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UA36I/29 Gary Ransdell - Federal Reserve Board - Ben Bernanke on the State of the Economy

St. Louis Federal Reserve Board

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Subject: FedDigest, June 9, 2010: Chairman Bernanke's Testimony Q&A on the State of the Economy

All - Despite the date of the event, this just in. I think it takes some time to receive and excerpt the transcripts.

Before the House Budget Committee.

This document is not an official transcript. The excerpts below are selectively drawn from the original unedited transcripts.

Bank Lending

Q. What have we got to do to get credit moving and flowing in this country again?

A. That is also a top priority for the Federal Reserve. Larger firms have been able to raise funding as needed, and in addition they have pretty liquid balance sheets. Problems still remain for smaller firms that are dependent on banks because banks, although they have stabilized, are continuing to be very conservative in their lending policies. The Federal Reserve has been working very closely with the banks and with the examiners and with small business. I was just at a conference on this last week in Detroit, trying to make sure that the banks are able to lend to all credit-worthy borrowers and they're not being excessively conservative or denying good borrowers access to credit.

Q. Are you satisfied that that message is getting down to the regulators and the examiners in particular?

A. I'm never satisfied. I'm sure that there are examples that we could point to where that's not happening, but we have made a very substantial effort in terms of training, in terms of conference calls, in terms of repeated exhortation to our examiners that it's very important to work with the banks to make sure that credit-worthy borrowers are not turned away. The banks themselves have undertaken a number of steps. For example, a number of banks have undertaken so-called "second look" programs where loans that have been denied in a first-round application are given a second look to see if perhaps there might be other circumstances that might justify the loan.

Q. I continue to hear concern about the commercial real estate market and that it is going to hit, it's going to be worse than the home mortgage market that drove us into the first recession. Are you concerned about that? And what are we doing about it?

A. It clearly is a very weak point in the economy. For many banks, particularly smaller or medium-sized banks, it is a problem. We have done a number of things. The Federal Reserve worked with the Treasury to develop a program to try to restart the commercial mortgage-backed security market. Beyond that, we have issued guidance to banks and commercial real estate, and we're trying to work with them to restructure commercial real estate loans and to find ways to manage troubled loans. So we're doing the best we can with the banks and with the markets. There seems to be, I would say, a few glimmers of hope in this area. There's some stabilization of prices in some markets, for example, but it does remain a very serious concern, and we're watching it very carefully.

Q. Can we do more to encourage small-business growth?

A. Small business is very important for job creation, particularly in a cyclical upturn. I think it's important to try to remove the barriers and impediments for small business to expand. I agree that we want to make tax policy as small-business friendly as possible to provide the right incentives, to give them the opportunities to invest and hire. Beyond that, though, I think for them to do that they need, first, they

need demand, they need sales. So we need to keep the economy growing, and Federal Reserve is doing its part by maintaining a supportive monetary policy. Again, from our own perspective, we have put bank lending and bank credit at the very top of our priority list and we have increased our information gathering, we've increased our consultation, we've increased our training of examiners.

Bank Supervision

Q. There is a report out today that the Federal Reserve, six months into a compensation study of the country's 28 largest banks, has found that many of the bonus and incentive programs that economists say contributed to the worst financial crisis since the Depression remain in place. What are some of the policy alternatives you have to deal with these compensation practices by our largest banks?

A. We did a series of surveys and questionnaires to try to understand what the pay practices were and whether they were consistent with safe and sound banking and good incentive structures. As the report says, we found that many banks had not modified their practices from what they were before the crisis. We anticipate an interagency guidance on this matter within the next few weeks. We will be putting out a set of criteria and a set of expectations very shortly and we will be pushing the banks to move as quickly as possible to restructure their compensation packages so that they will not be engendering excessive risk-taking. The structure of the compensation practices needs to change so that there's not an incentive to take excessive risks where the trader gets all the upside and none of the downside.

Q. Do you think that you need a better early warning system, something that would give you better lead time in recognition of incipient events that are about to turn critical?

A. There are multiple dimensions to how to address this and the financial regulatory reform legislation attempts to look at all the components. First, we need to have a better oversight of the system and a more macro-prudential or systemic approach to regulation that will allow us to identify gaps and problems before they lead to a crisis. That is part of the philosophy underlying the creation of a Systemic Risk Council and giving the Federal Reserve consolidated supervision over large systemically critical firms.

Secondly, we need to make the system more resilient so when crises occur it will be more stable. We're doing that through a wide variety of mechanisms, including increased capital requirements, increased liquidity requirements, efforts to make derivatives trading more transparent and the like. And thirdly, if a crisis does occur, we need the tools to manage it, and there, very importantly, Congress has been working on alternative mechanisms for safely winding down and putting in receivership a large systemically critical firm so that it can fail without bringing down the rest of the system.

Consumer Protection

Q. There's nothing requiring the servicers to come to the table. We need the Fed to take a look at this, since you deal in the bond market and you deal with these companies anyway. Is there some way you can use your power to do that?

A. We've been working hard to support the Treasury's efforts to do HAMP renegotiations between borrowers and lenders, and we have made clear to the banks that they should participate and cooperate in those programs. Well, as supervisors we can strongly encourage them to participate, but we don't have the power to make it mandatory. To have these loans in limbo is not good for the banks either so I think there's a common interest here. When you have a lot of foreclosures in a particular area, you have a breakdown in public order or in tax revenues and property values. So that's another issue where we've been very much involved. But, again, the government's primary tool for this has been through the Treasury, and we've tried to support them both analytically and through our supervisory function.

Q. We've seen in our country a significant rise in defaults on home mortgages. At the same time, the absence of the homebuyer's tax credit will, I'm afraid and I believe, lead to a decrease in demand. What can the Fed do to address this situation, if anything?

A. The main thing we're doing, of course, is that we purchased a large amount of mortgage-backed securities guaranteed by the government-sponsored enterprises. And right now, the 30-year mortgage rate is about 4.8 percent, so that's clearly going to make it accessible. Affordability right now, in terms of house price and interest rates, is about the best it's been for a very long time. The large amount of vacant and foreclosed properties is a major drag, particularly in some areas of the country. We need to work with the Treasury and with the banks to do what we can to get these resolved as quickly as possible, whether it's through renegotiation of the mortgage, whether it's through a short sale, or however it's done, get people situated and allow those houses to be turned over in the marketplace.

Deficit Spending

Q. As the head of the Fed and speaking of to this committee, speaking to the American people, in practical terms, if we don't get a plan, what does it mean to families across this country? What does it mean to the small business?

A. If confidence was lost in our long-term fiscal stability that we would see our interest rates go up quite a bit, as we are already seeing in Greece and in other countries. And that would affect, of course, the consumer's ability to buy houses and automobiles, et cetera. It would slow our economy. It would be reducing the value of government bonds put pressure on the balance sheets of financial institutions. So it would cause a lot of stress in the economy and in the worst case would cause financial instability like we're seeing in some extent in Greece. If you want a strong economy, you need to have capital investment; you need to have consumers' ability to buy houses and automobiles and so on. And the high interest rates that would make it even more difficult to balance the budget because interest payments are part of the deficit.

Q. By back-of-the-envelope calculation, gross debt in the U.S. to GDP is now 89 percent. I know debt held by public, I believe, is closer to 60 percent. Do you believe that the U.S. is at a tipping point with respect to its debt?

A. I don't think there's anything magic about 90 percent. However, I do think that if we were to go out as, say, the CBO's alternative scenario projects, then debt and interest payments are going to get explosive in 10 or 15 years. And so I think we are close to a situation where we need to be paying very close attention to our fiscal sustainability. Countries have different amounts of fiscal capacity, if you will. Countries like Greece, which are clearly being shut out from the market because of their debt and deficit ratios, need immediate and sharp changes in their position.

The United States, as I said in my remarks, is favored in that we are a safe haven currency, we are a large, diversified economy, and we have a long record of paying our debts, paying our interest. So we have a little more breathing space potentially, but I don't know exactly how much we have. We need a program for returning our trajectory of fiscal policy to a sustainable path.

Q. Do you believe that our economy is stable enough to enact immediate deficit reduction measures?

A. I think it's really a question of trajectory. A very sharp consolidation of fiscal policy this year would not be a good idea, I think, given the fragility of the recovery at this point. But maintaining a strong recovery and keeping interest rates low would be assisted by a commitment by Congress to bring the deficit to a sustainable level and the debt to a relatively flat level to GDP over the medium term.

Q. Can you describe the fiscal and economic consequences of doing nothing on entitlements and simply allowing Social Security and Medicare to run their course?

A. They're unfunded liabilities to a significant extent at this point. They are the biggest single component of spending going forward. Now, there are various ways to address this. You can restructure entitlement programs. You can cut other things. But at some point, you need to address the overall budgetary situation. If you don't, you'll get a picture like this one where interest rates are rising. Interest payments are rising because the debt outstanding is growing exponentially. And at that point, things will come apart.

A famous economist once said, "Anything that can't go on forever will eventually stop." And this will stop. But it might stop in a very unpleasant way in terms of sharp cuts, a financial crisis, high interest rates that--that stop growth, continued borrowing from abroad. So, clearly, we need to get control of this over the medium term. And we're certainly going to have to look at entitlements, because that's a very big part of the obligations of the federal government going forward.

Q. What, to you, is a good definition of medium to long term?

A. But right now, the various estimates of the CBO and the OMB under different scenarios show a structural deficit from, say, 2013 to 2020 of between 4 percent and 7 percent of GDP, which is not sustainable. So I would say medium term is three to five years out in the future. And, of course, the situation gets much more difficult beyond, say, 2020, when the entitlement spending becomes even greater.

Q. Is there an amount that the budget deficit you think we should be looking at--a percentage of GDP to which the deficit should be at?

A. One simple rule of thumb is that the primary deficit, which is the deficit excluding interest payments, should be about in balance. In practice that might be a 2 percent of GDP-type deficit. Keeping our debt relative to our income, constant or declining, would be a good indicator of sustainable policy. I don't think there's any way that the deficit for this next year is going to be brought down to 2 percent or 3 percent. As I've been emphasizing, this is really a medium-term objective. We still have some time, but we need to get a plan in place as soon as we can.

Economic Outlook

Q. Are you concerned about a double-dip--about the possibility of a relapse?

A. Forecasting is very difficult and I make no promises in any particular direction, but it appears to us that the recovery has made an important transition from being supported primarily by inventory dynamics and by fiscal policy, toward a recovery being led more by private final demand, including consumer spending. That is encouraging in terms of sustainability. And so our current most likely outlook is that the economy will continue to recover at a moderate pace. Of course, a double-dip never can be entirely ruled out, but right now our expectation is the economy will continue to grow at around a 3 percent to 4 percent pace this year.

Q. Three to 3.5 percent growth doesn't strike me as sufficient enough to get back to these kinds of lower unemployment levels that we've enjoyed in this country. What's your view on that?

A. As I said in my testimony, I do think that private final demand, including exports, but also consumer spending and investment, is taking the baton from fiscal policy and inventory accumulation to provide some source of growth. So, in that respect, as we all would like to see, the private sector is beginning to take over this recovery, but at the same time, there's not much evidence at this point that the recovery

will be robust enough, will be V-shaped enough, if you will, to get us back to historically normal levels of unemployment in a short period of time. So that is the downside and the disappointment with this recovery.

Q. What impact would higher taxes have on the growth that you're expecting to continue through the remainder of this year and into next year.

A. Well, the timing is critical. So we have a recovery under way now. So, in the very near term, increased taxes, cuts in spending that are too large would be a negative, would be a drag on the recovery. At the same time, we need to convince markets that in the medium and longer term we have a sustainable fiscal path. So the ideal strategy in my view is to provide soon a plan for balancing our budget or at least bringing deficits down over the medium and longer term. I'm not going to try to adjudicate for Congress, exactly how that should be done. But I would say that in the short term that you should, as you look at fiscal issues, you should take into account the recovery and the strength of the recovery.

Q. In your view, what would be the effect on the recovery if we pull back too soon and do not provide the kind of aid that states may need at a very critical moment?

A. Let me first say that in terms of any fiscal package, again I don't want to adjudicate specific parts of it, and Congress needs to provide which components they want to support and which ones they think will be most effective. But in terms of the timeframe, right now I don't think this very moment is not the time to radically reduce our spending or raise our taxes because the economy is still in a recovery mode and needs that support. However, the risk, of course, of ongoing deficits is the potential loss of confidence in the markets, and the way to reassure the markets is by creating a plausible plan for medium-term stability in the fiscal situation. We obviously can't run deficits of 10 percent of GDP forever.

Q. Do you believe the economy right now does not need further fiscal stimulus on the fiscal side?

A. I'll turn it back to you this way. If you decide to do more fiscal stimulus, and I know that there's some moderate-size bills being contemplated, it would be very helpful to combine that with a plan for the fiscal exit strategy. The Federal Reserve has a strategy for exiting from our monetary policy. The United States government--the fiscal authorities--have to have a strategy for exiting from your fiscal policy.

Q. At what point do we start to create the jobs in the private sector?

A. I think the private sector is starting to come back. We're starting to see growth from consumers, for example, and that will drive private sector job creation. We anticipate private sector job creation between 150,000 and 250,000 jobs, something like that going forward, not enough to get back all the jobs we lost, but still significant.

Q. You talk in your testimony that GDP is going to grow about 3.5 percent for 2010. That's a pleasant change from the 6 percent downturns that we were seeing at the end of 2008 and early 2009. You talk about a faster pace next year. What is that faster pace you're anticipating?

A. There's a lot of uncertainty, but we're looking at maybe 3.5 percent to 4 percent next year. There are three areas where private final demand is relatively strong. The consumer has been pretty strong, which is a very important component. It's a big component, obviously. Equipment and software investment by firms--not construction, but--but equipment and exports have been strong. Those are the main components. The others are relatively weak.

Q. Manufacturing output which has very well skyrocketed to 9 percent over the first four months. Is something like that sustainable?

A. Well, it's not sustainable indefinitely. But manufacturing has rebounded very quickly and was leading the economy out of the recession, and which often happens. But in part it's because manufacturing is trade intensive. And as the trade, global trade, has rebounded, manufacturing has taken advantage of that.

Q. What is your sense of appropriate policy with regard to assistance with states at this juncture?

A. Well, I'm going to disappoint you to some extent because, again, I don't want to tell Congress which specific programs to undertake. But to the extent that you decide to undertake short-term spending programs, whether it's to help the unemployed or to provide training or to help state and local governments or to provide infrastructure, it will be more effective and safer to do that on a twin-track basis where on the other track you're also thinking about the longer term.

Q. Let's go back to when we passed the stimulus. Was it useful or necessary to the economic recovery or could we have just gotten by without it?

A. I don't want to buy into the entire package and all the aspects of it. But I do believe that the fiscal policy was useful. It did help the economy recover and did help create jobs.

Q. Do you believe that were the Congress to pass free trade or expansion of free trade it would help the economy?

A. Yes, I do. I think we need to be part of the globalized economy. Trade is an important source of demand for our goods and also a source of materials and imports as well. So I think that generally speaking, we ought to push forward on the Doha round and on the free trade agreements that we're looking at.

European Debt Crisis

Q. In your opinion, is the ECB doing everything it needs to do to stem this crisis?

A. I'm encouraged by the response of the Europeans. Although they lack the central fiscal authority that the United States has, they have understood the importance of cooperation and they have put together some very substantial programs, including as you know a 500 billion euro stabilization mechanism that will stand behind countries on the periphery that need assistance in meeting their fiscal obligations, together with the IMF also providing substantial bilateral assistance.

The goals of those programs, and they are quite substantial, will be to make sure that these countries are able to meet their obligations and to achieve fiscal sustainability. I think the markets remain uncertain about whether these measures will be successful. That's why you're still seeing a lot of volatility in the markets. What I can assure you of is that the European leadership is fully committed to addressing this problem, preserving the euro zone and preserving the European Union and they are working, I think, very, very aggressively right now to try to establish some effective solution.

Monetary Policy

Q. Do you think that the steps taken in the financial crisis have been vindicated by events?

A. Yes, I do. We and other countries around the world took strenuous measures in the fall of 2008 to avert the collapse of the global financial system and to restore appropriate functioning to global financial markets. It took a while for that to work, but currently financial markets are in much better shape, obviously, than they were a year-and-a-half ago. Monetary and fiscal policy have been quite supportive, and this also added to growth. We see at this point a moderate recovery--it's not as fast as we would like, but certainly we have averted what I think would have been, absent those interventions, an

extraordinarily severe downturn, perhaps a great depression.

Q. With the countercyclical efforts we took, would monetary policy by itself have been sufficient?

A. I think that the fiscal policy, based on what we know about previous episodes of fiscal policy and the analysis we've been able to do, did increase growth and add job creation.

Q. Gold hit an all-time high yesterday, which I think most people would view as a vote of no confidence against currencies. I'm interested in what does that price signal tell you, and what is your view on the long-term repercussions with respect to weak currency policies?

A. Well, the signal that gold is sending is in some ways very different than what other asset prices are sending. For example, the spread between nominal and inflation-indexed bonds, the break-even, remains quite low, and suggests that markets expect about 2 percent inflation over the next 10 years. Other commodity prices have fallen recently quite severely, including oil prices and food prices.

So gold is out there doing something different than the rest of the commodity group. I don't fully understand the movements in the gold price, but I do think that there's a great deal of uncertainty and anxiety in financial markets right now and some people believe that holding gold will be a hedge against the fact that they view many other investments as being risky and hard to predict at this point.

Q. What leading indicators do you look at to inform your view on the future possibility of inflation? And how much do you put stock in those leading indicators?

A. Certainly, we look at resource utilization and price and wage pressure, which is very low right now. With the increases in productivity we're seeing, unit-labor costs are actually declining. So firms are finding that their labor costs are actually falling, rather than rising. Inflation expectations are very, very important and we take some comfort from that fact that as measured through a variety of mechanisms, they've been quite stable. And we look broadly at the economy, at commodity prices and a variety of other indicators to see what markets are anticipating. So it's a very eclectic process. Even though we have indeed expanded our balance sheet, as you know and understand, we can exit from those extraordinary policies as needed, when needed, without leaving any monetary or inflationary bias in the system. So we're comfortable that we have those tools.

TARP

Q. What do you believe would be the best estimate of the dollar cost to the taxpayers of TARP?

A. The direct cost for financial institutions, including AIG, at this point, not very large. Except for AIG, every other major institution has repaid with interest and dividends. And AIG, I believe, will repay. So, the financial institution part is really quite small and may, in the end, be in fact a profit. That doesn't include some of the other uses to which TARP was put, such as the automakers' support and the foreclosure program. Treasury has provided numbers on those. I think they have an overall cost of about \$110 billion for the program.

Q. Given your serious concerns about long-term structural deficits, critics might say that you're inconsistent in saying that you supported TARP and that the stimulus bill had positive effects. What would be your answer to those critics?

A. My answer is that deficits are sometimes necessary. They're necessary in wartime. They're necessary in deep recessions and this was a case where monetary policy was, you know, pushed very, very far. And I believe that the TARP--I realize it's very unpopular, but I do believe that it was very important in stabilizing our financial system. TARP in particular prevented a breakdown of the global financial

markets, the global financial system.

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