

For release on delivery
9:00 a.m. EST
February 25, 2010

Semiannual Monetary Policy Report to the Congress

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before the

Committee on Banking, Housing and Urban Affairs

United States Senate

February 25, 2010

Chairman Dodd, Ranking Member Shelby, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress*. I will begin today with some comments on the outlook for the economy and for monetary policy, then touch briefly on several other important issues.

The Economic Outlook

Although the recession officially began more than two years ago, U.S. economic activity contracted particularly sharply following the intensification of the global financial crisis in the fall of 2008. Concerted efforts by the Federal Reserve, the Treasury Department, and other U.S. authorities to stabilize the financial system, together with highly stimulative monetary and fiscal policies, helped arrest the decline and are supporting a nascent economic recovery. Indeed, the U.S. economy expanded at about a 4 percent annual rate during the second half of last year. A significant portion of that growth, however, can be attributed to the progress firms made in working down unwanted inventories of unsold goods, which left them more willing to increase production. As the impetus provided by the inventory cycle is temporary, and as the fiscal support for economic growth likely will diminish later this year, a sustained recovery will depend on continued growth in private-sector final demand for goods and services.

Private final demand does seem to be growing at a moderate pace, buoyed in part by a general improvement in financial conditions. In particular, consumer spending has recently picked up, reflecting gains in real disposable income and household wealth and tentative signs of stabilization in the labor market. Business investment in equipment and software has risen significantly. And international trade--supported by a recovery in the economies of many of our trading partners--is rebounding from its deep contraction of a year ago. However, starts of single-family homes, which rose noticeably this past spring, have recently been roughly flat, and

commercial construction is declining sharply, reflecting poor fundamentals and continued difficulty in obtaining financing.

The job market has been hit especially hard by the recession, as employers reacted to sharp sales declines and concerns about credit availability by deeply cutting their workforces in late 2008 and in 2009. Some recent indicators suggest the deterioration in the labor market is abating: Job losses have slowed considerably, and the number of full-time jobs in manufacturing rose modestly in January. Initial claims for unemployment insurance have continued to trend lower, and the temporary services industry, often considered a bellwether for the employment outlook, has been expanding steadily since October. Notwithstanding these positive signs, the job market remains quite weak, with the unemployment rate near 10 percent and job openings scarce. Of particular concern, because of its long-term implications for workers' skills and wages, is the increasing incidence of long-term unemployment; indeed, more than 40 percent of the unemployed have been out of work six months or more, nearly double the share of a year ago.

Increases in energy prices resulted in a pickup in consumer price inflation in the second half of last year, but oil prices have flattened out over recent months, and most indicators suggest that inflation likely will be subdued for some time. Slack in labor and product markets has reduced wage and price pressures in most markets, and sharp increases in productivity have further reduced producers' unit labor costs. The cost of shelter, which receives a heavy weight in consumer price indexes, is rising very slowly, reflecting high vacancy rates. In addition, according to most measures, longer-term inflation expectations have remained relatively stable.

The improvement in financial markets that began last spring continues. Conditions in short-term funding markets have returned to near pre-crisis levels. Many (mostly larger) firms

have been able to issue corporate bonds or new equity and do not seem to be hampered by a lack of credit. In contrast, bank lending continues to contract, reflecting both tightened lending standards and weak demand for credit amid uncertain economic prospects.

In conjunction with the January meeting of the Federal Open Market Committee (FOMC), Board members and Reserve Bank presidents prepared projections for economic growth, unemployment, and inflation for the years 2010 through 2012 and over the longer run. The contours of these forecasts are broadly similar to those I reported to the Congress last July. FOMC participants continue to anticipate a moderate pace of economic recovery, with economic growth of roughly 3 to 3-1/2 percent in 2010 and 3-1/2 to 4-1/2 percent in 2011. Consistent with moderate economic growth, participants expect the unemployment rate to decline only slowly, to a range of roughly 6-1/2 to 7-1/2 percent by the end of 2012, still well above their estimate of the long-run sustainable rate of about 5 percent. Inflation is expected to remain subdued, with consumer prices rising at rates between 1 and 2 percent in 2010 through 2012. In the longer term, inflation is expected to be between 1-3/4 and 2 percent, the range that most FOMC participants judge to be consistent with the Federal Reserve's dual mandate of price stability and maximum employment.

Monetary Policy

Over the past year, the Federal Reserve has employed a wide array of tools to promote economic recovery and preserve price stability. The target for the federal funds rate has been maintained at a historically low range of 0 to 1/4 percent since December 2008. The FOMC continues to anticipate that economic conditions--including low rates of resource utilization, subdued inflation trends, and stable inflation expectations--are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve is in the process of purchasing \$1.25 trillion of agency mortgage-backed securities and about \$175 billion of agency debt. We have been gradually slowing the pace of these purchases in order to promote a smooth transition in markets and anticipate that these transactions will be completed by the end of March. The FOMC will continue to evaluate its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

In response to the substantial improvements in the functioning of most financial markets, the Federal Reserve is winding down the special liquidity facilities it created during the crisis. On February 1, a number of these facilities, including credit facilities for primary dealers, lending programs intended to help stabilize money market mutual funds and the commercial paper market, and temporary liquidity swap lines with foreign central banks, were allowed to expire.¹ The only remaining lending program for multiple borrowers created under the Federal Reserve's emergency authorities, the Term Asset-Backed Securities Loan Facility, is scheduled to close on March 31 for loans backed by all types of collateral except newly issued commercial mortgage-backed securities (CMBS) and on June 30 for loans backed by newly issued CMBS.

In addition to closing its special facilities, the Federal Reserve is normalizing its lending to commercial banks through the discount window. The final auction of discount-window funds to depositories through the Term Auction Facility, which was created in the early stages of the crisis to improve the liquidity of the banking system, will occur on March 8. Last week we announced that the maximum term of discount window loans, which was increased to as much as 90 days during the crisis, would be returned to overnight for most banks, as it was before the

¹ Primary dealers are broker-dealers that act as counterparties to the Federal Reserve Bank of New York in its conduct of open market operations.

crisis erupted in August 2007. To discourage banks from relying on the discount window rather than private funding markets for short-term credit, last week we also increased the discount rate by 25 basis points, raising the spread between the discount rate and the top of the target range for the federal funds rate to 50 basis points. These changes, like the closure of most of the special lending facilities earlier this month, are in response to the improved functioning of financial markets, which has reduced the need for extraordinary assistance from the Federal Reserve. These adjustments are not expected to lead to tighter financial conditions for households and businesses and should not be interpreted as signaling any change in the outlook for monetary policy, which remains about the same as it was at the time of the January meeting of the FOMC.

Although the federal funds rate is likely to remain exceptionally low for an extended period, as the expansion matures, the Federal Reserve will at some point need to begin to tighten monetary conditions to prevent the development of inflationary pressures. Notwithstanding the substantial increase in the size of its balance sheet associated with its purchases of Treasury and agency securities, we are confident that we have the tools we need to firm the stance of monetary policy at the appropriate time.²

Most importantly, in October 2008 the Congress gave statutory authority to the Federal Reserve to pay interest on banks' holdings of reserve balances at Federal Reserve Banks. By increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates. Actual and prospective increases in short-term interest rates will be reflected in turn in longer-term interest rates and in financial conditions more generally.

² For further details on these tools and the Federal Reserve's exit strategy, see Ben S. Bernanke (2010), "Federal Reserve's Exit Strategy," statement before the Committee on Financial Services, U.S. House of Representatives, February 10, www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm.

The Federal Reserve has also been developing a number of additional tools to reduce the large quantity of reserves held by the banking system, which will improve the Federal Reserve's control of financial conditions by leading to a tighter relationship between the interest rate paid on reserves and other short-term interest rates. Notably, our operational capacity for conducting reverse repurchase agreements, a tool that the Federal Reserve has historically used to absorb reserves from the banking system, is being expanded so that such transactions can be used to absorb large quantities of reserves.³ The Federal Reserve is also currently refining plans for a term deposit facility that could convert a portion of depository institutions' holdings of reserve balances into deposits that are less liquid and could not be used to meet reserve requirements.⁴ In addition, the FOMC has the option of redeeming or selling securities as a means of reducing outstanding bank reserves and applying monetary restraint. Of course, the sequencing of steps and the combination of tools that the Federal Reserve uses as it exits from its currently very accommodative policy stance will depend on economic and financial developments. I provided more discussion of these options and possible sequencing in a recent testimony.⁵

Federal Reserve Transparency

The Federal Reserve is committed to ensuring that the Congress and the public have all the information needed to understand our decisions and to be assured of the integrity of our operations. Indeed, on matters related to the conduct of monetary policy, the Federal Reserve is

³ The Federal Reserve has recently developed the ability to engage in reverse repurchase agreements in the triparty market for repurchase agreements, with primary dealers as counterparties and using Treasury and agency debt securities as collateral, and it is developing the capacity to carry out these transactions with a wider set of counterparties (such as money market mutual funds and the mortgage-related government-sponsored enterprises) and using agency mortgage-backed securities as collateral.

⁴ In December the Federal Reserve published a proposal describing a term deposit facility in the *Federal Register* (see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Board Proposes Amendments to Regulation D That Would Enable the Establishment of a Term Deposit Facility," press release, December 28, www.federalreserve.gov/newsevents/press/monetary/20091228a.htm). We are now in the process of analyzing the public comments that have been received. A revised proposal will be reviewed by the Federal Reserve Board, and test transactions could commence during the second quarter.

⁵ See Bernanke, "Federal Reserve's Exit Strategy," in note 2.

already one of the most transparent central banks in the world, providing detailed records and explanations of its decisions. Over the past year, the Federal Reserve also took a number of steps to enhance the transparency of its special credit and liquidity facilities, including the provision of regular, extensive reports to the Congress and the public; and we have worked closely with the Government Accountability Office (GAO), the Office of the Special Inspector General for the Troubled Asset Relief Program, the Congress, and private-sector auditors on a range of matters relating to these facilities.

While the emergency credit and liquidity facilities were important tools for implementing monetary policy during the crisis, we understand that the unusual nature of those facilities creates a special obligation to assure the Congress and the public of the integrity of their operation. Accordingly, we would welcome a review by the GAO of the Federal Reserve's management of all facilities created under emergency authorities.⁶ In particular, we would support legislation authorizing the GAO to audit the operational integrity, collateral policies, use of third-party contractors, accounting, financial reporting, and internal controls of these special credit and liquidity facilities. The Federal Reserve will, of course, cooperate fully and actively in all reviews. We are also prepared to support legislation that would require the release of the identities of the firms that participated in each special facility after an appropriate delay. It is important that the release occur after a lag that is sufficiently long that investors will not view an institution's use of one of the facilities as a possible indication of ongoing financial problems, thereby undermining market confidence in the institution or discouraging use of any future

⁶ Last month the Federal Reserve said that it would welcome a full review by the GAO of all aspects of the Federal Reserve's involvement in the extension of credit to the American International Group, Inc. (see Ben S. Bernanke (2010), letter to Gene L. Dodaro, January 19, www.federalreserve.gov/monetarypolicy/files/letter_aig_20100119.pdf). The Federal Reserve would support legislation authorizing a review by the GAO of the Federal Reserve's operations of its facilities created under emergency authorities: the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, the Primary Dealer Credit Facility, the Term Asset-Backed Securities Loan Facility, and the Term Securities Lending Facility.

facility that might become necessary to protect the U.S. economy. An appropriate delay would also allow firms adequate time to inform investors through annual reports and other public documents of their use of Federal Reserve facilities.

Looking ahead, we will continue to work with the Congress in identifying approaches for enhancing the Federal Reserve's transparency that are consistent with our statutory objectives of fostering maximum employment and price stability. In particular, it is vital that the conduct of monetary policy continue to be insulated from short-term political pressures so that the FOMC can make policy decisions in the longer-term economic interests of the American people. Moreover, the confidentiality of discount window lending to individual depository institutions must be maintained so that the Federal Reserve continues to have effective ways to provide liquidity to depository institutions under circumstances where other sources of funding are not available. The Federal Reserve's ability to inject liquidity into the financial system is critical for preserving financial stability and for supporting depositories' key role in meeting the ongoing credit needs of firms and households.

Regulatory Reform

Strengthening our financial regulatory system is essential for the long-term economic stability of the nation. Among the lessons of the crisis are the crucial importance of macroprudential regulation--that is, regulation and supervision aimed at addressing risks to the financial system as a whole--and the need for effective consolidated supervision of every financial institution that is so large or interconnected that its failure could threaten the functioning of the entire financial system.

The Federal Reserve strongly supports the Congress's ongoing efforts to achieve comprehensive financial reform. In the meantime, to strengthen the Federal Reserve's oversight

of banking organizations, we have been conducting an intensive self-examination of our regulatory and supervisory responsibilities and have been actively implementing improvements. For example, the Federal Reserve has been playing a key role in international efforts to toughen capital and liquidity requirements for financial institutions, particularly systemically critical firms, and we have been taking the lead in ensuring that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking.⁷

The Federal Reserve is also making fundamental changes in its supervision of large, complex bank holding companies, both to improve the effectiveness of consolidated supervision and to incorporate a macroprudential perspective that goes beyond the traditional focus on safety and soundness of individual institutions. We are overhauling our supervisory framework and procedures to improve coordination within our own supervisory staff and with other supervisory agencies and to facilitate more-integrated assessments of risks within each holding company and across groups of companies.

Last spring the Federal Reserve led the successful Supervisory Capital Assessment Program, popularly known as the bank stress tests. An important lesson of that program was that combining on-site bank examinations with a suite of quantitative and analytical tools can greatly improve comparability of the results and better identify potential risks. In that spirit, the Federal Reserve is also in the process of developing an enhanced quantitative surveillance program for large bank holding companies. Supervisory information will be combined with firm-level, market-based indicators and aggregate economic data to provide a more complete picture of the risks facing these institutions and the broader financial system. Making use of the Federal Reserve's unparalleled breadth of expertise, this program will apply a multidisciplinary approach

⁷ For further information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

that involves economists, specialists in particular financial markets, payments systems experts, and other professionals, as well as bank supervisors.

The recent crisis has also underscored the extent to which direct involvement in the oversight of banks and bank holding companies contributes to the Federal Reserve's effectiveness in carrying out its responsibilities as a central bank, including the making of monetary policy and the management of the discount window. Most important, as the crisis has once again demonstrated, the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.

The Federal Reserve continues to demonstrate its commitment to strengthening consumer protections in the financial services arena. Since the time of the previous *Monetary Policy Report* in July, the Federal Reserve has proposed a comprehensive overhaul of the regulations governing consumer mortgage transactions, and we are collaborating with the Department of Housing and Urban Development to assess how we might further increase transparency in the mortgage process.⁸ We have issued rules implementing enhanced consumer protections for credit card accounts and private student loans as well as new rules to ensure that consumers have meaningful opportunities to avoid overdraft fees.⁹ In addition, the Federal Reserve has

⁸ For further information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Proposes Significant Changes to Regulation Z (Truth in Lending) Intended to Improve the Disclosures Consumers Receive in Connection with Closed-End Mortgages and Home-Equity Lines of Credit," press release, July 23, www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm.

⁹ For more information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Approves Final Amendments to Regulation Z That Revise Disclosure Requirements for Private Education Loans," press release, July 30, www.federalreserve.gov/newsevents/press/bcreg/20090730a.htm; Board of Governors of the Federal Reserve System (2009), "Federal Reserve Announces Final Rules Prohibiting Institutions from Charging Fees for Overdrafts on ATM and One-Time Debit Card Transactions," press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20091112a.htm; and Board of Governors of the Federal Reserve System (2010), "Federal Reserve Approves Final Rules to Protect Credit Card Users from a Number of Costly Practices," press release, January 12, www.federalreserve.gov/newsevents/press/bcreg/20100112a.htm.

implemented an expanded consumer compliance supervision program for nonbank subsidiaries of bank holding companies and foreign banking organizations.¹⁰

More generally, the Federal Reserve is committed to doing all that can be done to ensure that our economy is never again devastated by a financial collapse. We look forward to working with the Congress to develop effective and comprehensive reform of the financial regulatory framework.

¹⁰ For further information, see Board of Governors of the Federal Reserve System (2009), “Federal Reserve to Implement Consumer Compliance Supervision Program of Nonbank Subsidiaries of Bank Holding Companies and Foreign Banking Organizations,” press release, September 15, www.federalreserve.gov/newsevents/press/bcreg/20090915a.htm.