

4-23-2010

UA36I/29 Gary Ransdell - Fed. Reserve Board - Ben Bernanke, Joint Economic Committee

St. Louis Federal Reserve Board

Follow this and additional works at: http://digitalcommons.wku.edu/fac_staff_papers



Part of the [Corporate Finance Commons](#), [International Business Commons](#), and the [Taxation Commons](#)

Recommended Citation

St. Louis Federal Reserve Board, "UA36I/29 Gary Ransdell - Fed. Reserve Board - Ben Bernanke, Joint Economic Committee" (2010). *Faculty/Staff Personal Papers*. Paper 6.
http://digitalcommons.wku.edu/fac_staff_papers/6

This Other is brought to you for free and open access by TopSCHOLAR®. It has been accepted for inclusion in Faculty/Staff Personal Papers by an authorized administrator of TopSCHOLAR®. For more information, please contact topscholar@wku.edu.

From: Mary.H.Karr@stls.frb.org [<mailto:Mary.H.Karr@stls.frb.org>]

Sent: Friday, April 23, 2010 1:49 PM

Subject: FedDigest April 23, 2010: Selected Q&A from Chairman Bernanke's April 14, 2010 Appearance before the Joint Economic Committee

Before the Joint Economic Committee, U.S. Congress

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

Bank Lending

Q. What can we do to get small business moving?

A. Small businesses do create a lot of jobs, particularly in economic recoveries, and to the extent that they can't get credit, that's going to slow or prevent their expansion. That's very important, and so that's a top priority for the Federal Reserve. The issues really are complicated. There are some firms that got easy credit earlier, and now they can't qualify for tougher credit terms. There are some firms that are not demanding credit, frankly. If you look at the surveys, their number-one problem is lack of demand. The surveys also suggest that some firms are able to get credit.

That being said, if one creditworthy small business can't get credit, that's too many. We want to fix that. We've approached this from a long list of policy actions, including strengthening the banking system, and including our interest rate policies. In our supervisory role we have issued very strong guidance to banks and to examiners, and very explicitly to examiners, that small businesses are to be evaluated based on their ability to pay, not based on their industry, not based on their geography, and that we encourage, for example, second-round reviews if the first one doesn't pass. We are very explicit that decline in the value of the collateral--of the home or the store--is not in itself a reason to mark down or deny the loan.

We have been working very hard to get feedback. One of the problems we get, frankly, is that bankers tell their congressmen, "You know, we're having a problem," but they won't tell us for one reason or another, and we're trying to make sure we get as much feedback as possible. So we've been having meetings around the country at all the Reserve Banks with bankers, with small businesses, with community activists to try to understand, what are the barriers? What can we specifically do?

In terms of what Congress can do, there are some proposals. The administration has a proposal to use some leftover TARP funds to essentially incentivize small banks, because small banks are more likely to be lenders to small businesses. They know them better, and they have longer-term relationships. We have been doing a lot to increase our data about those loans. It would take another lengthy discussion to talk about the pros and cons, but there may be different ways to incentivize or support either through the SBA or directly through small banks.

Q. What do you think are steps we could take in the next six months to the next year that would have a positive impact on the jobs climate as it relates to small business?

A. I think part of this is a cooperation between the banks and the examiners working together, understanding each other, to make sure that every loan is evaluated on its own two feet, so to speak. You could very well have a situation where the value of a property has gone down, but the company has a stable business and has been able to repay for many years, in which case, you know, we have provided guidance to our examiners and training, and asking for feedback, in which case that loan should be made. Or at least it should be given a very careful assessment.

We are, of course, and safety and soundness examiners so we're obviously very concerned about making sure that banks are taking undue risks. But on the other hand, as the central bank of the United States we're also very concerned about the overall health of our financial system and our economy. Therefore, perhaps more than others, we are really focused on getting that balance right. We really want to make sure that good loans do get made that are very much in everyone's interest.

Q. Some financial institutions were highly leveraged, 60 percent, 35 percent. Do you believe that leverage should be limited?

A. In the United States as a first line of defense we have a risk-weighted capital ratio, which is not a straight leverage ratio. We have to hold more capital against riskier assets--which makes sense. The riskier the asset, the more capital you want to hold. The Federal Reserve and the other bank regulators are working very actively with other regulators around the world to strengthen the capital requirements (and) it's our intention to move forward with more conservative, higher capital requirements.

The leverage ratio is a backstop because it's a very simple ratio...one of the interesting things that appears to be coming out of the international negotiations is that the U.S. leverage ratio, which never was used abroad, now looks like it will be adopted by other countries, which is good for us, because it will create a more even playing field and create greater safety in the global banking system. I can't tell you offhand what the final number will be, but we are certainly looking to make the leverage ratio part of the more conservative approach to making sure that banks have enough capital.

Economy and Budget

Q. Could you talk about the importance of getting something done on the debt in the long term?

A. It has direct implications for the health of our economy, and maybe not just in the long run. If we have higher interest rates, that's going to reduce investment. That's going to reduce capital information, growth and job creation. It's going to mean we have to borrow more from abroad, which also means a heavier burden on our children to pay back...It doesn't mean we have to balance the budget tomorrow, but it does mean we have to have a plan and a credible process in the medium term to show that we can manage these difficult problems. And they are very, very difficult. You have all my sympathy, because they're extremely hard politically and intellectually to solve.

Q. At what point in time does the global financial community say the United States is not being serious enough (and) it starts raising the cost of capital into the United States?

A. That's inherently very hard to know. At some point the markets will make a judgment about...our political will to achieve longer-term sustainability. And at that point interest rates could go up.

Q. The first-time homebuyer tax credit is due to expire April 30th. And the FHA has recently tightened its restrictions on loan eligibility. These caused a positive effect on the housing market, but now those effects are being eliminated. Is this going to be a problem?

A. Unfortunately, all the efforts--including the low mortgage rates--have not really rejuvenated new construction very much, so that remains a concern. One other important aspect here is foreclosure mitigation. One of the most important aspects of the housing market is not even just the amount of construction, but what happens to house prices, because if house prices stabilize, that will help consumer confidence. One concern we have is that foreclosures will continue to put houses on the market and cause house prices to fall further. So we're watching that very carefully, and we're hopeful that some of the programs that the government has put in place will help mitigate that foreclosure rate.

Q. What happens if the unemployment rate does not decline as the economy improves?

A. Well, that's a possible risk. We anticipate the unemployment rate is likely to decline relatively slowly, and there are a couple of factors that will affect that. One is the pace of overall growth. Obviously, if growth is only moderate, that will not quickly lower the unemployment rate. That's the first observation. Second observation has to do with the rate of productivity. Following the 2001 recession, productivity gains were quite significant, which is a good thing generally, but meant that firms were relatively slow in bringing workers that, because they didn't need to. They had productivity gains in order to meet demand. We've seen remarkable productivity gains in the last year or so in the U.S. economy. We don't anticipate productivity growth will continue at that rate going forward, but if it does, then that may reduce the number of workers that firms need to bring back in order to meet demand.

I wouldn't consider it the leading possibility, but there is a possibility that unemployment will stay stubbornly high, around 10 percent. And if that were to happen, that would be one of the risks that we were just discussing, because that would reduce consumer confidence and make them concerned about their ability to sustain their spending.

Q. Is the price of oil important now in the global economy?

A. Every dollar that the price of oil goes up is another dollar out of pockets of consumers, and that makes it harder for them to spend on other things, and it also adds to inflation, so it's definitely a negative. We're at \$85 a barrel right now. The forward curve is pretty flat. The markets don't expect large increases in the future, but we don't know. We'll have to watch it very carefully. It depends a lot on global economic activity, which has been stronger, generally speaking, than in the U.S. and Europe. Of course, we're still a long way from \$145, which is where we were a couple summers ago. I don't think at this point that the price of oil is a serious threat to the recovery, but, you know, clearly, if it moved a lot, it would be a negative.

Q. Do you agree that China's currency policies contribute to harmful global imbalances and was one of the causes of the worldwide recession?

A. Yes, I broadly agree with that. Most economists agree that their currency is undervalued and has been used to promote a more export-oriented economy. I think it would be good for the Chinese to allow more flexibility in their exchange rate. It will give them more autonomy in their monetary policy so they could address inflation and bubbles within their own economy. It would be in their interests, also, to combine a more flexible exchange rate with other efforts to increase domestic demand, domestic consumption, and achieve a more balanced economy. So I don't think the exchange rate is the only factor, but it is a contributing factor.

Q. If it's in China's interest to do it, why don't they do it?

A. Because, like us, they have a variety of political considerations and concerns. They are being conservative, first of all, because they're concerned about the effect of any large changes given what they still perceive as the fragile state of the global economy.

Q. Are you in favor of an increase in IMF funding?

A. One of the agreements that the G-20 leaders came up with was to put more money into the IMF as a way of addressing the financial crisis around the world... I think in general that having the IMF available to try to avoid crises is a good idea.

Q. Are you satisfied with the solution Europe has reached? Do you see the problems plaguing Greece spilling over into other adjacent countries or possibly having an impact on the United States?

A. Well, it's a work in progress. It's politically difficult, because on the one hand, the Europeans don't want to assist Greece unless they're persuaded that the Greeks have made a very good-faith effort on their own to reduce their deficit and improve their own fiscal position. At the same time, the Europeans themselves have to agree, how they're going to share burdens and how they're going to set up the arrangements. I think there's a broad understanding that it's very important for them to come to a solution, and they've made a good bit of progress there, but I think there will still be further discussions going forward.

Exit Strategy and Monetary Policy

Q. Does the Fed still plan on, quote, "maintaining exceptionally low levels of the federal funds rate for an extended period of time?"

A. The Federal Open Market Committee has stated clearly that they currently anticipate that extremely low rates will be needed for an extended period. They have emphasized, however, three sets of conditions: one, very low resource utilization, high unemployment, low capacity utilization; second, subdued inflation trends, low inflation; and third, stable inflation expectations. If those conditions cease to hold and we anticipate changes in the outlook, then, of course, we will respond to that.

Q. Are there any other particular measures that the Fed will be using to determine when to raise the federal funds rate?

A. We'll certainly be looking at a broad range of economic indicators to try to assess where the economy is going... we'll continue to look at inflation and look at inflation expectations. We will also look at what's happening in financial markets...we want to be sure that financial imbalances are not building...We are not seeing obvious imbalances at this point, but...recent experience suggests that we need to be very cautious about that.

Q. Will you resist the pressure to monetize the debt, as rising borrowing costs intensify our federal budget problems?

A. Absolutely, we will. Our holdings of Treasury securities today are about the same as they were before the crisis. We have not monetized the debt, and we will not. And we will, of course, continue to make sure that price stability is central to our objectives. There really is no alternative but to try to find real solutions. Inflation is just not an answer.

Q. Professor Laurence Ball advocated raising the Fed's inflation target to 4 percent. His argument was that higher inflation would alleviate unemployment and give the Federal Reserve more room to reduce nominal interest rates in the future, sort of that tradeoff, again, inflation, unemployment. How do you respond?

A. His argument is that, at a higher inflation rate, then nominal interest rates would also be higher on average, and that would give more space to cut during a recession, and perhaps more ability to create impetus. That's not an illogical argument, but it has substantial risks. The Federal Reserve, over a long period of time, has established a great deal of credibility in terms of keeping inflation low, around 2 percent, roughly speaking. You can see that, for example, in inflation index Treasury debt, that people expect over the next 10 years about 2.2 percent inflation on average over that 10-year period.

If we were to go to 4 percent and say we're going 4 percent, we would risk losing a lot of that hard-won credibility, because folks would say, well, if we go to 4 percent, why not go to 6 percent? It'd be very difficult to tie down expectations at 4 percent. In the longer term, low inflation is good for the economy, and 4 percent is already getting up there a bit and would probably have detrimental effects on the

functioning of our markets and so on. So I understand the argument, but that's not a direction that we're interested in pursuing. We're going to keep our inflation objectives about where they are. We think about 2 percent is about appropriate, given biases and measurement of inflation, and given the need to have a little bit of space between the average inflation rate and the risk of having deflation or falling prices.

Q. One of the areas of uncertainty is the extraordinary balance sheet expansion of the Fed. Are you prepared to lay out a definitive road map to normalization?

A. Yes, to the extent that we've determined all of the details. We're obviously going to see how things evolve. I have recently testified before the House Financial Services Committee and also released separately a document which has laid out our proposed exit strategy. This has been an ongoing campaign on my part and on the Fed's part going back to last summer when I'd published a Wall Street Journal op-ed that laid out the strategy.

Early on, there was a lot of concern in the markets about this large balance sheet and the large amount of reserves in the banking system. Over time we have provided a lot of information about our exit strategy. And my sense is that it's had a good effect, that for the most part, there's a lot of confidence in the financial markets that we do know how to exit effectively and we will exit effectively and that we'll do so in a way that doesn't lead to any increase in inflation. One piece of evidence is the long-term breakevens in the inflation-indexed bond market.

I don't think we can give quantitative rules at this moment because I don't think we have enough knowledge, but we do know that we have all the tools we need to drain those reserves, and to reduce the balance sheet over time, and to raise interest rates when it becomes necessary to do so to avoid inflation.

Q. In March, the Federal Reserve stopped purchasing mortgage-backed securities, which had kept interest rates low and helped to stabilize the housing market. Can you give us the justification for that?

A. We have already expanded our balance sheet quite considerably, and we didn't want to create such a large balance sheet that it would create uncertainty or concern about our ability to normalize policy at an appropriate time. We were concerned about the potential impact of the cessation of MBS purchases on mortgage interest rates. For that reason, we announced well in advance our proposal, and we reduced our purchases very gradually. We tapered off our purchases. I'm pleased to say that so far we see very little effect on mortgage rates. They've been essentially no effect on mortgage-backed security yields. At this point, I don't anticipate any significant impact on mortgage rates. I think the net change since we stopped purchasing is pretty close to zero.

If the economy weakens and the issue is housing and mortgage rates, there's nothing that says we couldn't resume those purchases if necessary, and we'll certainly keep that option open. At this point we are still holding \$1.4 trillion in agency MBS and debt, and that amount being taken off the market seems to be having the ongoing effect of keeping mortgage rates pretty low.

Q. In your opinion what is the primary source of risk to the recovery at this time? And what is your assessment of the risk of a double-dip recession?

A. I was always fairly humble about forecasting. In the last few years I've become extremely humble about forecasting, so I have to be very cautious. But having said that, I think there's a pretty broad view that we're seeing some building momentum in final demand. Consumer spending looks to be picking up. At least equipment and software investment looks healthy. The broader global economy is stronger, which implies more exports. So it looks like we're on a path to moderate recovery and that the risk of a

double-dip, while certainly not negligible, is certainly less than it was a few months ago.

That being said, there are any number of possible things that could derail it. If, for whatever reason, consumers under the pressure of a weak labor market and tough balance sheets, decided to become more conservative and slow their spending, a financial problem emanating, from unknown source that could cause more problems in the financial markets. There are all kinds of scenarios you could imagine--oil prices being driven up by a geopolitical problem. One thing we do in our Federal Open Market Committee meetings is look at alternative stimulations and alternative scenarios that look at alternative possibilities that could occur.

As I said at the beginning, it looks like the financial markets are more stable. Banks are still working their way out of a period of high losses and financial stress, but they are making progress. The consumer looks to be doing better. So for all those reasons, I think the best bet is that we'll see a moderate recovery.

Q. When does the Federal Reserve plan to close TALF? Are there any additional actions that can be taken by Congress or others to protect against the crisis in commercial real estate?

A. The only remaining facility is in fact the TALF for commercial real estate, and we left it in longer because of the extra needs there and because it takes longer to bring the commercial mortgage-backed security deals to market. We're planning to close that on June 30th, because we're only making those loans on an emergency basis, and we do have to justify having this emergency program. And we have in fact seen improvements in the commercial mortgage-backed security market, so our current plan is to close that at the end of June.

On commercial real estate, that is for many banks, particularly small and medium-sized banks, it is a very big challenge. And we're seeing a few glimmers of improvement, but it's still going to be perhaps a few more quarters before banks have worked through their commercial real estate book and have gotten to the point where they have complete control and understanding of their losses and risks in that area. In our capacity as bank supervisor, the Fed has, along with the other supervisors, issued new guidance on commercial real estate. Among other things we want to encourage workouts the same way that government policy has been to help residential mortgages, to help residential borrowers work out troubled mortgages. We'd like to see the same thing happen for commercial real estate mortgages. And in fact we believe that's happening in many cases, and we want to promote that. And we--again, we've instructed our examiners to work with banks to try to work out problem loans and in general to maintain the flow of credit wherever possible.

So it's a difficult problem, and it's not just a financing issue. It's fundamentals. Prices of commercial real estate have fallen by 40 percent in many places vacancy rates are up. Rents are down. And so it's understandable that there are going to be stresses in this market, so we're going to continue to work with banks to try to help work through that.

Financial Reform

Q. Do you have views on the stand-alone consumer agency being placed within the Fed?

A. I'd like to understand better how it would work. My current understanding is that the agency would...not be reporting to the board or to the chairman. It would essentially be freestanding, so that means that being within the Fed is a vague idea at this point. It is true that the current proposal would involve the Federal Reserve financing this agency. That, of course, doesn't make it any less costly to the taxpayer. It just means that there would be less revenue remitted from the Federal Reserve to the Treasury.

Q. The new consumer bureau proposed in the Senate financial reform bill will only have enforcement power over large non-banks, and that power will have to be exercised through a rule-making process. Payday lenders, rent to own, debt collectors, these are some of the most rapacious people. Do you agree they should be regulated?

A. I think they should be regulated. I think there should be an even playing field, if you wish, between, say, banks and non-banks, in terms of the rules that they face. The only complexity is that, of course, there are many states involved in regulating. Some do a better job than others, and I think working with the states would be an important part of trying to do this effectively.

Q. Do you have any concerns about making the president of the Federal Reserve Bank of New York a presidential appointee?

A. I don't think that's the right way to go. I think we want to maintain accountability through the Board of Governors, which then oversees the system, and that is really the appropriate way for us to be accountable to the Congress, which we will be. We want to be completely open, transparent to the Congress on all financial matters, but we do need to maintain our independence.

Q. Do you feel like some of the proposed changes could weaken the regional Reserve Banks and undermine the independence of the Fed in dealing with monetary policy?

A. Our FOMC structure, which was created in the late '30s, has worked pretty well. It's got a good combination of Presidentially appointed Senate-confirmed governors here in Washington and Reserve Bank presidents around the country. I think we get both the Washington perspective and the Washington accountability, but we also get very important information and input from around the country. One of the sources of that information is our oversight of state member banks, which are very well informed about their local economies and, therefore, a very important source of information for us. It is a concern that we have that we would lose that oversight.

Q. What do you expect will come out of the study with regard to the inclusion of the Volcker rule in the reform legislation?

A. We all agree that we don't want to have banks or investment banks taking speculative positions with the U.S. safety net behind them, so clearly we have to draw that line. I think inevitably what the study will find is that drawing a sharp line is not easy. There are various activities such as hedging other positions or making markets that involve temporary proprietary holdings, so it may not be easy to say this is proprietary, this is not. We would need to have a set of rules or criteria that help us distinguish which is applicable under the Volcker rule and which is not. I think that's going to be the big challenge.

Q. Back in 1933 when Glass-Steagall was put into place, it was effective in the context of the Great Depression. Should we go back to the separation of commercial and investment banking?

A. I don't think Glass-Steagall by itself would solve our problems because we had commercial banks losing money on regular loans, and we had investment banks losing money on speculative securities trades. I think we do need to take important steps. They would include, for example, stronger capital requirements to make sure that the institutions who are taking risks are bearing those risks themselves. It would include making sure that every large financial firm has a strong consolidated supervisor so we don't have the gaps that we had. I think it's also very important to have this resolution regime that allows us to wind up a failing firm, which means basically that the creditors and the shareholders would bear the costs.

Q. I'd like to hear your perceptions of proposals to take the community banks out from under the Federal Reserve and to change the Federal Reserve Banks' responsibilities.

A. We're very concerned. We need to play a role with the large institutions as part of a process of trying to keep our financial system stable but it would be a very bad outcome if we were to lose all connection with the small and medium-sized banks. First of all, that provides us a great deal of useful information about what's happening out there in the country, about small business loans, about credit, about the local economy. It gives us a perspective on the whole financial system, on the whole economy. We don't want to just be looking at Wall Street.

We need to look at the whole economy, and not only for monetary policy purposes, but also for financial stability purposes. Small banks, medium-sized banks can be part of a financial crisis, too, as they were, for example, during the thrift crisis or during the Great Depression, or Penn Square in 1982. So, both because we want to have that connection with the rest of the economy, and because both monetary policy and financial stability require we have a broad view of the entire banking system, we think it's very important that we maintain that connection. The regional Federal Reserves are, in fact, our ears to the ground. They're where the actual supervisors reside. And they do the operational work, and they have those local connections. We rely very heavily on those eyes and ears around the country.

Q. Two proposals have been floated to increase banking taxes. Your views on those taxes?

A. The tax on transactions, the Treasury has rejected that idea, I agree with the Treasury's judgment on that. The problem is that by taxing transactions, you would greatly reduce liquidity in markets, and people who are just ordinary investors transacting in those markets would find the bid-ask spreads had gotten much wider and much more costly for them to buy and sell assets and to hedge their portfolios and so on. What would probably happen is that so long as there was any jurisdiction in the world that didn't have those transaction taxes, everything would go offshore. In the current world, I don't think that's a very good way to raise revenue.

The fee on financial institutions--it is basically a tax, and as such it's up to Congress to decide whether it wants to raise revenue through taxing large financial institutions. I think the only observation I would make there is that if you do do it, it should be structured in a way that doesn't create unnecessary problems. So, for example, one of the original ideas was to tax based on leverage, but some further investigation and discussion sort of revealed that that would cause very severe problems in the repo market that would essentially disrupt some very important market, because it would create essentially a tax on certain kinds of transactions.

Q. Is there merit in Congress specifically addressing the issue of banks being able to put aside more reserves during good times?

A. I don't know whether it's best handled by Congress or by the regulators, but the basic idea I certainly agree with, which is that a lot of the reserves policy was governed by the desire to avoid income smoothing and those kinds of things. As a result, the main purpose of reserves, which is to protect against losses, was lost. And there was not enough reserving done in advance of the crisis. So I'm very much in favor, and I think the world is coming around to the view that banks should be allowed to reserve not only for known losses, but for, you know, yet unknown but nevertheless predictable losses that they will face in the future.

Q. In February, you testified that the Fed was going to look into regarding credit default swaps on sovereign debt. And can you tell us what you found?

A. We looked at the Goldman Sachs arrangement with Greece. In 2000 and 2001, there was a contract between the Greek government and Goldman Sachs, which, by using exchange rates that were different from the market rates, had the effect of modestly changing the reported debt and deficit ratios that Greece reported to Eurostat, their statistical agency. Goldman Sachs sold this position in 2005 to a Greek bank.

The effects, even though they did have the effect of distorting the numbers, were relatively modest, about 1 percentage point. The debt-to-GDP ratio changed from about 101 percent to 100 percent, so it wasn't a large effect. This happened well before the Federal Reserve was supervising Goldman Sachs, and it was also before the Enron episode, following which the Fed and other bank supervisors greatly strengthened our rules against arrangements which are basically intended to affect the accounting valuations. We have discussed the issue with Goldman, and, as they are required to do, they have a much more elaborate procedure now to evaluate such possible deals to make sure that they are not being motivated by accounting and other kinds of appearance issues. So we believe that that situation is now well under control. And as I said, they divested that position in 2005.

On credit default swaps, we haven't found large positions in U.S. banks vis-a-vis European governments. We have not addressed the question of using CDS to manipulate prices, which, of course, would be illegal and inappropriate. That would be more an SEC responsibility, and I know they're looking at that issue. But, again, exposures of U.S. banks to European governments is relatively limited.

This material is intended for authorized users only. No unauthorized distribution.