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Statement of

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Chairman

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before the

Committee on the Budget

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Chairman Spratt, Representative Ryan, and other members of the Committee, I am pleased to be here to offer my views on the near-term economic outlook and related issues.

Developments in Financial Markets

Since late last summer, financial markets in the United States and in a number of other industrialized countries have been under considerable strain. Heightened investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates, triggered the financial turmoil. Notably, as the rising rate of delinquencies of subprime mortgages threatened to impose losses on holders of even highly rated securities, investors were led to question the reliability of the credit ratings for a range of financial products, including structured credit products and various special-purpose vehicles. As investors lost confidence in their ability to value complex financial products, they became increasingly unwilling to hold such instruments. As a result, flows of credit through these vehicles have contracted significantly.

As these problems multiplied, money center banks and other large financial institutions, which in many cases had served as sponsors of these financial products, came under increasing pressure to take the assets of the off-balance-sheet vehicles onto their own balance sheets. Bank balance sheets were swelled further by holdings of nonconforming mortgages, leveraged loans, and other credits that the banks had extended but for which well-functioning secondary markets no longer existed. Even as their balance sheets expanded, banks began to report large losses, reflecting marked declines in the market prices of mortgages and other assets. Thus, banks too became subject to valuation uncertainty, as could be seen in the sharp movements in their share prices and in other market indicators such as quotes on credit default swaps. The combination of larger balance sheets and unexpected losses prompted banks to become protective of their

liquidity and balance sheet capacity and thus to become less willing to provide funding to other market participants, including other banks. Banks have also evidently become more restrictive in their lending to firms and households. More-expensive and less-available credit seems likely to impose a measure of restraint on economic growth.

The Outlook for the Real Economy

To date, the largest effects of the financial turmoil appear to have been on the housing market, which, as you know, has deteriorated significantly over the past two years or so. The virtual shutdown of the subprime mortgage market and a widening of spreads on jumbo mortgage loans have further reduced the demand for housing, while foreclosures are adding to the already-elevated inventory of unsold homes. New home sales and housing starts have both fallen by about half from their respective peaks. The number of homes in inventory has begun to edge down, but at the current sales pace the months' supply of new homes has continued to climb, and home prices are falling in many parts of the country. The slowing in residential construction, which subtracted about 1 percentage point from the growth rate of real gross domestic product in the third quarter of 2007, likely curtailed growth even more in the fourth quarter, and it may continue to be a drag on growth for a good part of this year as well.

Recently, incoming information has suggested that the baseline outlook for real activity in 2008 has worsened and that the downside risks to growth have become more pronounced. In particular, a number of factors, including continuing increases in energy prices, lower equity prices, and softening home values, seem likely to weigh on consumer spending as we move into 2008. Consumer spending also depends importantly on the state of the labor market, as wages and salaries are the primary source of income for most households. Labor market conditions in December were disappointing; the unemployment rate increased 0.3 percentage point, to

5.0 percent from 4.7 percent in November, and private payroll employment declined. Employment in residential construction posted another substantial reduction, and employment in manufacturing and retail trade also decreased significantly. Employment in services continued to grow, but at a slower pace in December than in earlier months. It would be a mistake to read too much into one month's data. However, developments in the labor market will bear close attention.

In the business sector, investment in equipment and software appears to have been sluggish in the fourth quarter, while nonresidential construction grew briskly. In light of the softening in economic activity and the adverse developments in credit markets, growth in both types of investment spending seems likely to slow in coming months. Outside the United States, however, economic activity in our major trading partners has continued to expand vigorously. U.S. exports will likely continue to grow at a healthy pace in coming quarters, providing some impetus to the domestic economy.

Financial conditions continue to pose a downside risk to the outlook. Market participants still express considerable uncertainty about the appropriate valuation of complex financial assets and about the extent of additional losses that may be disclosed in the future. On the whole, despite improvements in some areas, the financial situation remains fragile, and many funding markets remain impaired. Adverse economic or financial news thus has the potential to increase financial strains and to lead to further constraints on the supply of credit to households and businesses.

Even as the outlook for real activity has weakened, some important developments have occurred on the inflation front. Most notably, the same increase in oil prices that may be a negative influence on growth is also lifting overall consumer prices. Last year, food prices also

increased exceptionally rapidly by recent standards, further boosting overall consumer price inflation. The most recent reading on overall personal consumption expenditure inflation showed that prices in November were 3.6 percent higher than they were a year earlier. Core price inflation (which excludes prices of food and energy) has stepped up recently as well, with November prices up almost 2-1/4 percent from a year earlier. Part of this rise may reflect pass-through of energy costs to the prices of core consumer goods and services, as well as the effects of the depreciation of the dollar on import prices, although some other prices--such as those for some medical and financial services--have also accelerated lately.[1]

Thus far, the public's expectations of future inflation appear to have remained reasonably well anchored, and pressures on resource utilization have diminished a bit. Further, futures markets suggest that food and energy prices will decelerate over the coming year. Given these factors, overall and core inflation should moderate this year and next, so long as the public's confidence in the Federal Reserve's commitment to price stability is unshaken. However, any tendency of inflation expectations to become unmoored or for the Fed's inflation-fighting credibility to be eroded could greatly complicate the task of sustaining price stability and reduce the central bank's policy flexibility to counter shortfalls in growth in the future. Accordingly, in the months ahead we will be closely monitoring the inflation situation, particularly inflation expectations.

Monetary Policy Response

The Federal Reserve has taken a number of steps to help markets return to more orderly functioning and to foster its economic objectives of maximum sustainable employment and price stability. Broadly, the Federal Reserve's response has followed two tracks: efforts to improve

[1] Prices for some financial services are implicit; for example, depositors may pay for "free" checking services only indirectly, by accepting a lower interest rate on their deposits. The Bureau of Labor Statistics uses estimates of such prices, as well as other nonmarket prices, in calculating the inflation rate.

market liquidity and functioning and the pursuit of our macroeconomic objectives through monetary policy.

To help address the significant strains in short-term money markets, the Federal Reserve has taken a range of steps. Notably, on August 17, the Federal Reserve Board cut the discount rate--the rate at which it lends directly to banks--by 50 basis points, or 1/2 percentage point, and it has since maintained the spread between the federal funds rate and the discount rate at 50 basis points, rather than the customary 100 basis points. In addition, the Federal Reserve recently unveiled a term auction facility, or TAF, through which prespecified amounts of discount window credit can be auctioned to eligible borrowers. The goal of the TAF is to reduce the incentive for banks to hoard cash and increase their willingness to provide credit to households and firms. In December, the Fed successfully auctioned $40 billion through this facility. And, as part of a coordinated operation, the European Central Bank and the Swiss National Bank lent an additional $24 billion to banks in their respective jurisdictions. This month, the Federal Reserve is auctioning $60 billion in twenty-eight-day credit through the TAF, to be spread across two auctions. TAF auctions will continue as long as necessary to address elevated pressures in short-term funding markets, and we will continue to work closely and cooperatively with other central banks to address market strains that could hamper the achievement of our broader economic objectives.

Although the TAF and other liquidity-related actions appear to have had some positive effects, such measures alone cannot fully address fundamental concerns about credit quality and valuation, nor do these actions relax the balance sheet constraints on financial institutions. Hence, they alone cannot eliminate the financial restraints affecting the broader economy. Monetary policy (that is, the management of the short-term interest rate) is the Fed's best tool for

pursuing our macroeconomic objectives, namely to promote maximum sustainable employment and price stability.

Monetary policy has responded proactively to evolving conditions. As you know, the Federal Open Market Committee (FOMC) cut its target for the federal funds rate by 50 basis points at its September meeting and by 25 basis points each at the October and December meetings. In total, therefore, we have brought the federal funds rate down by 1 percentage point from its level just before the financial strains emerged. The Federal Reserve took these actions to help offset the restraint imposed by the tightening of credit conditions and the weakening of the housing market. However, in light of recent changes in the outlook for and the risks to growth, additional policy easing may well be necessary. The FOMC will, of course, be carefully evaluating incoming information bearing on the economic outlook. Based on that evaluation, and consistent with our dual mandate, we stand ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks.

Financial and economic conditions can change quickly. Consequently, the FOMC must remain exceptionally alert and flexible, prepared to act in a decisive and timely manner and, in particular, to counter any adverse dynamics that might threaten economic or financial stability.

A number of analysts have raised the possibility that fiscal policy actions might usefully complement monetary policy in supporting economic growth over the next year or so. I agree that fiscal action could be helpful in principle, as fiscal and monetary stimulus together may provide broader support for the economy than monetary policy actions alone. But the design and implementation of the fiscal program are critically important. A fiscal initiative at this juncture could prove quite counterproductive, if (for example) it provided economic stimulus at the wrong time or compromised fiscal discipline in the longer term.

To be useful, a fiscal stimulus package should be implemented quickly and structured so that its effects on aggregate spending are felt as much as possible within the next twelve months or so. Stimulus that comes too late will not help support economic activity in the near term, and it could be actively destabilizing if it comes at a time when growth is already improving. Thus, fiscal measures that involve long lead times or result in additional economic activity only over a protracted period, whatever their intrinsic merits might be, will not provide stimulus when it is most needed. Any fiscal package should also be efficient, in the sense of maximizing the amount of near-term stimulus per dollar of increased federal expenditure or lost revenue. Finally, any program should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the federal government's structural budget deficit. As I have discussed on other occasions, the nation faces daunting long-run budget challenges associated with an aging population, rising health-care costs, and other factors. A fiscal program that increased the structural budget deficit would only make confronting those challenges more difficult.

Thank you. I would be pleased to take your questions.