request of members of Congress, reviews or the threat of reviews in these areas could be seen as efforts to try to influence monetary policy decisions. A perceived loss of monetary policy independence could raise fears about future inflation, leading to higher long-term interest rates and reduced economic and financial stability. We will continue to work with the Congress to provide the information it needs to oversee our activities effectively, yet in a way that does not compromise monetary policy independence.

² See "Credit and Liquidity Programs and the Balance Sheet" on the Board's website.

³ See the monthly reports on the Board's website at "Credit and Liquidity Programs and the Balance Sheet," Congressional Reports and Other Resources, Federal Reserve System Monthly Reports on Credit and Liquidity Programs and the Balance Sheet.