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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

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Chairman Frank, Ranking Member Bachus, and members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. As you know, this occasion marks the thirtieth year of semiannual testimony on the economy and monetary policy by the Federal Reserve. In establishing these hearings, the Congress proved prescient in anticipating the worldwide trend toward greater transparency and accountability of central banks in the making of monetary policy. Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy, even as they have served to enhance the Federal Reserve's accountability for achieving the dual objectives of maximum employment and price stability set for it by the Congress. I take this opportunity to reiterate the Federal Reserve's strong support of the dual mandate; in pursuing maximum employment and price stability, monetary policy makes its greatest possible contribution to the general economic welfare.

Let me now review the current economic situation and the outlook, beginning with developments in the real economy and the situation regarding inflation before turning to monetary policy. I will conclude with comments on issues related to lending to households and consumer protection--topics not normally addressed in monetary policy testimony but, in light of recent developments, deserving of our attention today.

After having run at an above-trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid, with more than 850,000 jobs having been added to payrolls thus far in 2007 and the unemployment rate having remained at 4-1/2 percent. The combination of moderate gains in output and solid advances in employment implies that recent increases in labor productivity have been modest by the standards of the past decade. The cooling of productivity growth in recent quarters is likely the result of cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector. Over the past year, home sales and construction have slowed substantially and house prices have decelerated. Although a leveling-off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales. Accordingly, construction of new homes has sunk further, with starts of new single-family houses thus far this year running 10 percent below the pace in the second half of last year.

The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment as well as by mortgage rates that--despite the recent increase--remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter, following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace, aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual decline in labor force participation. Real compensation appears to have risen over the past year, and barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

In the business sector, investment in equipment and software showed a modest gain in the first quarter. A similar outcome is likely for the second quarter, as weakness in the volatile transportation equipment category appears to have been offset by solid gains in other categories. Investment in nonresidential structures, after slowing sharply late last year, seems to have grown fairly vigorously in the first half of 2007. Like consumption spending, business fixed investment overall seems poised to rise at a moderate pace, bolstered by gains in sales and generally favorable financial conditions. Late last year and early this year, motor vehicle manufacturers and firms in several other industries found themselves with elevated inventories, which led them to reduce production to better align inventories with sales. Excess inventories now appear to have been substantially eliminated and should not prove a further restraint on growth.

The global economy continues to be strong. Supported by solid economic growth abroad, U.S. exports should expand further in coming quarters. Nonetheless, our trade deficit--which was about 5-1/4 percent of nominal gross domestic product (GDP) in the first quarter--is likely to remain high.

For the most part, financial markets have remained supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly, reflecting mounting delinquency rates on adjustable-rate loans. In recent weeks, we have also seen increased concerns among investors about credit risk on some other types of financial instruments. Credit spreads on lower-quality corporate debt have widened somewhat, and terms for some leveraged business loans have tightened. Even after their recent rise, however, credit spreads remain near the low end of their historical ranges, and financing activity in the bond and business loan markets has remained fairly brisk.

Overall, the U.S. economy appears likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend. Such an assessment was made around the time of the June meeting of the Federal Open Market Committee (FOMC) by the members of the Board of Governors and the presidents of the Reserve Banks, all of whom participate in deliberations on monetary policy. The central tendency of the growth forecasts, which are conditioned on the assumption of appropriate monetary policy, is for real GDP to expand roughly 2-1/4 to 2-1/2 percent this year and 2-1/2 to 2-3/4 percent in 2008. The forecasted performance for this year is about 1/4 percentage point below that projected in February, the difference being largely the result of weaker-than-expected residential construction activity this year. The unemployment rate is anticipated to edge up to between 4-1/2 and 4-3/4 percent over the balance of this year and about 4-3/4 percent in 2008, a trajectory about the same as the one expected in February.

I turn now to the inflation situation. Sizable increases in food and energy prices have boosted overall inflation and eroded real incomes in recent months--both unwelcome developments. As measured by changes in the price index for personal consumption expenditures (PCE inflation), inflation ran at an annual rate of 4.4 percent over the first five months of this year, a rate that, if maintained, would clearly be inconsistent with the objective of price stability.[1] Because monetary policy works with a lag, however, policymakers must focus on the economic outlook. Food and energy prices tend to be quite volatile, so that, looking forward, core inflation (which excludes food and energy prices) may be a better gauge than overall inflation of underlying inflation trends. Core inflation has moderated slightly over the past few months, with core PCE inflation coming in at an annual rate of about 2 percent so far this year.

Although the most recent readings on core inflation have been favorable, month-to-month movements in inflation are subject to considerable noise, and some of the recent improvement could also be the result of transitory influences. However, with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower, on net, over the remainder of this year and next year. The central tendency of FOMC participants' forecasts for core PCE inflation--2 to 2-1/4 percent for 2007 and 1-3/4 to 2 percent in 2008--is unchanged from February. If energy prices level off as currently anticipated, overall inflation should slow to a pace close to that of core inflation in coming quarters.

At each of its four meetings so far this year, the FOMC maintained its target for the federal funds rate at 5-1/4 percent, judging that the existing stance of policy was

[1] Despite the recent surge, total PCE inflation is 2.3 percent over the past twelve months.

likely to be consistent with growth running near trend and inflation staying on a moderating path. As always, in determining the appropriate stance of policy, we will be alert to the possibility that the economy is not evolving in the way we currently judge to be the most likely. One risk to the outlook is that the ongoing housing correction might prove larger than anticipated, with possible spillovers onto consumer spending. Alternatively, consumer spending, which has advanced relatively vigorously, on balance, in recent quarters, might expand more quickly than expected; in that case, economic growth could rebound to a pace above its trend. With the level of resource utilization already elevated, the resulting pressures in labor and product markets could lead to increased inflation over time. Yet another risk is that energy and commodity prices could continue to rise sharply, leading to further increases in headline inflation and, if those costs passed through to the prices of non-energy goods and services, to higher core inflation as well. Moreover, if inflation were to move higher for an extended period and that increase became embedded in longer-term inflation expectations, the re-establishment of price stability would become more difficult and costly to achieve. With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.

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In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions. For nearly forty years, the Federal Reserve has been active in implementing, interpreting, and enforcing consumer protection laws. I would like to discuss with you this morning some of our recent initiatives and actions, particularly those related to subprime mortgage lending.

Promoting access to credit and to homeownership are important objectives, and responsible subprime mortgage lending can help advance both goals. In designing regulations, policymakers should seek to preserve those benefits. That said, the recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms. Financial losses have subsequently induced lenders to tighten their underwriting standards. Nevertheless, rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities--problems that likely will get worse before they get better.

The Federal Reserve is responding to these difficulties at both the national and the local levels. In coordination with the other federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures. Federal Reserve Banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations. We continue to work with organizations that provide counseling about mortgage products to current and potential homeowners. We are also meeting with market participants--including lenders, investors, servicers, and community groups--to discuss their concerns and to gain information about market developments.

We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of these problems. First, we are committed to providing more-effective disclosures to help consumers defend against improper lending. Three years ago, the Board began a comprehensive review of Regulation Z, which implements the Truth in Lending Act (TILA). The initial focus of our review was on disclosures related to credit cards and other revolving credit accounts. After conducting extensive consumer testing, we issued a proposal in May that would require credit card issuers to provide clearer and easier-to-understand disclosures to customers. In particular, the new disclosures would highlight applicable rates and fees, particularly penalties that might be imposed. The proposed rules would also require card issuers to provide forty-five days' advance notice of a rate increase or any other change in account terms so that consumers will not be surprised by unexpected charges and will have time to explore alternatives.

We are now engaged in a similar review of the TILA rules for mortgage loans. We began this review last year by holding four public hearings across the country, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable-rate products. As we did with credit card lending, we will conduct extensive consumer testing of proposed disclosures. Because the process of designing and testing disclosures involves many trial runs, especially given today's diverse and sometimes complex credit products, it may take some time to complete our review and propose new disclosures.

However, some other actions can be implemented more quickly. By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. We already have improved a disclosure that creditors must provide to every applicant for an adjustable-rate mortgage product to explain better the features and risks of these products, such as "payment shock" and rising loan balances.

We are certainly aware, however, that disclosure alone may not be sufficient to protect consumers. Accordingly, we plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive. We held a public hearing on June 14 to discuss industry practices, including those pertaining to pre-payment penalties, the use of escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the evaluation of a borrower's ability to repay. The discussion and ideas we heard were extremely useful, and we look forward to receiving additional public comments in coming weeks. Based on the information we are gathering, I expect that the Board will propose additional rules under HOEPA later this year.

In coordination with the other federal supervisory agencies, last year we issued principles-based guidance on nontraditional mortgages, and in June of this year we issued supervisory guidance on subprime lending. These statements emphasize the fundamental consumer protection principles of sound underwriting and effective disclosures. In addition, we reviewed our policies related to the examination of nonbank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.

As a result of that review and following discussions with the Office of Thrift Supervision, the Federal Trade Commission, and state regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations. The reviews will begin in the fourth quarter of this year and will include independent state-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations of and improved enforcement for nondepository mortgage lenders. Working together to address jurisdictional issues and to improve information-sharing among agencies, we will seek to prevent abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

I believe that the actions I have described today will help address the current problems. The Federal Reserve looks forward to working with the Congress on these important issues.