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St. Louis Federal Reserve Board

Bernanke Q&A, House Financial Services Monetary Policy Hearing, 7/22/10

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Monetary Policy

Q. What has the Fed done to address high unemployment?
A. To address the unemployment issue, the Federal Reserve has been extremely aggressive. We have brought our interest rate down close to zero. We have committed to an extended period. We have taken extraordinary actions to stabilize financial markets. And we have purchased $1.5 trillion of securities. And that has indeed eased financial conditions quite considerably. Mortgage rates are about 4.5 percent. Corporate bond rates are very low, et cetera, Treasury yields and so on.

Q. Can you explain what the Fed is doing to create jobs and lower unemployment?
A. Well, first, Congressman, I absolutely agree that unemployment is the most important problem we have right now. And we take the dual mandate extremely seriously…We have pushed monetary stimulation to the highest point in American history. We have zero interest rates. We have tripled our balance sheet. We have taken very strong steps.

What the Federal Reserve can do is to try to make financial conditions more conducive to growth and investment. So Americans, for example, are seeing 4.5 mortgage rates instead of 6.5 percent. We've helped other interest rates go down. We've supported growth in that respect. And those are the things that monetary policy can do.

Q. **What additional tools does the Fed have to reduce unemployment and avoid a double dip recession?**
A. As I said in my remarks, "We remain prepared to take further policy actions as needed to foster a return to full utilization of our nation's productive potential in the context of price stability." We are ready and we will act if the economy does not continue to improve, if we don't see the kind of improvements in the labor market that we are hoping for and expecting.

Now, what can we do…We would have to step into new areas. I do believe that there are things we could do and we are considering all options. Those include our communicating to the public our intentions about future policy action, perhaps in a context of some conditionality or framework that will help clarify our willingness to maintain policy support for the economy.

We can lower the interest rate we pay on excess reserves, which is currently only a quarter of a percent, but does have a bit of scope to be lowered. And we can do things to expand our balance sheet further, for example, to buy additional securities.

The effectiveness of these actions will depend in part on financial conditions. If financial conditions become more stressed, as would happen presumably if the economy began to weaken, I think those steps would be more effective relatively speaking so we're clearly going to continue looking at those...

Q. You gave three options for additional monetary stimulus. How would you rank those three options?
A. It's difficult to do that because it depends a lot on the details. So, for example, the balance sheet options could involve something like just not letting the mortgage-backed securities run off anymore versus actually buying new securities. Those different options involve many specific choices.

Q. Reducing interest payments on reserves seems like an outstanding option to use now. First, it certainly has a stimulative effect in the short run. It provides incentives to banks to lend, as opposed to keep those reserves at the Fed. I think it also helps us deal with our medium and long-term deficit issues: more money would go back to the treasury for deficit reduction. Why is the Federal Reserve not acting to reduce interest on these excess reserves to zero right now?
A. Let me first point out for everyone that we are paying one-fourth of 1 percent. So it's obviously a very, very low rate of interest. The rationale for not going all the way to zero has been that we want the short-term money markets, like the federal funds market, to continue to function in a reasonable way because if rates go to zero there will be no incentive for buying and selling federal funds, overnight money, in the banking system. And if that market shuts down, if people don't operate in that market, it'll be more difficult to manage short-term interest rates when the Federal Reserve begins to tighten policy at some point in the future. So there's really a technical reason having to do with market function that has motivated the 25-basis-point interest on reserves.

That being said, it would have a bit of effect on monetary policy conditions, we're certainly considering that as one option.

Q. At what point in time do we say maybe the marketplace just has to work itself through this and that the Fed and the federal government need to just kind of be still for a while and let normal market forces come into play?
A. Well, speaking for the Fed, we're not interfering with market forces, we're just trying to

provide some support through accommodative financial conditions to give the private sector the opportunity to invest and grow. And that's, of course, where the growth is going to come from.

More generally, certainly, the Fed, the Treasury, the Congress, everyone should try to focus on growth-oriented policies. It's important to take steps, including control the fiscal deficit, that will support longer-term growth, which will increase confidence in the present, and to do what we can to reduce uncertainty about policies and about the economy.

So, for example, the Federal Reserve is engaged in negotiating new capital standards for our banking system, and I think it's very important for us to get clarity on that as soon as possible so the banks can plan and feel free and comfortable going back to lending.

So I agree on trying to reduce uncertainty is a useful thing.

Managing the Fed's Securities Portfolio

Q. What is the weighted average maturity of your security portfolio?
A. The treasuries are about seven years weighted average maturity, and the agencies. I'm not precisely sure, but I think it's around four years.

Q. Does that mean that unless you make a decision to do otherwise, within four years, the agency securities will have rolled off the books?
A. Not entirely because it's distributed over a range. Some is shorter; some is longer. But there would be substantial reductions over the next four or five years, even if we don't sell anything.

Q. What would be the effect of the Federal Reserve not replacing the treasuries that are rolling off the books?
A. It would probably have a modest effect, in terms of increasing the yields on treasuries. As we discussed, we believe that the economy continues to need monetary policy support. And this is one measure that we have to keep rates low and to provide support for the recovery. In addition, the amount of treasuries that we currently hold is more or less identical to what we held before the crisis. And so there's no real need, in terms of the long-term normalization of our portfolio, to reduce that significantly.

Economy

Q. What effect has the European financial crisis that began with the Greek debt crisis had on the U.S. economy?
A. It certainly did have some negative effects. The increased financial concerns led to declines in the stock market, and increased credit spreads, and was one of the reasons why we marked down our outlook for the U.S. economy.

I think that that situation is improving. Confidence has been coming back in part because of the Federal Reserve support for the dollar funding markets. There have been a few other things we've seen in the data such as the weakness in the housing market after the end of the tax credit, for example. And of course the labor market has been disappointing in the last couple of months.

But again, our baseline scenario is that as the effects of the European financial crisis pass, we will continue to see moderate growth in the economy.

Q. Is there any good news about the macro-economy?
A. Certainly there's a lot to be concerned about, including a very high rate of unemployment, but there are some positive signs. Clearly, we've made a huge amount of progress since the depth of the financial crisis in terms of stabilizing financial markets and getting the banking system back on its feet, which in turn is helping the economy recover.

We had a very sharp recession at the end of '08 and beginning of '09. Since the middle of last year, the economy has been growing and the Federal Reserve expects a moderate recovery to go forward with declining unemployment. Inflation is very low. Productivity gains are very strong. Profits are up… So there certainly are some positive steps, and our recovery, though it's not nearly so strong as we would like, is still stronger than many other industrial countries around the world.

That being said, we can hardly be satisfied when the unemployment rate is over 9 percent and I think that's the main source of the concern.

Q. Is it possible that we are in "irrational pessimism"? That continuing to trash the economy, or downplay the fact that we are in some modest recovery, is even a self-fulfilling prophecy ?
A. Well, there's a bit of that. The consumer sentiment numbers are derived in part from questions asking people, "Have you seen news about the economy on television." And they say, "Yes, bad news I've seen in the media." And that in turn is used to interpret consumer buying decisions and the like.

So yes, I think there is some self-fulfilling prophecy elements to business cycles in general. But clearly, the best way to overcome that is to get the fundamentals strong and then people will begin to see improvements and their views will improve as well.

Q. To what degree do you think that nonfinancial firms are hoarding cash, because they see that skyrocketing federal debt out there and have this expectation of future tax increases?
A. Well, we certainly hear a lot from firms and are gathering anecdotes and so on that uncertainty in general is a constraint on their activities and their expansion. They cite the fiscal deficit. They also cite policy uncertainty. They also cite economic uncertainty because we don't know, you know, exactly where the economy is going to be. It's very hard, frankly, to know how big the effects are.

Q. Do you believe that uncertainty is a significant impediment to job growth today?
A. This is going to sound like a dodge, but I can't really quantify it. If you look the facts, it's mixed. What you see, first of all, as noted, that firms are holding a lot of cash. That's true. It's also true they're not hiring very much. On the other hand, their investment in equipment and software has been pretty robust.

So there are some mixed signals there I'm sure there's some effect there, and I think it's important. We don't need to measure the effects to take the lesson that whatever we can do to reduce uncertainty we should do....

Fiscal Situation

Q. What do you think about federal budget deficits in the short run, in the medium term, and in the long run?
A. I think that the deficits that we have for 2010, for example, were necessary and reflected the need to support the economy and support the financial system in this crisis. It's not even feasible, I think, to really rein in the current deficit and I wouldn't recommend it.

But I think (with regard to) the medium term, anything we can do to show the public, the corporations and the markets that we are serious about bringing our unsustainable debt trajectory under control, I believe would be positive and would contribute to confidence and would be helpful conceivably even in the short run.

…In the medium term, say from 2013 to 2020, the deficit-to-GDP ratio is, depending on whose estimate you look at, is between 4 and 7 percent, that's too high. We need to get it down to 2 to 3 percent. And that's in fact what the commission has been charged with.

In the longer term, I think inevitably we're going to have to look at entitlements, because there are some large unfunded liabilities there, and we need to find ways to continue to provide the services and meet the promises we've made to (inaudible), but to find ways to do it without breaking the bank, so to speak.

So there's really three time periods to look at, but the specific choices, obviously, are up to Congress, and you have to look at a lot of criteria to do that.

Q. Is the current budget path unsustainable?
A. That is correct.

Q. Are you urging the Congress to come up with a credible, immediate plan for a sustainable fiscal exit?
A. I think it's very important to try to demonstrate that we are committed to a medium-term consolidation and stabilization of our fiscal situation.

Q. Do you believe the task would become increasingly difficult if we postpone it, because the cuts we need to make will be even sharper and the tax increases will be even greater?
A. That's right.

Q. Do you agree that we've only got a couple of years in order to turn our federal budget debt and deficit situation around?
A. I don't think anybody has any objective basis for saying how long we have. I think the question is, what signal are we sending to the markets in particular if the markets become convinced tomorrow that the United States doesn't have the political will or ability to address these problems at some point? And that could be the tipping point.

Alternatively, if we're making steady progress and showing that we're committed to it, then we could have quite a bit of time. But it is important to begin to address these things soon because, for no other reason, to give people adequate warning if you're going to make any changes in programs.

Q. Does the fiscal policy of this Congress or Congress, period, impact your assessment of economic growth going forward?
A. ...uncertainty issues are real. There are a number of sources of those including both economic, political and other sources. The long-term fiscal stability I think does have very significant consequences. It depends a lot on how bond market investors anticipate what the

Congress will eventually do.

Right now, apparently there's pretty good confidence in the U.S. government in the sense that yields are pretty low. It's possible, though, that at some point in the future, could be soon, that there will be a loss of confidence in the will and ability of Congress to manage its medium-term fiscal deficits, in which case you could see yields going up, which would be a negative for recovery and growth.

And so clearly, at some point there will be a cost to growth from excessive deficits, whether it's near term or long term it's hard to tell, but it's an issue that needs to be addressed.

Fiscal Policy--Taxes

Q. According to Christine Romer, the President's chief economic adviser, tax cuts have large and persistent positive output effects. Do you agree?
A. I would agree with the general proposition that tax cuts have short-term aggregate demand effects, and they can be beneficial to growth if they're well- structured in the longer term.

Q. Should the tax cuts that are due to expire at the end of this year be continued?
A. There are a number of different issues there. There are, first of all, considerations of efficiency and growth…But there are also issues of both short-term stimulus and long- term stability. In the short term, I would believe that we ought to maintain a reasonable degree of fiscal support, stimulus for the economy. There are many ways to do that. This is one way. There are other ways as well. In the longer term, I think we need to be taking steps to reassure the American people and the markets that our fiscal situation is going to be well-controlled. Now that means that if you extend the tax cuts, you need to find other ways to offset them. To get the deficit down, you have to have either more revenues, less spending, or both.

Q. Is uncertainty in the business world about what Congress is going to do with corporate tax rates, with individual rates as it relates to small business and subchapter S corporations a challenge for job creation?
A. Uncertainty is a negative for investment and job creation. I frankly don't know how big the effect is, but the lesson we take from that is that it's important to try to achieve clarity as quickly as you can.

Q. Would it not be helpful to have Congress provide some certainty of communication to the American people and to the economic system about tax rates for small business? A. It's difficult to provide perfect certainty certainly, but anything that can be done to create more clarity about policy goals, objectives and plans is certainly going to be helpful.

Q. Should Congress increase taxes?
A. Well, again, the broader issue is that we should maintain our stimulus in the short term and we need to take steps to improve our fiscal situation in the longer term. There are many ways to do that. I am reluctant to take positions on specific tax and spending measures. But my broad view is that we need to think both about the short term and the long term, about both stimulus and growth, and that all of these measures have implications for each of them.

Fiscal Policy--Spending

Q. Should Congress cut spending?
A. I think all options need to be on the table. We need to look at all the programs for their merits, both in terms of their short-term stimulative effects and also in terms of how well they would support growth in the long term.

Q. Could you give us the top maybe three recommendations to how we can cut spending?
A. I really can't pick specific programs or tax programs to recommend. As you know, there's a commission which is supposed to report later this year. I know they're working hard to come up with some suggestions.

Effects of Fiscal Stimulus

Q. How many permanent jobs did the Obama stimulus package create?
A. It’s intrinsically very difficult to get an exact count. Because we don't know what would have happened in the absence of the program. And so, economists use models and other ways of trying to estimate what the effect has been.

The CBO gave a very broad range of estimates, between 1 million and 3.5 million jobs, which is a very wide range, you can see. But it encompasses what most private sector economists have estimated. And it encompasses what the Federal Reserve has estimated, which is somewhere in the middle of that range. So there has been some job creation. Although we'll know a lot more over time as we're able to do more studies and look back at the data and how the economy evolved.

Certainly, a significant part of that job creation was in the private sector because of indirect effects, spending and the like. And as far as jobs in the government are concerned, of course, many of those jobs are providing essential services like education and so on. So I wouldn't completely discount those jobs, by any means. But it's very difficult to know how big the effect was. And certainly, we'd like to have more precise estimates to judge whether additional policies would be useful.

Q. Where would GDP be today had the Congress and the Fed not acted to stimulate the economy?
A. Most economists, most modeling exercises suggest that the fiscal efforts created some additional 1 to 3 million jobs relative to where we would have been absent that. And my own view -- and I think it's been supported by others as well -- is that the monetary policy actions which got down interest rates and helped stabilize the financial system, were also very important in turning the economy around.

Q. What would work to stimulate the economy, such as tax cuts versus spending efforts?
A. In general, as I said, I think that maintaining the current level of fiscal support is important because the economy is still quite weak. At the same time, in the medium and longer term we have an unsustainable fiscal trajectory and we need to address that in order to maintain the confidence of the public in the markets. And so, it's a two pronged element, as far as overall fiscal policy is concerned.

Now the fact that we are, for example, in a mode of stimulus now doesn't mean that what we do doesn't matter, that the particular choice of tax cuts or spending programs is irrelevant. You still want to look at every program and try to judge how effective it is, and will it provide support for long-run growth?

And some of the areas I've talked about have been training for workers and for the unemployed, support for small businesses. There are areas I think that would be productive. But, of course, it's up to Congress to look very carefully at you know what you're trying to address, but make sure that those programs are effective and well designed.

Bank Lending

Q. Bank lending to individuals and companies is going down, and banks' holding of federal securities is actually up. Is there an arbitrage today of banks being able to borrow at a very, very low interest rate and basically reinvest that money in treasuries or mortgage-backed securities issued by Fannie and Freddie, which undermines incentives to bring new capital to the marketplace?

A. I don't think that's true. We're actually very careful to tell the banks not to do that because it is actually a risky thing to do. If you're taking very short-term money and investing in longer-term securities, it's true that you can make some money in the short term. But you're always risking capital losses, which could be quite dangerous. So we pay a good bit of attention to the interest rate risk that is assumed by the banking system.

I think the reason banks aren't lending is either because lending requires capital and they're unsure about how much capital they have or will need, or more generally, because they feel that either the risks in the economy or the lack of credit-worthy borrowers is constraining their opportunities to make good loans. But as the economy improves, I'm sure that they'll return to the credit markets.

Small Business Lending

Q. In the addendum to your testimony there seemed to be some support for a small-business lending fund that could inject $30 billion of capital to community banks based on the level of lending they do. Do you have any thoughts on that? And also about a amendment to the SBA 504 program that would address the commercial real estate market?
A. As you noted, we had a lot of meetings with people on small-business credit access. And there was a lot of support for more action from the government in this area. There was a lot of support for the capital to small banks, who do make a lot of the loans to small businesses. And there's a lot of support for further extensions of enhancements to the SBA's authorities.

I would just make a general point that small businesses create a lot of the gross jobs in our economy. It's very difficult for them to expand in the current circumstances. And even more so than the existing small businesses, we are particularly short of funding for startups and new firms and growing firms. So I think this is an area that'll be very important to look at...

Q. Are overly aggressive bank examiners contracting small business credit?
A. Well, there's a natural tendency for examiners to be conservative because they don't want to be held responsible if a bank were to fail. But it's been the point of view of the Federal Reserve not just in this crisis, but going back to the 1990s and previous periods, that it's important to take a balanced approach. We heard from banks complaints that examiners were too unreasonable or too tough. And we just want to be sure to do everything we can to make sure there's a balanced approach being taken.

Q. A businessman in my district had his line of credit cut in half by his bank, despite the fact that business was going well for him. He planned continued expansion. Instead, he spent the following year laying people off. What can the Fed do to help?

A. In terms of the specific case, it would be important to know more. It could just be that the bank disagreed with his assessment. But it is a common complaint. And, again, I think, in part, it's because banks have tightened their standards, and part of that was appropriate because some of the lending before the crisis was not well-managed. And, of course, the general weakness of the economy and decline in collateral values and so on makes some borrowers who were previously good risks no longer such good risks. And that's why banks have become tighter in their lending.

That being said, it's very important that, if a borrower is truly creditworthy that they get access to credit. And the best thing I can do and the Federal Reserve can do is to make sure that our examiners are taking an appropriately balanced position, which is, on the one hand, we want banks to be prudent and make good loans, but on the other hand, excessive conservatism and restriction is not constructive.

So if Federal Reserve examiners are the problem, we would like to hear about that, either from the borrower, or the bank itself could be in touch with the Federal Reserve through the local district or on the board.

Q. I know you've put on an examiner boot camp as to what you're looking for. How do you expect that to work out over the next year?

A. Well, we've gone beyond the point of issuing guidance and doing training to trying to get feedback and evaluation. So, for example, we have done baseline studies of several hundred banks, in terms of how they deal with troubled commercial real estate properties. And we looked at how they acted and what their procedures were prior to the guidance we put out.

Now we can go back and survey them subsequent to our guidance and our training and see if there has been a change in their behavior. If there hasn't, then we want to understand why. So we're doing our best now to get feedback. That's really all we can do is get feedback, try to adjust and see how that works.

But, again, we have an ombudsman at the Board of Governors, and every Reserve Bank has got people who are there to talk to banks or borrowers. And I hope that they'll get back in touch with us.

Q. Where do you expect to be in six months in terms of small business lending?

A. I think there are hopeful signs. We survey banks about standards, and they have stopped tightening standards for small businesses. And we're beginning to see some little bit of improvement. So I think we're turning it around. I think it's going to be better. It's still tight, but it's not getting worse, at least, and that's the first step toward improvement.

Q. How can we promote more lending to small businesses?
A. (One area to address is to assured adequate competition among lenders.) The Federal Reserve is charged with making sure that competition is adequate whenever we approve a merger, for example. And our approach has been to look at local banking areas and to make sure that retail customers have plenty of choices in terms of their local banking services, or that small businesses have adequate choices in terms of their borrowing.

So we do pay attention to that, and the financial reform bill includes additional restraints on the share of total liabilities that any large firm can have. So there are some things in place to address the competition issues.

And indeed, I think during this crisis, actually it's been quite interesting that where a number of the larger banks because of their various problems have pulled back to some extent, particularly in smaller communities, small banks have stepped up and have made more loans.

We had an attempt at policy (under TARP) which did put capital in to banks of all sizes. That has been a stigmatized policy. It has not been as effective for that reason.

In terms of the funding from the Federal Reserve, we loan to all banks, directly or indirectly, at the same interest rate. So the low-cost funds that are available to large banks are also available to smaller banks.

From Congress's point of view, there are some individual programs that could be done. And those include some of the things that you're talking about now to encourage small-business lending, for example.

The other thing, which I'm sure you hear, is that small banks complain all the time about regulatory burden...I think it is important to recognize that small banks find it much more difficult to comply with complex regulations, and where possible, we need to simplify or reduce those burdens for smaller banks. In many cases, it is the bank's own decision about what kind of loans they want to make, and not the examiners constraining them.

Consumer Financial Protection Bureau

Q. What will the Fed be doing on consumer protection until the new Consumer Financial

Protection Bureau is up and running?
A. Although the new bureau will be housed in the Federal Reserve and be budgetarily supported by the Federal Reserve, it will be completely independent of the board and of the Federal Reserve. It will be acting as a separate agency.

So we have two immediate concerns. One is, during the transition period, to continue to protect consumers and take actions necessary to make sure that the financial products are fair and well explained.

And our other responsibility is to work with the Treasury to do the transition in moving our capacity, moving employees and so on to the new bureau.

But where we're going here is from a situation where the Fed was writing these rules to one where, within six months or a year, the independent bureau will be responsible, not the Federal Reserve.

And bilaterally, I hope that we'll work effectively with this bureau to make sure that we're cooperating,

And, for example, the Fed will retain the ability to do examinations of consumer compliance for smaller institutions. We will retain consumer affairs and community affairs departments that will try to reach out and understand what's going on with consumers.

But, again, the principal rule writing authorities will be transferred to this new bureau.

Effects on Financial Reform on ABS Market

Q. It's reported today that as a result of the recently passed Wall Street reforms that the asset-backed securities markets have effectively seized up, for lack of a better term; that uncertainty over the liability provisions concerning the rating agencies has frozen that marketplace. Can you comment on that and address what impact that may have in terms of a ripple effect throughout the economy and credit and liquidity markets?

A. The issue, as I understand it, is that because of the liability exposure that credit rating agencies have declined to have their ratings attached to ABS issuance, which has had some effect on the salability of the ABS.

This is an SEC issue and I think it is important for the SEC and we'll be happy to work with them in any way that they see fit to try to find alternative solutions to address this problem. But it is an issue that needs to be looked at because it does, as I understand it, it does inhibit somewhat the sale of ABS.

Q. Can you envision a scenario where the Fed's TALF program may be required again as a result of this situation?
A. I think it would be better to find some kind of solution that works so that investors can get the information they need when they buy the ABS. I don't think the Fed's intervention would be very useful in that.

Fannie Mae and Freddie Mac

Q. What should Congress do about mortgage giants, Fannie Mae and Freddie Mac?
A. Almost two years ago I laid out some options. I agree it's very important to address this current situation. It's not sustainable, obviously. Basically, the two broad approaches would be to break up and privatize the companies, perhaps supported by a government insurance program for their mortgages that they would pay for. The alternative would be make them more like government utilities and have them just provide services under full government control rather than having shareholders the way Ginnie Mae does, for example. So those are the two broad options. We're sort of half fowl, half horse at this point. You need to go one direction or the other. But clearly, this is something we need to take on pretty soon.