MONETARY POLICY AND THE STATE OF THE ECONOMY, PART I

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MONETARY POLICY AND THE STATE OF THE ECONOMY, PART I

Thursday, February 15, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Kanjorski, Waters, Maloney, Gutierrez, Watt, Ackerman, Sherman, Moore of Kansas, Capuano, Hinojosa, Clay, McCarthy, Miller of North Carolina, Green, Cleaver, Bean, Moore of Wisconsin, Davis of Tennessee, Sires, Hodes, Ellison, Klein, Mahoney, Wilson, Perlmutter, Murphy, Donnelly, Wexler, Marshall; Bachus, Baker, Pryce, Castle, Royce, Lucas, Paul, Gillmor, Jones, Biggert, Shays, Capito, Feeney, Hensarling, Garrett, Pearce, McHenry, Campbell, Bachmann, and Roskam.

The CHAIRMAN. Today's hearing of the Committee on Financial Services will come to order. This is the semi-annual hearing that we have on the Humphrey-Hawkins Act, with testimony by the Chairman of the Board of Governors of the Federal Reserve System, Hon. Ben S. Bernanke. Chairman Bernanke will be testifying on the state of the economy and discussing the Federal Reserve's 2007 Monetary Policy Report to the Congress. Under the procedures, Chairman Bernanke alternates between the House and the Senate. This is done twice a year—once a year, the chairman goes to the Senate first, and once a year, he goes to the House first. Since, in this rotation, he went to the Senate first, one assumes that there will be no opportunities to game the stock market today. Those all happened yesterday, so people can stay through the whole hearing. Reporters won't have to leave to run to report to the wire services so people can hysterically overreact to the Chairman's perfectly sensible statements, which, of course, is the pattern. Although I know people who are in the market explain that they are not overreacting themselves—they are, in fact, reacting to other people's overreaction—the consequences are the same.

I say that because, in the interest of being able to have rational policy discussions unconstrained by irrelevant factors, I just would plead with people not to read excessively into what the Chairman says, and not to read excessively into what we say. We ought to be able to have rational conversations about the important topic of today's hearing without the overreactions. And I would say, since that may not be possible, as far as I am concerned, people overreact at their own peril. And I don't think the Chairman or anybody else should be held accountable because people engage in this form of anticipatory hysteria.

As to the subject at hand, and under the rules, there will be four opening statements—by myself, the ranking member of the full committee, the chairman of the Subcommittee on Domestic and International Monetary Policy, and the ranking member of the subcommittee—and the Chairman has very graciously agreed to stay until 2 p.m. I am deeply appreciative of this.

This is a very large committee. We will take one 15- to 20-minute break, and members can gauge appropriately. And we will be able to accommodate more of the members if we can. Mr. Chairman, again, I appreciate your willingness to do this.

I will be asking the Chairman about some of the specifics of his testimony, and of the areas particularly relevant to monetary policy, but I want to begin with an expression of disappointment, not in Chairman Bernanke, but in the business community and many of my conservative colleagues. I believe that we are at a very sensitive point in the making of economic policy in this country.

There is, on the part of the business community and many of its supporters, the view that a full embrace of globalization—of technological change, essentially of public policies that allow capital to be fully mobilized and fully mobile, and able to be employed to its best use—is in the best interests of society as a whole.

For some time now, until fairly recently, that was the governing policy in the United States, and in much of the rest of the world.

That has now come to an end, I believe temporarily, perhaps for a long temporary period, because increasingly, average citizens, in America and in other countries, have come to doubt that the growth that results from this policy of entirely free capital to move to wherever it finds its best return, people have come to doubt that this is in their interest. Indeed, there are a large number of people throughout the world who believe that they are being hurt by this.

And in consequence, we are at a policy deadlock. I think people should understand that the chances of an extension of trade promotion authority going through are quite slender at this point, unless there is some change in the attitude of many who are its advocates.

My own view is that if they were, in fact, to come to an agreement in the Doha Round, that the resulting agreement—if they reach it as they currently talk about it—wouldn't pass the House of Representatives. There is resistance, in my view unfortunately, to the general approach that the President took on immigration.

In almost all of the important areas in which—and let me just say, this committee reported out earlier this week on a voice vote a bill for foreign investment, and there was a paradox. Because if you talk to the people in the business community, as the ranking member and I, and the former chairman of that subcommittee, and others involved in that, if you talked to them, they were, on the whole, pleased with the result because it was better than they had expected.

If you read some of the business press, they were concerned that it was too restrictive. Well, that is an example of where we are. It is a bill that was more restrictive than some might have liked on foreign investment, but better than some people expected reflecting this mood.

So I want to reiterate what I said earlier. Many of us are prepared to work towards policies that are pro growth, that do take advantage of what you have when capital is allowed to reach its best level and find its greatest return, when technology can be fully taken advantage of, but only if we put in place public policies that make sure that is more fairly shared, and in particular, that reverse the tendency which the Chairman has acknowledged, and I appreciate that, and which the President has acknowledged, that inequality has been growing.

As I said before, inequality is an essential part of a capitalist economy—no one is trying to get rid of it, at least no one sensible. But it can also become excessive to the point where it is socially harmful and economically beyond what is needed for the capitalist system.

We are at that point. We are at a point where there is an excessive amount of inequality in this economy. And it is growing, and not just in this economy. I recently read an article which said that in the last set of state elections in India, every chief minister who was seen as pro foreign was defeated in terms of the economy. So there is a worldwide concern. We see in Latin America where an anti-democratic left is threatening the democratic left in part because of this economic unhappiness.

I don't see any recognition of that. I regret that. But people who will continue to resist trying to do something about healthcare or trying to do something about the right of employees to join unions, even something as minimalist as the minimum wage should not be surprised when they run into absolute resistance to other things which they will argue are good for the economy.

With that, I call on the ranking member.

Mr. BACHUS. Thank you, Mr. Chairman, and I appreciate you holding this hearing. And Chairman Bernanke, thank you for your report. As you can see, on this committee, we share the same concerns, but we have different views on how to address those concerns and different philosophies. And as you come before us today, we are interested in your insights regarding not only monetary policy but also the state of the economy, and as the chairman specifically mentioned, global competitiveness and trade and issues of that nature.

Of course, when we talk about differences of philosophy—as the chairman and I have—on how to approach these issues, how one perceives the state of the economy greatly depends on one's point of view.

From my perspective, the economy appears strong and vibrant, and absent some unforeseen shock, likely to remain so. When I look at your report and the supporting economic data, I see vigorous 3.4 percent growth. I see low unemployment of 4.6 percent and inflation of 2.5 percent.

And in a society where opportunity awaits anyone who uses their talents and efforts to improve the standard of living for their family—opportunities are there, educational opportunities, and work opportunities, that is what I see from your report. I see 7½ million new jobs created since 2003.

I see a structurally sound economy performing as well as it did in the 1990's in what we now know is an artificial economic bubble.

Currently, I see strong 2.2 productivity increases and record stock market levels not fueled by unrealistic dot.com speculation, but by globally competitive businesses.

I also see most Americans benefiting from the stock market growth through individual stock ownership and retirement funds.

In this environment, claiming that record corporate profits do not benefit most Americans—as some on this committee do—is not a valid argument.

Others have a different perspective. You have heard the chairman's perspective. And they see another reality. Some on this committee believe that the best way to create jobs and promote economic growth is through aggressive trade restrictions and barriers.

While I recognize the need to help those economically displaced or as the chairman says, hurt, by global forces beyond their control, economic experience does not lead me to the conclusion that protectionism or isolationism is an appropriate response.

Some think we need to somehow mandate the elimination of income disparities. While I share the exasperation of the chairman over some of the outrageous CEO compensation recently reported, I believe our corporate governance system works and that shareholders will correct these abuses without Government interference. I believe education, not government attempts to redistribute income, is the proven route to improve wages for all workers.

Chairman Bernanke, the members of this committee, Republicans and Democrats alike, respect your experience, your judgment and your obvious commitment to keeping America's economy strong and competitive. We all share a goal of doing that and doing what is best for American workers. We appreciate you being here and look forward to hearing your comments.

The CHAIRMAN. The gentleman from Illinois, the chairman of the Subcommittee on Domestic and International Monetary Policy is recognized.

Mr. GUTIERREZ. Thank you, Mr. Chairman. And thank you, Chairman Frank. Chairman Bernanke, I think it is safe to say that you and I have different backgrounds and that we bring disparate perspectives to the table when dealing with economic and monetary issues. But after taking over the chairmanship of the Monetary Policy Subcommittee, I am getting a sense of the significant and daunting task that you face.

You should rest assured, however, that I will be here over the next 2 years, along with 443 Members of the House and 100 Members of the other body, to second-guess your every move.

When it comes to economic and monetary policy, we are entering a very crucial and complex period, especially for the Federal Reserve and its mandate of maximum employment, stable prices, and moderate long-term interest rates.

For example, the housing boom has taken a substantial downturn. Energy prices have climbed and we are facing some serious issues about our long term energy security. Some economists warn the threat of inflation is on the horizon. Yet others appear less worried about inflation than the rising mortgage delinquencies and foreclosures effecting a wider economy.

The two major Asian currencies are undervalued, and the U.S. trade deficit is at record highs, while accusations of currency manipulations are frequently leveled against both China and Japan. And perhaps most important of all, we face a huge Federal deficit at a time when baby boomers are reaching retirement age and healthcare costs are at an all time high.

While I am anxious to hear from you, Mr. Bernanke, what concerns me most is retirement insecurity. When it comes to kitchen table issues, retirement insecurity is the obstacle for many American families. The U.S. economy is now producing over $13 trillion a year. But many American families are struggling just to maintain their living standards and they are up against stagnating wages, diminishing healthcare, and retirement benefits that are just disappearing.

More and more families are living paycheck-to-paycheck with very little in their bank accounts or none at all, and paying higher interest rates and more fees than they should. And hanging over their heads is retirement.

I know, Chairman Bernanke, that you have publicly addressed the related issues of retirement insecurity, the budget deficit, and the looming retirement of 78 million baby boomers on several occasions. But from what I have heard and read, you have approached the problem only in terms of entitlement reform. Entitlement reform is needed. No question. But this is not just an issue of entitlement reform. The skyrocketing cost of healthcare are not just going to disappear if we reduce entitlement spending. The costs will just be shifted to already strapped family budgets. Many baby boomers are simply not financially ready for retirement. If we substantially cut healthcare, and Social Security spending for the baby boomer generation, many will face healthcare crises that will drive them into bankruptcy.

The correlation between rising healthcare expenses and personal bankruptcy filings is well-documented. And merely moving these expenses from the public sector to the American families, in my opinion, is not good for long-term economic growth. We need more than entitlement reform to give Americans retirement security. I would like to hear your views on this today.

Clearly, no single political party and no single body, the Fed, the Congress, or the Administration, has the answers to the problems we face. We must work together. And I look forward to an open frank dialogue with the Federal Reserve, my subcommittee counterpart, Dr. Paul, and the Treasury Department on all these issues. And I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, the ranking member of the subcommittee.

Dr. PAUL. Thank you, Mr. Chairman, and welcome, Chairman Bernanke. I am very pleased to be here today as the ranking member. In the midst of a great optimism of monetary policy and how the economy is doing, I still have some concerns. And of course, one of my long-term goals has always been to emphasize maintaining the integrity of the monetary unit, rather than looking superficially at some of our statistics. But I also share the concern of the chairman of the committee of our responsibilities for oversight and your interest as well, Chairman Bernanke, on having the transparency that I think we all desire.

Transparency in monetary policy is a goal we should all support. I have often wondered why Congress has so willingly given up this prerogative over monetary policy.

Congress, in essence, has ceded total control of the value of our money to a secretive central bank. Congress created the Federal Reserve, yet it had no constitutional authority to do so. We forget that those powers not explicitly granted to the Congress by the Constitution are inherently denied to the Congress, and thus, the authority to establish a central bank was never given.

Of course, Jefferson and Hamilton had that debate early on and the debate seemingly was settled in 1913. But transparency and oversight are something else, and they are worth considering. Congress—although not by law—essentially has given up all its oversight responsibilities over the Fed.

There are no true audits. Congress knows nothing of the conversations, the plans, and the action taken in concert with other central banks. We get less and less information regarding the money supply each year, especially now that we don't even have access to M3 statistics.

The role the Fed plays in the President's secretive working group on financial markets goes essentially unnoticed by Congress. The Federal Reserve shows no willingness to inform Congress voluntarily about how often the working group meets, what action it takes that affects the financial markets, or why it takes these actions.

But all these actions directed by the Federal Reserve alter the purchasing power of our money, and that purchasing power is always reduced. The dollar today is worth only 4 cents compared to the dollar that the Federal Reserve started with in 1913. This has significant consequences on our economy and our political stability. All paper currencies are vulnerable to collapse and history is replete with examples of great suffering caused by these collapses, especially to the Nation's poor and middle class.

This can lead to political turmoil as well. Even before a currency collapses, the damage done by a fiat system is significant. Our monetary system insidiously transfers wealth from the poor and the middle class to the privileged rich. Wages never keep up with profits on Wall Street and the banks, thus sowing the seeds of class and discontent.

When economic trouble hits, free markets and free trade are often blamed, while the harmful effects of a fiat monetary system are ignored.

We deceive ourselves that all is well with the economy and ignore the fundamental flaws that are a source of growing discontent among the various groups. Few understand that our consumption and apparent wealth is dependent on a current account deficit running at approximately $800 billion a year.

This deficit shows that much of our prosperity is based on borrowing rather than a true increase in production. Statistics show year after year that our productive manufacturing jobs continue to go overseas. This phenomenon is not seen as a consequence of the international fiat money system where the U.S. Government benefits as the issuer of the world reserve currency.

Government officials consistently claim that inflation is in check at barely 2 percent, but middle class Americans know that their purchasing power—especially when it comes to housing, energy, medical care, and school tuition—is shrinking much faster than 2 percent per year.

Even if prices are held in check in spite of our monetary inflation, concentrating on the CPI statistics distracts from the real issue.

We must address the important consequences of the Fed manipulation of interest rates. When interest rates are artificially low, below market rates, insidious malinvestment, and excessive indebtedness inevitably brings about the economic downturns that everyone dreads.

We look at GDP figures and reassure ourselves that all is well. Yet a growing number of Americans still do not enjoy the high standard of living that monetary inflation brings to the privileged few. Those who benefit the most are the ones who get to use the newly created credit first—

The CHAIRMAN. The gentleman's time has expired. If the gentleman will come to a conclusion.

Dr. PAUL. I will yield back.

The CHAIRMAN. I will now turn to the Chairman. And he is recognized for his opening statement.

Thank you.

STATEMENT OF HON. BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Chairman Frank, Representative Bachus, and other members of the committee, I am pleased to present the Federal Reserve Monetary Policy Report to the Congress. Real activity in the United States expanded at a solid pace in 2006, although the pattern of growth was uneven.

After a first quarter rebound from weakness associated with the effects of the hurricanes that ravaged the Gulf Coast in the previous summer, output growth moderated somewhat on average over the remainder of 2006. Real Gross Domestic Product is currently estimated to have increased at an annual rate of about 2¾ percent in the second half of the year.

As we anticipated in our July report, the U.S. economy appears to be making a transition from the rapid rate of expansion experienced over the preceding several years to a more sustainable average pace of growth.

The principal source of the ongoing moderation has been a substantial cooling in the housing market which has led to a marked slowdown in the pace of residential construction.

However, the weakness in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other sectors of the economy.

Consumer spending has continued to expand at a solid rate, and the demand for labor remains strong. On average, about 165,000 jobs per month have been added to nonfarm payrolls over the past

6 months. And the unemployment rate, at 4.6 percent in January, remains low.

Inflation pressures appear to have abated somewhat following a run-up during the first half of 2006. Overall, inflation has fallen in large part as a result of declines in the price of crude oil. Readings on core inflation—that is inflation excluding the prices of food and energy—have improved modestly in recent months. Nevertheless, the core inflation rate remains somewhat elevated.

In the five policy meetings since the July report, the Federal open market committee, or FOMC, has maintained the Federal funds rate at 5¼ percent. So far, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing of core inflation.

However, in the statement accompanying last month's policy decision, the FMOC again indicated that its predominant policy concern is the risk that inflation will fail to ease as expected, and that it is prepared to take action to address inflation risks, if developments warrant.

Let me now discuss the economic outlook in a little more detail beginning with developments in the real economy and then turning to inflation. I will conclude with some brief comments on monetary policy.

Consumer spending continues to be the mainstay of the current economic expansion. Personal consumption expenditures, which account for more than two-thirds of aggregate demand, increased at an annual rate of around 3½ percent in real terms during the second half of last year, broadly matching the brisk pace of the previous 3 years.

Consumer outlays were supported by strong gains in personal income reflecting both the ongoing increases in payroll employment and a pickup in the growth of real wages.

Real hourly compensation, as measured by compensation per hour in the nonfarm business sector deflated by the personal consumption expenditures price index, rose at an annual rate of about 3 percent in the latter half of 2006.

The resilience of consumer spending is all the more striking, given the backdrop of the substantial correction in the housing market that became increasingly evident during the spring and summer of last year.

By the middle of 2006, monthly sales of new and existing homes were about 15 percent lower than a year earlier, when the previously rapid rate of house price appreciation had slowed markedly. The fall in housing demand in turn prompted a sharp slowing in the pace of construction of new homes. Even so, the backlog of unsold homes rose from about 4½ months' supply in 2005 to nearly 7 months' supply by the third quarter of last year.

Single family housing starts have dropped more than 30 percent since the beginning of last year. And employment growth in the construction sector has slowed substantially.

Some tentative signs of stabilization have recently appeared in the housing market. New and existing home sales have flattened out in recent months. Mortgage applications have picked up. And some surveys find that homebuyers' sentiment has improved.

However even if housing demand falls no further, weakness in residential investment is likely to continue to weigh on economic growth over the next few quarters as homebuilders seek to reduce their inventory of unsold homes to more comfortable levels.

Despite the ongoing adjustments in the housing sector, overall economic prospects for households remain good. Household finances appear generally solid. And delinquency rates on most types of consumer loans and residential mortgages remain low. The exception is subprime mortgages with variable interest rates for which delinquency rates have increased appreciably.

The labor market is expected to stay healthy. And real incomes should continue to rise, although the pace of employment gains may be slower than those to which we have become accustomed in recent years.

In part, slower average job growth may simply reflect a moderation in economic activity. Also, the impending retirement of the leading edge of the baby boom generation, and an apparent leveling out of women's participation in the workforce, which had risen for several decades, will likely restrain the growth of the labor force in coming years.

With fewer job seekers entering the labor force, the rate of job creation associated with the maintenance of stable conditions in the labor market will decline.

All told, consumer expenditures appear likely to expand solidly in coming quarters, albeit a little less rapidly than the growth in personal incomes if, as we expect, households respond to the slow pace of home equity appreciation by saving more out of current income.

The business sector remains in excellent financial condition with strong growth in profits, liquid balance sheets, and corporate leverage near historical lows. Last year, those factors helped support continued advances in business capital expenditures.

Notably, investment in high tech equipment rose 9 percent in 2006. And spending on nonresidential structures such as office buildings, factories, and retail space increased rapidly through much of the year after several years of weakness.

Growth in business spending slowed toward the end of last year, reflecting mainly a deceleration of spending on business structures, a drop in outlays in the transportation sector where spending is notably volatile, and some weakness in purchases of equipment related to construction and motor vehicle manufacturing.

Over the coming year, capital spending is poised to expand at a moderate pace, supported by steady gains in business output and favorable financial conditions. Inventory levels in some sectors, most notably in motor vehicle dealers and in some construction-related manufacturing industries, rose over the course of last year leading some firms to cut production to better align inventories with sales. Remaining imbalances may continue to impose modest restraints on industrial production during the early part of this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad helped spur a robust expansion in U.S. real exports, which grew about 9 percent last year. The pattern of real U.S. imports was somewhat uneven partly because of fluctuations in oil imports over the course of the year. On balance, import growth slowed in 2006 to 3 percent.

Economic growth abroad should further support steady growth in U.S. exports this year. Despite the improvements in trade performance, the U.S. current account deficit remains large, averaging about 6½ percent of nominal GDP during the first three quarters of 2006.

Overall, the U.S. economy seems likely to expand at a moderate pace this year and next with growth strengthening somewhat as the drag from housing diminishes.

Such an outlook is reflected in the projections that the members of the Board of Governors and presidents of the Reserve Banks made around the time of the FOMC meeting late last month. The central tendency of those forecasts—which are based on information available at that time and on the assumption of appropriate monetary policy—is for real GDP to increase about 2½ to 3 percent in 2007, and about two- or three-quarters to 3 percent in 2008.

The projection for GDP growth in 2007 is slightly lower than our projection last July. This difference partly reflects an expectation of somewhat greater weakness in residential construction during the first part of this year than we anticipated last summer.

The civilian unemployment rate is expected to finish both 2007 and 2008 around 4½ to 4¾ percent.

The risks to this outlook are significant. To the downside, the ultimate extent of the housing market correction is difficult to forecast and may prove greater than we anticipate.

Similarly, spillover effects from the developments in the housing market onto consumer spending and employment and housing related industries may be more pronounced than expected.

To the upside, output may expand more quickly than expected if consumer spending continues to increase at the brisk pace seen in the second half of 2006.

I turn now to the inflation situation. As I noted earlier, there are some indications that inflation pressures are beginning to diminish. The monthly data are noisy, however, and it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated.

Recent declines in overall inflation have primarily reflected lower prices for crude oil, which have fed through to the prices of gasoline, heating oil and other energy products used by consumers.

After moving higher in the first half of 2006, core consumer price inflation has also edged lower recently reflecting a relatively broad-based deceleration in the prices of core goods. That deceleration is probably also due, to some extent, to lower energy prices, which have reduced costs of production, and thereby lessened one source of pressure on the prices of final goods and services.

The ebbing of core inflation has likely been promoted as well by the stability of inflation expectations.

A waning of the temporary factors that boosted inflation in recent years will probably help foster a continued edging down of core inflation.

In particular, futures quotes imply that oil prices are expected to remain well below last year's peak.

If actual prices follow the path currently indicated by futures prices, inflation pressures would be reduced further as the benefits of the decline in oil prices from last year's high levels are passed through to a broader range of core goods and services.

Nonfuel import prices may also put less pressure on core inflation particularly if price increases for some other commodities, such as metals, slow from last year's rapid rates. But as we have been reminded only too well in recent years, the prices of oil and other commodities are notoriously difficult to predict. And they remain a key source of uncertainty in the inflation outlook.

The contribution from rents and shelter costs should also fall back following a step up last year. The faster pace of rent increases last year may have been attributable in part to the reduced affordability of owner-occupied housing which led to a greater demand for rental housing. Rents should rise somewhat less quickly this year and next reflecting recovering demand for owner-occupied housing as well as increases in the supply rental units. But the extent and pace that of that adjustment is not yet clear.

Upward pressure on inflation could materialize if final demand were to exceed the underlying productive capacity of the economy for a sustained period. The rate of resource utilization is high, as can be seen in rates of capacity utilization above their long term average, and most evidently, in the tightness of the labor market.

Indeed anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in certain occupations. Measures of labor compensation—though still growing at a moderate pace—have shown some signs of acceleration over the last year, likely, in part, as the result of tight labor market conditions.

The implications for inflation of faster growth in nominal labor compensation depend on several factors. Increases in compensation might be offset by higher labor productivity or absorbed by a narrowing of firm's profit margins rather than passed on to consumers in the form of higher prices. In these circumstances, gains in nominal compensation would translate into gains in real compensation as well. Underlying productivity trends appear favorable. And the markup of prices over unit labor costs is high by historical standards, so such an outcome is certainly possible.

Moreover, if activity expands over the next year or so at the moderate pace anticipated by the FOMC, pressures in both labor and product markets should ease modestly. That said, the possibility remains that tightness in product markets could allow firms to pass higher labor costs through to prices, adding to inflation and effectively nullifying the purchasing power of at least some portion of the increase in labor compensation. Thus, the high level of resource utilization remains an important upside risk to continued progress on inflation.

Another significant factor influencing medium term trends in inflation is the public's expectations of inflation. These expectations have an important bearing on whether transitory influences on prices, such as those created by changes in energy costs, become embedded in wage and price decisions, and so leave a lasting imprint on the rate of inflation.

It is encouraging that inflation expectations appear to have remained contained. The projections of the members of the Board of

Governors and the presidents of the Federal Reserve Banks are for inflation to continue to ebb over this year and next. In particular, the central tendency of those forecasts is for core inflation—as measured by the price index for personal consumption expenditures excluding food and energy—to be 2 to 2¼ percent this year and to edge lower to 1¾ to 2 percent next year. But as I noted earlier, the FMOC has continued to view the risk that inflation will not moderate as expected as the predominant policy concern.

Monetary policy affects spending and inflation with long and variable lags. Consequently, policy decisions must be based on an assessment of medium term economic prospects. At the same time, because economic forecasting is an uncertain enterprise, policy makers must be prepared to respond flexibly to developments in the economy when those developments lead to a reassessment of the outlook.

The dependence of monetary policy actions on a broad range of incoming information complicates the public's attempts to understand and anticipate policy decisions. Clear communication by the central bank about the economic outlook, the risk to that outlook, and its monetary policy strategy, can help the public to understand the rationale behind policy decisions and to anticipate better the central bank's reaction to new information. This understanding should, in turn, enhance the effectiveness of policy and lead to improved economic outcomes.

By reducing uncertainty, central bank transparency may also help anchor the public's longer term expectations of inflation. Much experience has shown that well-anchored inflation expectations help to stabilize inflation and promote maximum sustainable economic growth.

Good communication by the central bank is also vital for ensuring appropriate accountability for its policy actions, the full effects of which can be observed only after a lengthy period.

A transparent policy process improves accountability by clarifying how a central bank expects to attain its policy objectives and by ensuring that policies are conducted in a manner that can seen to be consistent with achieving those objectives.

Over the past decade or so, the Federal Reserve has significantly improved its methods of communication, but further progress is possible. As you know, the FOMC last year established a subcommittee to help the full committee evaluate the next steps in this continuing process. Our discussions are directed at examining all aspects of our communications and have been deliberate and thorough. These discussions are continuing and no decisions have been reached. My colleagues and I remain firmly committed to an open and transparent monetary policy process that enhances our ability to achieve our dual objectives of stable prices and maximum sustainable employment.

I will keep members of this committee apprised of developments as our deliberations move forward. I look forward to continuing to work closely with the members of this committee and your colleagues in the Senate and the House on the important issues pertaining to monetary policy and the other responsibilities with which the Congress has charged the Federal Reserve. Thank you. I would be happy to take questions.

[The prepared statement of Chairman Bernanke can be found on page 71 of the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman. I have to say that when you say you would be happy to take questions, you were somewhat more persuasive than when your predecessor used to say that.

And I will apologize in advance to the media, because you have, I think, over the past months in particular, said some very reasonable things from my standpoint, so I have less to complain about than they might have hoped, I am sure, in Karl Rove's eyes, so they should not lose heart.

I particularly want to begin by thanking you for the very appropriately nuanced discussion of wages. It has troubled me for some time, and particularly when I read some of the financial pages, that there is a good news, bad news story. The good news is that profits are up; the bad news is that wages are up. And wages are too often written about as if they were simply a constraint on prosperity.

I particularly appreciate on page 7 of your testimony where you note that an increase in wages, certainly to the level of productivity, should not be a problem, and that in general, there is nothing automatic about a rise in wages leading to inflation.

It depends on the impact on prices. And in that context, I especially welcome your noting that not only the underlying productivity trends appear favorable—and this is in your discussion of wages and inflation. Underlying productivity trends appear favorable and the markup of prices over unit labor costs is high by historical standards.

I hope this is widely noted, your statement that, in fact, it would not appear to be wage driven pressure to raise prices, because as you note, the markup of prices over cost in this regard is high by historical standards.

I would add you did not cover that, it was not in your topic, that there has also been a reduction in the tax burden. So we ought to be clear that this simplistic notion that if wages go up, that is going to cause inflation, is not the case, and that, in fact, there is, as you say, and I appreciate this, some reason, some room for legitimate wage increases to be absorbed without that being inflationary.

Now, there is, however, some bias still in the way we talk about things. And I did note that there was great relief that you apparently indicated yesterday that it is unlikely that you will be presiding over increases in interest rates in the future. But as I read your report, it seems to me that frankly, the question ought to be whether or not there are decreases. In the Monetary Policy Report, on the first page of your—let me read two statements: "On balance growth of real Gross Domestic Product appears likely to run slightly below that of the economy's potential over the next few quarters, and then to rise to a pace around that of the long run trend."

Next paragraph. "Regarding inflation increases in core consumer prices are expected to moderate on balance over the next 2 years." In other words, the prediction is, economic growth below the economy's potential for a while, and then reaching potential but not going above it.

Similarly, "inflation is going to moderate an economy performing somewhat", not enormously, but "somewhat below potential tending towards potential and inflation that is expected to moderate." I suppose that would be an argument for balance if nothing changes. But I don't see how we get a concern of inflation as the major concern here.

And as you say, well, but you're still worried more about inflation and the sense is, stop him before he raises again, but no likelihood of a drop.

I don't understand why this shouldn't make it at least as likely as a drop. Again, we have an economy that is running below potential and we have moderating inflation. Why is that not at least an equal chance for there to be a reduction in the time ahead?

Mr. BERNANKE. Mr. Chairman, first of all, policy is going to respond to new information. We are going to be continually reassessing our outlook and responding appropriately as we see the economy evolving. Policy also has to respond to risks. There are risks in both directions. On the real side, I talked about housing as a downside risk, but there is also some upside risk.

We have seen very strong consumer spending numbers. We have seen some strong income growth which suggests that the economy may be stronger than we think. It is possible. And in a sense, aggregate spending may exceed our capacity and put pressure on product markets, and that would be a concern.

The other issue is on inflation. We have had a period where inflation has been above where we would like to see it as far as consistency with price stability is concerned.

In order for this expansion to continue in a sustainable way, inflation needs to be well-controlled. If inflation becomes higher for some reason, then the Federal Reserve would have to respond to that by raising interest rates. That would not contribute to the continued—

The CHAIRMAN. I understand that, Mr. Chairman, but you know, I am a little puzzled—you tell me that your report says production below potential rising to potential. But then you say, well, you think it might be more than you think. I mean, if you think it might be more than you think, why didn't you think it? It does seem to be a little odd for you to say that here is what I think, but I also think it might be worse than I think.

That is literally double-think.

And what particularly concerns me, I read those two sentences, production now below potential, and prediction only to get to potential not above it, and inflation moderating, and I don't see how that computes with, as I noted earlier, the FOMC has continued to view the risk that inflation will not be moderated as the predominant policy concern.

I can understand it being a concern. I don't understand how, given this, it outweighs the other.

And let me say in that regard, and I more or less stick to time limits, I appreciate your discussion about transparency on—and your discussing this. And I do want to—let me point—there he is.

When I came to Congress, in 1981, the open market committee was, from the standpoint of publicity, the closed market committee because it did not even announce on the day of the vote what the vote was. And that gentleman up there, Mr. Gonzalez of Texas, crusaded, I think, effectively and appropriately, for some transparency. We have much more.

Here is my concern. When you talk about changing the way you communicate uncertainty, here is the problem. It is easier for you to be certain about what you want the interest rate to be than about what you want employment to be, because you have more control of one than the other. I admire the desire for more transparency. I express my concern that procedure and substance may intermix here and that the argument for greater certainty can become—and you say we have the two objectives, stable employment—stable prices and employment.

But one of those might—I appreciate the fact that you have two children and you love them both. But I am afraid that one of them might get a little bit more for Hanukkah than the other if we are not careful. So I do want to ask that we be kept involved in this process.

But I also want to reiterate from the standpoint of what I talked about before from the social health of this country—and I will close. I know there are people saying that the economy is very good. Let me be partisan for a minute. I say to my Republican friends, keep telling the American people how good the economy is, because the disparity between what you tell them is happening and what they feel themselves makes them even angrier.

But if inflation is the predominant concern, given your own statements, it seems to me that you have made an argument that it ought to be at least balanced; that is troubling to me.

Mr. BACHUS. Thank you. Chairman Bernanke, the chairman mentioned the economy and our different perspectives and our viewpoints. The chairman and others have said that all these 7.5 million new jobs that have been created are all low-income workers. They are not higher paying jobs. I notice that the Bureau of Labor statistics job data that was released just yesterday indicates that job creation was roughly distributed across the income spectrum.

Can you tell me why there is a perspective and whether it is true that this viewpoint that all these new jobs are low income, when I say that the recovery is benefiting the middle class and the creating higher paying jobs?

Mr. BERNANKE. Well, in terms of the distribution of jobs, as I mentioned in my testimony, there is an enormous demand for highly skilled workers and of high-paying jobs. And the constraints on the highest paying jobs, for example in manufacturing, is not the demand but the supply. Firms can't find workers of sufficient qualifications in many different areas. So there certainly has been job creation at the high level as well as throughout the distribution of wages.

Mr. BACHUS. So the economy is, in fact, creating so many highly paid, skilled jobs that there simply is not the workforce to fill those jobs?

Mr. BERNANKE. As I have indicated recently, I think one of the major constraints in our economy and one of the sources of concern about equality and inequality has to do with educational differentials. And the more that we can help people acquire sufficient skills so that they can be eligible for those high-paying jobs, the better off we are going to be.

Mr. BACHUS. Thank you.

The chairman said he was more pleased with you than he has been in the past. And I am sure that he read the same article I read in The American Banker, where it was titled that you had endorsed the GSE housing fund—that the affordable housing fund that the chairman put forward.

When I saw your testimony I didn't see that in it at all. But let me ask you this question. There is a philosophical debate going on in this committee about the creation of these funds, government control, government mandate, government-directed funds. There really are two of them. One that has gotten all the publicity is the affordable housing fund, to which the GSE's will be required to pay a portion of their revenue.

And members of this committee, at least Republican members, we see this as an added cost to low- and middle-income homeowners. Now, I think across the—I will call this the divide, across the divide, there is an agreement that the GSE's could do a better job on their affordable housing mission. But we are very skeptical that if you take money that is designated to provide liquidity for people to buy homes, you either increase the cost of that home, of that home mortgage, or the availability of that home mortgage, and we think there is a better way than a government-dictated plan. Clearer maybe than that is the other proposal that has achieved almost no publicity, and we had a spirited debate in this committee 2 days ago, is that my Democratic colleagues are endorsing an insurance company's funding of a community reinvestment fund. Massachusetts created such a fund in 1998 where insurance companies are directed to pay a part of their income into a fund which the, I guess the State of Massachusetts, directs into affordable housing or community investment projects.

And we debated that because we Republicans felt that when we pay our premiums to an insurance company, we want that money to be invested at the highest possible return so that claims can be paid. We feel like the proper role of an insurance company is not to take our money, an insured's money, and invest it in some community's project, we feel that the proper role for them is to pay claims.

So I just ask you, first of all, would you clarify your remarks over in the Senate, or is there any clarification needed, and do you have any unease over the creation of more government funds of this nature, and the cost on American homeowners or any of us who pay premiums to insurance companies?

Mr. BERNANKE. Congressman, the story was misreported, and you misunderstand my position. I did not address the affordable housing fund, either pro or con. The concern that the Federal Reserve has had for a long time about GSE's is the potential for their portfolios to create systemic risk in our financial system. I should say that we very much support the GSE's housing mission, and we believe, in particular, that the securitization function contributes to liquidity in the mortgage market. Again, our concern is about the portfolios and their enormous size and the complex derivative exercises that are needed to maintain the balance of those portfolios.

My comment was one that built on suggestions that Chairman Greenspan had made in previous testimonies, which was that one way to limit the growth of the portfolios, but also to achieve the stated public purpose of the GSE's was, in some way, to anchor the portfolios in the public purpose, which is affordable housing.

According to OFHEO, only about 30 percent of the portfolios are related in any way to affordable housing. So I think what I would like to see would be the portfolios to be more directly connected to a public purpose, perhaps holding affordable housing mortgages or another way, more directly promoting affordable housing rather than acquiring all different kinds of assets that are not related to affordable housing.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Mr. Chairman, welcome to the committee. It is fascinating to listen to the discussion, and obviously long-ranging, but I have a few questions in regard to the emphasis in the public press over the last several months on executive salaries and what the appropriate response would be to them.

First of all, I would like your opinion as to how they rate on that scale of fair or unfair—whether or not they should be subjected to oversight, and if subjected to oversight, should they be subjected to some curative action by the Congress? In particular, we are looking at the U.K.'s shareholders' rights approach and their ability to give advisory opinions on executive packages.

If you can summarize, in some way, your views and what the effect of that would be, positively or negatively on the market and the economy, it would be most appreciated.

Mr. BERNANKE. Thank you. I think it is very important for shareholders to be aware of compensation packages that CEO's are receiving. So if they are displeased, they can register that displeasure through the directors or through selling stock. So I strongly support disclosure efforts. The Securities and Exchange Commission recently built on the efforts of the exchanges, the NYSE, for example, in requiring more extensive disclosure of compensation packages on details. I think that is a very important step in the direction of making sure that shareholders have full information so they can make appropriate decisions about whether these packages are in the interest of the company or not.

Mr. KANJORSKI. Do you have any opinion as to the United Kingdom's approach of actually enacting advisory opinions expressed by shareholders and whether or not that has had any positive effect on the reduction of some of these packages and/or other shareholders rights, litigation, and other things that may have been modified? When you look at the numbers, the U.K. is significantly lower than the American market. We are wondering whether that is something that has been reviewed by the Federal Reserve?

Mr. BERNANKE. In general, the CEO salaries are lower in Europe than the United States, and, to some extent, it is a puzzle why that is the case. I think there are a lot of reasons for it. But certainly, one thing we want to be sure we are doing is ensuring good disclosure and good oversight.

I don't really have an opinion on the advisory council. I think we should be sure that the compensation decisions are being made in a disinterested independent way, and that the directors who are involved in compensation are independent, and not subject to the influence of the management.

Mr. KANJORSKI. Very good. If you rate on a scale of what is economically fearful in our society today, particularly the domestic economy, what would be the greatest fear that you have?

Mr. BERNANKE. There is a set of issues that are interconnected, having to do with savings and deficits and current account and so on. We are a low-saving society in general, and we are facing a demographic transition which will mean that a much larger share of our population is of retirement age or outside the workforce. That is going to pose enormous challenges to our fiscal budget. It is also going to pose enormous challenges to our economy as a whole, because with fewer workers, we need to have more capital, more savings, and more preparation for the economy to be able to absorb a larger number of retired workers. Related to that, of course, is the increase in medical care costs which also puts pressure on fiscal policy.

So the fiscal issues in the low savings rates, which also contribute to the current account deficit, I think are at the center of the issues we should be concerned about. We really need to address our savings issues and the implications of the demographic transition that we are seeing not very far in the future.

Mr. KANJORSKI. What role should Congress or the government play in that?

Mr. BERNANKE. The government needs to address both the fiscal implications of aging—certainly a part of that is the cost of medical care, which is a big part of the economic cost of aging—and also of the fiscal burden. And to the extent that outside of the fiscal arena we can find ways to encourage savings more broadly, and asset-building, I think that would be very constructive.

Mr. KANJORSKI. So you see a very positive role for government to play?

Mr. BERNANKE. Good policies would certainly be helpful, yes.

The CHAIRMAN. The Chair wants to announce, in recognizing members, that the two parties follow different patterns, and the Chair is accepting the ranking member's suggestions. So you may notice some disparity. We go by seniority; they go by, I guess, when members arrive.

I want to explain that part because a recent analysis of what I am thinking made a great deal of the fact that a certain witness will be testifying tomorrow, and the witness is the choice of the gentleman from Texas. So I realize that people may not be fully aware of what we are doing.

Next on the list is the gentleman from Louisiana.

Mr. BAKER. I thank the chairman.

Chairman Bernanke, following up in some measure on the course relative to problems of significance going forward, there are undoubtedly negative effects of the inversion in the workforce, where we have more people retired, and less people working.

At the same time, though, there has been an offsetting growth that has been, frankly, surprising to me at the number of investors in equities over the last 2 decades. I was particularly struck by the fact, according to the mutual fund industry, that in households with aggregate annual incomes of less than $35,000, 31 percent hold mutual fund holdings. What it triggers for me is an understanding by working families that for their long-term financial security, they need to be invested in the markets.

Now, we can debate whether it is index investing, whether or not actively managed is good or not. The bottom line is, if you are going to do something beyond your earnings from salary, investing in overall economic growth is a very sound policy, particularly for the younger and newer entries into the workforce.

There are now issues, I believe, in international competitiveness that are overhangs that cause concern, whether it be potential for class action litigation, whether it is the wage—excuse me, the tax rates here as contrasted with those in Europe, and there seems to be certainly an outflow of manufacturing-type employment to other countries, leaving us with a more technology-based economy going forward.

Having said all of that, it seems that with the percentage of Federal spending in 1956 at—20 percent of Federal spending was on Social Security and related entitlements; today we see that crossing over 60 percent. Given your comment and concern as to the biggest problem facing us, how do we provide for retirement security for working families?

It seems most Americans have figured that out; they need to be in the markets. Isn't it time for this Congress to really seriously consider voluntary, not saying mandated requirement, but voluntary flexibility and directing your Social Security or retirement savings into market-invested, market-based investments? It would seem to me that the sooner we get out or away from these enormous entitlement obligations with the inversion in the workforce and the expectations of most people to retire at age 65, that there isn't a way out of this morass without allowing people to share in the overall economic prosperity of this Nation through some sort of equities investment.

If we don't do that, what is the solution to the retirement problem we face?

Mr. BERNANKE. I think it is very valuable for people to have the opportunity to own an account, to have some exposure to investment even if it is in index funds which you point out, so that people have the pride of knowing that they are providing for their own retirement. So I think it is a very good idea to encourage people to begin to build wealth, and to begin to hold assets.

As you know, the Social Security aspect of this is a very complex debate. The diverting of funds the way you describe has some of the benefits of giving people the opportunity to have control over their own accounts, but it also doesn't really directly address the long-term imbalance on the fiscal side of the spending and revenues of the Social Security system.

Another approach, which is related and might work better without addressing the Social Security concern directly would be to have add-on accounts where people would have the option to put in additional moneys that could be invested in—

Mr. BAKER. If I may before my time expires, just as a quick follow-up, the rate of return, though, on the Social Security investment is currently so low that if you were to divert any portion of that into an active investment account, the yield would be so much greater than what you currently earn—and I know of your concern that current earnings are paying current retirees' benefits. I believe with the proper managed investment account over time, you could pay those current retirees' benefits and still have a yield sufficient left as a net margin that would beat the current rate of return for a Social Security recipient. In essence, we can accomplish both goals with a very carefully managed investment.

Mr. BERNANKE. I understand that position has been espoused. I think just one concern is that the historical outperformance of equities relative to bonds may reflect to some extent the higher riskiness of stocks. To some extent it is a risk premium, and you know—

Mr. BAKER. But there has never been a 10-year period when the market didn't beat Social Security.

The CHAIRMAN. It is a very deep issue about why equities have performed better than bonds. But if you look at stock markets in czarist Russia, they wouldn't look so good today. The United States has been very successful. We have had a growing economy. We have succeeded in escaping the Depression and World War II and so on. So in that respect our stock market may not be representative of the world's equities in some sense.

It is a very difficult question. I would only make the point that you cannot assume that equities will pay the high rate of return in the future that they have in the past. There certainly is some risk to that.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank Chairman Bernanke for being here this morning.

It is always good to have you before this committee discussing the important economic issues of the day. I worked to prepare a statement last evening, but I have decided not to read that statement because my staff just gave me this morning, remarks by Chairman Ben S. Bernanke on the level and distribution of economic well-being.

I just read it. I am extremely moved by your remarks, and I do think that you have taken a rather complicated issue and helped to remove it from simply a discussion of you either have education or you don't, you either are going to make it, pull yourself up by your bootstraps, kind of the government has no responsibility for that.

It is not that simple. And you talk about opportunity and ensuring a fairness and opportunity, but not guaranteeing any outcomes, and you talk about the responsibility of the individual, but in this discussion it was quite expansive.

I watched the closing of a Goodyear plant in Los Angeles when I first ran for office, and I saw people who had worked at that plant for 20, or 25 years who paid taxes, sent their kids to school, and had mortgages, suddenly out of a job, and I watched men go to the bar across the street from the plant for the next 5 or 6 years and just drink themselves into oblivion—not being retrained, unable to get jobs because of their age, etc. You kind of allude to that.

You also talk about the importance not only of formal education, K through 12, but also the other opportunities in our society for job training, the community colleges. You even allude to and talk a little bit about preschool, and of course, I am from Head Start. Having taught and worked in Head Start, I think that is extremely important, building self-esteem and certain kinds of values at an early age.

But I would like to hear you talk a little bit more about policy implications. Aside from that which you alluded to, you know, education through job training, etc., do you think there is room for perhaps tax incentives to corporations and businesses that do on-the-job training to make sure that people are trained for real jobs that are sustainable?

I would like to hear a little bit more about what you think we could do with public policy to close this growing income and wage gap. You discussed the superstars and CEO's and globalization and trade and all of that, and the bottom line is, there is this growing wage and income gap. What other policy possibilities can you share with us for helping to close this gap?

Mr. BERNANKE. Thank you for taking the time to read my speech. I know it wasn't a short set of remarks.

The broad point I am trying to make in those remarks is that I believe that technology and trade, which are tremendously important forces for American economic growth, unfortunately have the side effect that they sometimes cause dislocations, like the one you were just describing, and I think it is very important that we not respond to those dislocations by saying, "Well, we are going to stop trade, we are going to stop technological improvement." That is really doing more harm than good, I think.

So then the logical consequence is, if we want to protect people and help them deal with these dislocations, and we don't want to stop the processes that generate growth in our economy, we have to find other ways to help people adjust and adapt. And I talked about a number of general approaches in my remarks.

I do sincerely believe that what you know and what you can do is critical, that training—not just K–12 education, but all kinds of training—community colleges, junior colleges, online courses, training on the job—all those things are critical to getting people the skills they need so they will be in demand and be able to find good work when changes in the global economy mean that their Goodyear plant has shut down.

I also indicated in my remarks that we could perhaps reduce some of the anxiety about job loss if we didn't tie all benefits so directly to employment. So, for example, I think it is an issue that healthcare is so directly tied to employment.

Ms. WATERS. Portability of healthcare?

Mr. BERNANKE. Portability of health insurance would be, I think, a positive development. It would reduce the anxiety that people face when they worry about their jobs, and indeed, some of the anxiety which I hear a great deal about may be less what has actually happened than what people fear may happen. It is the insecurity rather than the actual outcome so far that people are worried about. So I think there are, you know, a number of general things we should try to do.

Now, one thing I also said in my remarks is that solving this problem is very, very difficult. How exactly we can make sure that training programs work effectively instead of just wasting money is very difficult. Finding the best way to make health insurance portable; there are lots of ways to approach it, but it is difficult.

So I turn it back to you, unfortunately. I think the Congress is going to have to think hard about the best ways to address these things, but they need to think about them.

Ms. WATERS. Mr. Chairman, I would like to ask unanimous consent to submit these remarks for the record.

The CHAIRMAN. Without objection.

The gentleman from Texas, Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

I would like to pursue the issue of the current account deficit. It seems like almost all economists express concern, some worry about it, but I can't find anybody who tells us that we should totally ignore it. And we do now borrow approximately $800 billion every year. We have a foreign debt of several trillions of dollars, and to me it represents an imbalance which is the consequence of the monetary system and presents a potential problem for us. Likewise, I see that potential problem in the number of derivatives out there. There is one figure that says there are $236 trillion of derivatives, and it seems like very few people understand exactly what that means, and it certainly is so huge and diverse. I don't even think the Congress that we have that is always anxious to regulate everything has offered a scheme for regulating derivatives because, quite frankly, I don't think they are capable of doing that.

Foreigners now own 43 percent of our debt, approximately twice as much as the Fed has been required to borrow. And one of the questions I have is how much pressure would it put on you if—I guess in even a theoretical sense, what if they didn't buy any of our debt, and all of a sudden you had to deal with that problem? Right now, there is a sign that maybe they are buying less. We have heard rumors and innuendos in the media and hints from China that, yes, they are not going to be buying as much, and yet there hasn't been really a crisis. There has been no panic, and we know there is self-interest on their part to maintain the dollar because they hold so many.

But in many ways I think we get a free ride. We get to export our dollars. We don't have to monetize them here. We get to export our inflation, but it potentially has a problem for us if all of a sudden they buy less, and these dollars come home or these dollars go into goods and services.

Also the other concern that I have that I would like you to address is the subject of the revaluation of the yuan. I understand you and Secretary Paulson went over to China to put pressure—at least the media presented it that way—put pressure on them to increase the value of the yuan and decrease the value of the dollar in relationship, which in reality, it seems to me, would put pressure on our interest rates and push our interest rates up and raise our prices. And some people have reported that couldn't possibly be our policy where we would deliberately want to do that. And then again, it would put more pressure on—I know it is an artificial arrangement right now.

But in some ways what the Chinese have done is they have revived the old Bretton Woods standard of fixing their currency to our dollar, and some people look longingly to the Bretton Woods days where we worked with fixed exchange rates. Of course, there were different conditions then.

But if you would, if you would address both what our position is with the Chinese yuan as well as what happens if they significantly—if the foreigners, especially Japan and China, start to buy a lot fewer dollars and how that would affect your policy.

Mr. BERNANKE. Thank you. You are correct that we are to some extent dependent on capital inflows to support the trade and current account deficits we currently have. The current demand for U.S. assets from abroad both from public and private sources remains strong, so there doesn't seem to be any immediate concern that will not continue. However, there is a risk sometime in the future that there would be less demand for dollar assets, and that could cause some movements in currency and bond markets that might be disruptive. And for that reason I have advocated, as many others in Congress have, that we have tried gradually to move our current account deficit down to a more sustainable level.

The way to do that essentially, it is a very complex subject, but essentially the current account deficit arises because of asymmetries in the saving investment balance here and abroad. In the United States we have a decent rate of investment, including construction of new homes, but relatively low saving rates, and that difference we have to borrow abroad, whereas in many other countries in East Asia, and among oil producers and the like, they have an excess of saving over investment, and they are lending us that difference, and that is why the capital flows are moving from abroad to the United States.

The way to adjust that, over time, is to create a better balance of savings and investment both in the United States, which would be through primarily greater saving, but also abroad by creating more reliance on domestic demand for growth. So, for example, in China there is a long-term plan, which we support, to try to reduce the reliance of the economy on exports and increase its reliance on domestic consumption, thereby reducing their savings rate to a more appropriate level, which also increases the living standard of their people. So I think with that process we can move gradually toward a greater balance.

With respect to the yuan, I think there are several reasons to move towards greater flexibility in the yuan, and I described them in a speech I gave in China. First, China is a very large country, and it should at some point have an independent monetary policy of its own rather than being tied to the United States. In order to do that, they have to have a flexible currency.

Secondly, the flexibility of the yuan is needed to accomplish this rebalancing from export orientation to domestic demand that I was referring to earlier.

And thirdly, yuan appreciation and flexibility makes some contribution to helping us to rebalance the current account deficit we currently have, although I think the larger force quantitively would be the rebalancing of demand from exports towards domestic demand in China.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman.

And welcome back, Chairman Bernanke. Many of my colleagues have been quoting "American Banker." I would like to show you "The Hill." There you are on the cover. It says your testimony sparked a stock price rally, and the Dow is up 87 percent, and there is great optimism for our economy, and I hope you are right. I hope the stock market is right.

But regrettably, some of my constituents are not feeling optimistic. They feel that the economic expansion has not ended up in their take-home pay, and some are very concerned about losing their homes, and I share that concern. They are concerned about the rising rate of mortgage defaults and home foreclosures. In my district employment is high and stable, yet I am being told that foreclosures are at rates that are up by an order of magnitude—they have jumped up dramatically from what they were last year. Some of my colleagues tell me that they are experiencing the same thing in their districts around the country, and they are being told that homeowners are losing their homes in very stable neighborhoods, and some say that this is due to various causes such as unemployment. Yet in my district and others where employment is high, and in some other areas, it is due to the decline in the housing market.

But many also ask whether certain mortgage products, particularly in the subprime market, have contributed to this foreclosure crisis or challenge. In particular, many point to the so-called 2/28 ARM's, and some have described them—and I quote—as an inherent predatory product. And as you have told me and others, these 2/28 ARM's are 80 percent of the subprime market.

Recently the Fed wrote back to Senator Dodd, taking the position that in its recent guidance on nontraditional mortgages, they did not extend to 2/28 for similar projects. And since these are what many people think is the problem, my question is why is the Fed not addressing the 2/28's and issuing guidance for what many people feel is the main problem in the foreclosure rates and the loss of homes of many people?

You eloquently have said many times that homeownership leads to participation in our economy and increased wealth for Americans, yet if you are losing your home, it is leading you to a personal crisis, and if it continues, we will be facing a tremendous crisis in our economy and in our districts. And now for your comments on whether or not the Fed plans to extend guidance to the 2/28 subprime project, products.

Mr. BERNANKE. You are correct, Congresswoman. There has been a surge in delinquencies and foreclosures, particularly—as I mentioned in my testimony—in subprime lending with variable rates, rates that adjust with short-term interest rates, and that is a concern to us. We certainly have been following it carefully. It is obviously very bad for those who borrow under those circumstances, and it is not good for the lenders either, who are taking losses.

We have tried, together with the other banking agencies, to address some of these concerns. We recently issued a guidance on nontraditional mortgages, which had three major themes. The first was that lenders should underwrite properly, that is, they should make sure that borrowers had the financial capacity to pay even when rates go up, and not simply underwrite based on the initial rate but also deal with the possible payment shock. Secondly, that lenders should give full disclosure and make sure that people understand the terms of the mortgages they are getting into. And I would add that the Federal Reserve provides a number of documents, booklets, and descriptions that are required to be included along with mortgage applications for adjustable rate mortgages. And thirdly, and this is more on the issue of the lenders rather than the borrowers, that lenders should make sure they appropriately risk manage these exotic mortgages, which we don't have much experience with, so some caution is needed in managing them, as we are now seeing. So those, I think, are very good principles, and I think we would stand by those principles.

Now the question has arisen whether the 2/28's, 3/27's are covered by this guidance, and I think the answer is yes and no. The guidance as written refers to specific types of mortgages, including those that have negative amortization, that is, the amount owed can actually go up for a period, which is not usually the case with 2/28's and 3/27's. So in that respect, those types of mortgages were not, you know, literally included in that initial guidance.

We, the Federal Reserve, along with the other banking agencies, are currently preparing a clarification to the initial guidance which will say that these same principles apply also to mortgages of this type that have variable rates, and particularly those that are of a subprime nature. But I would just say now that I hope that in our guidance, in our supervision, that we have conveyed to lenders that those three principles, good underwriting, good disclosure, and good risk management, are broad, good business principles, and they should be applying those to all mortgages they make.

Mrs. MALONEY. My time is up, but, Mr. Chairman, can I just ask when will this guidance be up? Because it is very important. What is the time frame for my constituents?

Mr. BERNANKE. Very soon, very soon.

The CHAIRMAN. The gentlewoman from Ohio.

Ms. PRYCE. Well, thank you, Mr. Chairman.

Welcome, Mr. Bernanke. It is great to have you here. I would like to actually discuss for a moment the cost of healthcare in this country, it is definitely one of the major concerns when I talk to business and industry in my district. It certainly drives up the cost of doing business in our country. Certainly not the only thing, regulation, litigation and other factors, but it is more important because it affects families everywhere.

The greatest problem is that people just can't find health insurance that they can afford; therefore, they don't get the medical treatment that they need. And it occured to me, and many others that one of the reasons for this is because there is really no consumer factor in healthcare in this country. We don't shop for our benefits. We take what our insurance companies provide for us.

Market forces seem to work very well in all other aspects of our society. Is this what is wrong with our healthcare delivery system, this lack of market force, so to speak? And as I am sure you are aware, the President has proposed a very ambitious healthcare plan designed to provide enhanced tax benefits to individual purchasers, and I assume that is so that more people will purchase insurance, more people will shop for insurance, and therefore they will pay more attention to their healthcare needs, and it would bring healthcare more in line with how we make other purchases in this country.

I just would like to know if you think that would be a good way to go, how it might affect international competitiveness, and then, of course, your thoughts on portability. I assume you made mention in response to Mrs. Maloney, or I guess it was Ms. Waters, that pensions and healthcare should be portable, and if you have time on my time, would you further your response? Thank you.

Mr. BERNANKE. Congresswoman, you are correct in pointing out a very serious, serious problem, and I think you are also correct that one of the main reasons why healthcare is so expensive in the United States has to do with the fact that we are always buying it with somebody else's money and not with our own money. We have a system where technology is advancing rapidly, where our ability to do new and sophisticated tests, and provide new and sophisticated drugs, and new procedures is advancing rapidly. In most industries, new technologies save costs, but not in medicine because of third-party payment, and the doctor and the patient are not making a cost-based decision. The cost efficiency is not perhaps what it should be.

Now, one approach to this is to increase market forces in the determination of what test to order and what costs and how much to shop and so on. There are ways to do that. The health saving accounts, for example, create a catastrophic coverage, ask for a catastrophic coverage, and ask people to save money within this account to buy coverage for medical care below the catastrophic level. Some people may be uncomfortable with having to make those kinds of decisions, so an alternative is to have competition between, say, HSA catastrophic plans and other types of medical management, HMO's, PPO's, traditional insurance and the like. By creating more competition, I think there would be some benefits.

But, again, it is a complex subject. There are a lot of other things we could do. I think we could increase transparency in terms of hospitals and doctors letting us know what they charge, what their quality is, and improving information technology in healthcare, which I think would reduce errors and create more consistency across the country. We currently have very big differences in the cost of managing a certain kind of condition in different parts of the country. More uniformity and more best practice would help reduce costs as well. So I think markets could have a useful role to help reduce, or at least control, the cost.

Portability is a difficult question. One approach to portability is to have insurance companies insure workers rather than insure employers, so to speak. That would require somehow creating different kinds of pools rather than employer-based pools. You need pools in order to share risk, and there are some issues associated with that.

The main alternative would be to give people the ability to take their policy from their current employer and then move over to another employer with the same policy. These are all things we should be looking at, but none of them is a really simple problem because in each case we want to make sure that people are buying as part of the pool, a risk pool, rather than buying on an individual basis where, if they are ill or have a preexisting condition, they won't be able to afford insurance.

Ms. PRYCE. Thank you very much.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Welcome, Chairman Bernanke. I am over here. I happen to like your predecessor. The problem is I didn't understand a thing he ever said. So you are a breath of fresh air in the sense that, whether I agree with you or not, at least you are speaking in English, and I can understand what you are saying. And I especially want to thank you for your response to Ms. Waters' question.

Let me follow up quickly on Mrs. Maloney's question, because I am not clear, and I hope you can answer this question just with a yes or a no answer. Does the guidance that the underwriting—the guidance that you are issuing regarding 2/28 and 3/27 mortgages require that those mortgages be underwritten to the fully indexed rate just like you do with traditional mortgages, or does it not?

Mr. BERNANKE. This is a joint guidance. We are still working on it with the other banking agencies. We have not yet determined that.

Mr. WATT. But the one that you put out previously, did it require—

Mr. BERNANKE. Yes.

Mr. WATT. So if it were the same, it would require—

Mr. BERNANKE. Same principle, yes.

Mr. WATT. Okay. The increase in foreclosures is a serious problem, and one of the concerns we have is that the Fed has never adopted a final rule under its authority under the truth and lending act to prohibit practices or acts that it found to be unfair or deceptive or designed to evade the purposes of HOPA over the entire class of mortgage loans. There has never been a real rule on these things, and I think that is one of the things that is putting pressure on us to be more aggressive in having a Federal predatory lending standard, or at least a Federal predatory lending floor.

I am wondering whether you view that as a problem, and maybe I could just get you to discuss with me why the Fed has never used that more aggressive, unfair, deceptive trade practices language to be more aggressive in this area in light—and especially in light of the increasing number of foreclosure that we are experiencing.

Mr. BERNANKE. Congressman, we have found that it is very difficult to write rules in advance that strike out entire practices under all circumstances. We find it is more effective to be flexible and work on a case-by-case basis. It is one of these things like, "You know it when you see it."

And so what we have done rather than write specific rules, is to work with the FDIC to develop a set of principles, and there has been much talk lately about principles-based regulation. One of the principles on which we are making these decisions provides guidance to the banking agencies for implementing to take action against unfair and deceptive acts and practices, and we believe that set of principles provides full authority for not only us, but also the OCC and other agencies to take actions to prevent unfair and deceptive acts or practices. So, for example, the OCC has recently taken substantial action, I think it was a credit card case, based on this, and they were not inhibited from taking those actions because of any lack of rulemaking. Again, whether an act is unfair and deceptive depends often frequently on the context and circumstances.

Mr. WATT. Can I just interrupt you long enough to ask you to comment on whether you think we need a Federal predatory lending statute?

Mr. BERNANKE. I think good progress has been made in trying to understand how to distinguish predatory lending from legitimate subprime lending. That is always the challenge. How do you define the rules in a way to address predatory lending without driving out legitimate subprime lending? And what we have seen lately is that a number of States, and your own State, North Carolina, has been one of the pioneers there, have introduced legislation which have moved the ball forward in terms of achieving that objective. And I was very pleased to see that because I think the States are good laboratories. They can really try out different things, and we can see what works and what doesn't work.

At some point when we understand well enough how to distinguish between predatory and legitimate lending, probably a Federal standard would be a good idea because it would eliminate the many differences across States and make it more costly for lenders to lend on a national basis. I don't really have a good judgment as to whether the States have reached a point where we feel, you know, we are ready to do that, but at some point we should really consider—

Mr. WATT. In the meantime should we be talking about a Federal floor as opposed to a preemptive stand?

Mr. BERNANKE. I have no objection at all to your discussing those issues. I think the question is making sure that you are making a clear distinction between predatory—

The CHAIRMAN. I would ask the gentleman to yield. I just want to say, first of all, the question he raises is a very important one that is widely—is of great concern to the civil rights community. I will say a couple of things, if I could, because this is really essential.

First, the State versus Federal has been complicated by the very strong preemptions of State law issued by both the Office of the Comptroller of the Currency and the Office of Thrift Supervision. So part of the problem we face is that some of those State laws that we agree are good ideas don't reach, for instance, operating subsidiaries of national banks. So the argument for me being at the State level would have been stronger if it hadn't been for those preemptions.

Secondly, with regard to the rule—and the gentleman's question is one many feel strongly about. I understand your argument that you can still reach these after the fact, but some people feel, and I am inclined to agree with them, that there might be a greater deterrent effect if there was to be some rulemaking. It is one thing to go to people's rescue after the fact, but it does seem to be a proliferation here, and that is why we think we may need more. But we will be continuing this discussion.

Mr. WATT. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Thank you, Mr. Chairman, and thank you, Chairman Bernanke.

This committee has been debating GSE reform now for some time, I think for about 4 years now. Surprisingly, while debating reform with Fannie Mae and Freddie Mac, we have not heard testimony from the Federal Reserve on this topic, and we are going to re-engage in this debate next month, and I was wondering if you would be willing to come up and to testify as to the Federal Reserve's view on GSE reform. I think it would be very helpful for all of us.

Mr. BERNANKE. The Federal Reserve has testified in the past, I believe. I believe Chairman Greenspan has testified, but if that is not the case—

Mr. ROYCE. He has testified as to the subject, but I am thinking about the hearings we are going to hold specifically on GSE reform. And that was my question as to whether you might testify on that.

Mr. BERNANKE. We would be very interested in having our perspective heard on this issue.

Mr. ROYCE. I hope the committee leadership can accommodate you on that.

I also wanted to say that it is not just New York that has grown quite concerned about the disadvantage competitively that our capital markets face and the flight of capital. I think all over the United States, people are getting worried. We saw the Bloomberg-Schumer report, and then the Committee on Capital Markets Regulation report that came out, and they have really stressed this issue.

And I also noticed last November, the late Dr. Milton Friedman said this, and I would just like to read it quickly. He said, "Sarbanes-Oxley is very unfortunate. It tells every entrepreneur in America, don't take risks, that is not what we want. The function of the entrepreneur is to take risks, and if he is forced not to take risks and spend on accountants rather than products, the economy is not going to expand or grow."

And then also the same month, Alan Greenspan said that most of Sarbanes-Oxley is, "a cost creator with no benefit I am aware." And he went on to say that regulatory and statutory, statutory changes need to be made as well if we are going to move forward. And he concluded with something that I thought was rather forceful. He said, "I hope it happens before the whole financial system walks off to London."

It seems to me that Dr. Greenspan and others were concerned that the regulatory climate will not only deter investment in the country, but that it is also going to suppress future entrepreneurship and suppress innovation. And I was going to ask you because, you know, if they are correct, that could have a very harmful effect not only on future U.S. productivity, but as a result of that will reduce the potential standard of living gains in this country.

And so, Chairman Bernanke, do you share the concerns of Dr. Greenspan and Dr. Friedman on this issue?

Mr. BERNANKE. Let me say this: I think it is very important that as we try to achieve the objectives of greater clarity and transparency in corporate governance and internal controls and so on that we do it at the lowest cost we can, and I think that it is a good development that the Public Company Accounting Oversight Board along with the SEC has recently promulgated for a comment a new audit standard which would be less "checking of the box" and more focused on the major concerns of the company, and also that would take into account the size and complexity of the company, so we wouldn't be putting these costs on the smaller companies. I think that is an important step in the right direction. I would be curious to see how that goes.

More generally, you know, as a regulator, I think it is very important that we have to achieve the objectives that Congress gives us, and there are some very important ones, but we also need to do the best we can to minimize the cost and unnecessary burden created by those regulations.

Mr. ROYCE. But going back to my question, and quoting former Chairman Greenspan again, he spoke to the regulatory changes that you spoke to, but he also spoke to statutory changes that he thought were necessary. And that very much concerns us going forward in terms of whether or not we addressed these recommendations made by the Bloomberg-Schumer report or made by the Committee on Capital Markets Regulation report.

Mr. BERNANKE. We are continuing to monitor the application and effectiveness of Sarbanes-Oxley. I am not prepared at this point to call for any specific legislation changes. I would like to see how the audit standard works.

Mr. ROYCE. Well, in the meantime, to paraphrase Dr. Greenspan, hopefully it will happen before the financial system walks off to London, because as I read the papers every week, that egress, that exit, is becoming more and more pronounced, and we have an arithmetical increase not just of capital flight, but also a resistance of companies coming into the public market in the United States. Capital is basically avoiding our capital markets with very dire consequences, I think, in the long term, to the standard of living here in the United States and our competitive position.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you.

The gentleman from California.

Mr. SHERMAN. I would like to comment first on the gentleman—the other gentleman from California, and that is that we have in our capital markets kind of a one-size-fits-all approach. You are either a private company, or you are so public that your statements are so good that if widows and orphans want to put 100 percent of their net worth into your stock, it is entirely legal to do so. We might want to explore some intermediary category where the amount of disclosure does not meet full-blown Sarbanes-Oxley on the one hand, and investment, while publicly traded, is only among highly accredited investors who are investing less than 1 percent of their net worth. I think as long as—to be a public company, you have to be a company that I want my mother to, legally at least, be able to put 100 percent of her net worth in means that you are going to have to meet a very high standard.

I have a number of questions for you. One is to respond to that, and I will lay out a few others, and you will probably have to respond for the record, Mr. Bernanke. But if I talk fast, maybe you will be able to comment orally.

The first is, you have talked about the problem of income inquality. Do you know of any systematic economywide approach with a near-term effect to deal with such income inequality other than making our tax system more progressive?

Second, we have a lot of smart, educated young people. They go and get college educations, but they only have the slightest information about which careers will be in demand by our economy. Should we publish an official guide that is forward-looking, that uses our best economic resources to project for the guidance of young people what careers will be in demand in the decades to come?

Third, over in the Senate you talked about your concern that the ILC loophole could be used to mix banking and commerce. I wonder if you have an equal concern—I hope you have an equal concern—about the exploitation of other loopholes that combine real estate brokerage with banking, or auto sales with banking, or any kind of sales with banking on just on the pretext that the sale—that the consumer needs financing. And I hope that you are as strong at preventing bankers from getting into commerce as you are in preventing commercial firms like Wal-Mart from getting into banking.

Last year we talked about the need for certain—my perceived need for an emergency plan to be available to deal with a precipitous decline of the dollar. You responded to me in the letter of April 25, 2006, noting that from 1985 to 1988, we had a roughly 40 percent decline in the value of the dollar, and the sky did not fall. But do you think that the risk of a 40 percent decline in the U.S. dollar in 4 weeks, rather than 4 years, is so remote that we shouldn't think about it, or are you just confident that our society and the world trading system could adjust to it? Or should we be doing some planning, given that we have had another year since we have talked last of record trade deficits?

Finally, the New York Fed processes dollar transactions. We recently stopped two Iranian banks from having access to that through U-turn transactions. What would be the effect if we prevented all Iranian banks from having such access? I ask for you to comment from a technical monetary policy, you know, banking regulatory policy. Obviously we have other venues to talk about, whether that would be a good approach in negotiating with Iran. Or could we cause significant concern in Tehran if we didn't stop at the two banks, but went with all Iranian banks in banning their access to transactions through the Fed? Do you have any other comments?

Mr. BERNANKE. I can respond quickly to a few. Multiple standards for Sarbanes Oxley is an interesting idea, but I would note that the audit standard that allows size and complexity to be a consideration does to some extent do that.

On income inequality, this is a very long-term trend. At least since the 1970's, and according to some measures from the 1950's, we have been seeing this trend, and I don't think there is any really good way to reverse it overnight. I think it is going to be a slow progress.

Mr. SHERMAN. Although a more progressive income tax system would do a lot to change the ultimate flows of income, or do you disagree?

Mr. BERNANKE. It would not do so without some cost to incentives and the like.

On official guides to future skills, I think the best thing we can do for young people is to make sure they have good general analytical skills, and that they are not—it has turned out well for us that we don't necessarily put kids in the eighth grade—

Mr. SHERMAN. So if we had lots of people with good analytic skills—

The CHAIRMAN. I'm sorry. We don't have time for further questioning. I will give the gentleman 30 seconds.

Mr. SHERMAN. Please continue.

Mr. BERNANKE. I would focus on general problem-solving skills that are most flexible.

On real estate brokerage, the Federal Reserve and the Treasury have never had an opportunity to make a determination about whether this fits under the Gramm-Leach-Bliley law. Congress has not permitted us to go ahead with that, and so we have had an opportunity to look at it.

With respect to financial crises, I would just say that the Federal Reserve takes financial crisis management extremely seriously, and we have made a number of efforts to improve our monitoring of the financial markets to study and assess vulnerabilities, and to strengthen our own crisis management procedures and our business continuity plans. And, I hope we never have another financial crisis, but should one ever occur, we want to be well prepared for that.

I would have to get back to you on the Iranian question.

The CHAIRMAN. Thank you.

The gentleman from Connecticut. And the Chair will announce that the Chairman has been very gracious to agree to give us until 2 p.m.—we will take a break for about 15 minutes at noon. So the gentleman from Connecticuit will—after his questioning and answers, we will take a 15-minute break.

Mr. SHAYS. Thank you for being here.

I want to kind of agree with Congressman Watt. I thought the responsibility of the Fed Chair was to speak in tongues, so I have been a little shocked that I can actually understand you. The only other person I have trouble understanding is sometimes the chairman when he gets excited.

I want to ask you, I think of ourselves as a consuming Nation that drives our economy, and yet I wrestle with the fact that we talk about how we should save. Now, I am a consumer. The only savings I have is my house and my Thrift Savings Plan. Should I feel guilty?

Mr. BERNANKE. It is not a question of feeling guilty. The question you want to ask yourself is, are you well prepared for retirement?

Mr. SHAYS. Well, really what I am trying to say is if I want my country to be stable, are we asking Americans to stop consuming and to save? What are we asking them to do?

Mr. BERNANKE. Well, I think the issue is at the national level. Your question is at the individual household level. At the national level, low rates of savings create the need to borrow from abroad, and it does have some risks involved. The most direct way to address savings is to try to improve the saving of the government sector.

Mr. SHAYS. What confuses me is that we are trying to get consumers to consume so that our economy moves forward. So I just wonder how you would wrestle with that, and how do you wrestle with it?

Mr. BERNANKE. There is no inconsistency. In short-term business cycle dynamics, consumer spending can drive growth. But over a longer period, if people save more, then that can be replaced by higher, stronger investment spending, for example, and that would be a desirable way to go.

Mr. SHAYS. Okay. With regard to tax cuts, I believe that dividends and capital gains in particular have had a huge impact in getting us to have constant growth since we have lowered these rates. I am concerned that my Democratic colleagues are going to allow these tax rates to go up. I am interested to know your opinion.

Mr. BERNANKE. I think most economists would say that lower dividend and capital gains tax rates have efficiency gains. They are providing centers for saving. They reduce distortions in capital structure. They allow retained earnings to be circulated back into the capital markets, and there are many other areas where I think they contribute to efficiency in the economy.

As always, with any tax measure, there are competing considerations of revenue and progressivity and so on. And as you know, given my position as the head of a nonpartisan central bank, I can't really take positions on specific measures.

Mr. SHAYS. Well, okay. It just seems to me that you can give us advice as to whether or not you believe that continuing these low rates will contribute to a stronger economy. And if you don't think that, then you should tell us. If you think that letting them go up will not impact our economy, you should tell us that. I think that is a fair question.

Mr. BERNANKE. Well, let me say this, which is that there needs to be a balance between spending and taxes. So I think that well-designed lower taxes can contribute to a stronger economy. But there is also a responsibility to make sure that the spending is commensurate with that.

Mr. SHAYS. Right.

Let me get to the next one. When I am encouraged to refinance my house and pay 2 percent to 3 percent, you know, and then you look at the fine print, and you are paying 7 percent or more. So I see this, and think that—well, I am not following them. I think a lot of people are. What is the role of the Fed to try to address that issue, if any?

Mr. BERNANKE. The size of the cost to refinancing?

Mr. SHAYS. The incredible amount of effort to get consumers to basically use their homes, thinking that they are only going to pay a 2 percent or 3 percent rate, when in actual effect they are going to pay 7 percent or 8 percent. They have to pay it. They just don't have to pay it each year.

Mr. BERNANKE. Adjustable-rate mortgages and the like.

Mr. SHAYS. Adjustable rates, but where they actually pay less each year, less than the rate they are being charged.

Mr. BERNANKE. Those are option ARM's and so on. Those have negative amortization.

Mr. SHAYS. I shouldn't have said it that way. But the bottom line is that I am scared many people are just going to fall into that trap.

Mr. BERNANKE. I share your concern. As I was discussing earlier, our nontraditional mortgage guidance is very clear that lenders should, first of all, make sure people understand what it is they are signing, what they are getting involved in, and secondly should underwrite in such a way that if the borrower stays in that mortgage and rates go up, then the borrower will be able to make the payments and not be foreclosed.

Mr. SHAYS. Thank you. I yield back.

The CHAIRMAN. We will now take a 15-minute recess.

[Brief recess]

The CHAIRMAN. We are going to convene a minute early, but the next person on our list here is from Kansas, Mr. Moore. Would someone please close the doors—thank you—and Mr. Chairman, we appreciate, again, your giving us all this time.

The gentleman from Kansas is recognized for 5 minutes.

Mr. MOORE OF KANSAS. Thank you.

Mr. Chairman, thank you and welcome to the committee, and I appreciate your coming here and taking our questions.

I want to follow up on kind of an area at least that the gentleman from Texas asked you about, and that was our debt as a Nation and what that is going to do to future generations in our country.

I have seven grandchildren, and I am very concerned that we are accumulating a debt in this country that presently stands at $8.7 trillion. I understand it has gone up approximately $3 trillion in the past 6 years, and I was at the White House about 6 weeks ago, and I had a chance to talk with the President. I said, Mr. President, I am not pointing a finger at your Administration, and saying it is your fault, because this goes back 25 years, 30 years, but through a process of borrowing and accumulating debt, interest on our national debt now stands at $8.7 trillion, and as I think Mr. Paul pointed out, over 40 percent of our debt is held by foreign nations.

Should we, as a Nation, be concerned about that much debt? Should we, as a Nation, be concerned about the fact that more than 40 percent of our debt is held by foreign nations? If for any reason, whatever reason, foreign nations decide to sell off our debt, what impact, if any, would that have on interest rates in our country?

Mr. BERNANKE. The Federal debt that I am most concerned about is sort of the implicit debt, the debt associated with our promises to future retirees for Social Security and Medicare. If we were to stop here in some sense, it would not be quite so bad. The amount of government debt held by the public currently is about 37 percent of the GDP, which is fairly normal across industrial countries, lower than some in fact, but the situation is going to get a lot worse as we have retirements of the baby boomers and so on and medical care costs go up.

According to the Congressional Budget Office, in the immediate scenario, by 2030, the debt, instead of being 37 percent of GDP, will be 100 percent of GDP, and the deficit will be 9 percent of GDP instead of being a little under 2 percent as it is this year. So, if we allow things to continue, the debt interest cycle will continue to build up, and we will hurt our fiscal position to the detriment of our children and grandchildren.

On the issue of holding the treasury debt, the reason that foreign countries hold our debt is, for the most part, because they find it beneficial to themselves to have ownership of this very safe, liquid, and convenient form of assets, and I find it unlikely that anywhere in the foreseeable future there will be a major sell-off of any kind. If there were to be some sell-off, there would probably be some short-term effects, but—

Mr. MOORE OF KANSAS. What kind of short-term effects, Mr. Chairman?

Mr. BERNANKE. We would have movements in the asset financial markets, responding to the sale of the treasuries and other securities.

Mr. MOORE OF KANSAS. Would interest rates respond to the sale of securities?

Mr. BERNANKE. The impact effect of large sales of treasuries would be to raise interest rates, yes, but over a longer period of time, I believe interest rates are determined by fundamentals, by Federal Reserve policy, and I would also point out that the ownership, say, by the Chinese, of dollar-denominated assets is less than 5 percent of all of the fixed-income dollar assets in the world, even though it is a larger share, as you point out, of the treasury market. So I do not consider that to be a major concern.

As I mentioned earlier in response to a question, there could come a point where foreign investors become less willing to accumulate more of our debt and would begin to drive up interest rates, and in order to avoid that contingency down the road, we should probably be trying to bring our current account down gradually over time.

Mr. MOORE OF KANSAS. Well, I understand, and I appreciate the fact that you, I am sure, feel a responsibility not to alarm people by any statements you might make, but my concern again is if foreign nations decide for whatever reason to sell off our debt, that is going to—there is the old law of supply and demand in effect, and if foreign nations are not going to hold our debt, that means that we are going to have to finance that, and I would think that would cause interest rates to go like this.

I remember 30 years ago there was a guy named Jimmy Carter, who was President of the United States. We had interest rates going up to 12-, 14-, 16 percent. That would be absolutely devastating for our Nation right now, and I am not trying to be an alarmist here. I just do not want to see us get in a position where anything like that happens again to our country, because that would be devastating, I think, for small businesses, for consumers, for people in this country, and that is my concern, I guess.

One more question. Oh, we are out of time. Sorry.

Mr. Chairman, thank you very much.

The CHAIRMAN. Would the Chairman like to respond?

Mr. BERNANKE. No.

The CHAIRMAN. Well, then we will take one more question.

Mr. MOORE OF KANSAS. Okay. I understand that you all have a rule that says that the presidents of your banks have to retire at a certain age.

Is that consistent with what some people are saying, that because of life expectancy going up that we should require people to retire at a certain age?

Mr. BERNANKE. We have thought it valuable to have some turnover there. We do not have quite the same pressures that the private market would have, you know, with leadership in a company, so we think that getting new leadership is beneficial, but if there are concerns I would be certainly willing to ask our committees to look at that. I have found, basically, that there has been a reasonable amount of turnover in the sense that people do not stay so long as to stagnate, but they stay long enough that their knowledge and experience can accumulate.

The CHAIRMAN. Of course, they could always retire, rest for a few years, and then run for the Senate.

The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman, and Chairman Bernanke, thank you for your patience.

To some extent, I would like to follow up a bit on a line of questioning from my colleague from Kansas, and I know that his commitment to the long-term fiscal health of our Nation is a very sincere one. We sometimes come about it in different ways, but I know his commitment is sincere.

I was reviewing testimony you gave before the Senate Budget Committee recently on entitlement spending, and you have alluded to it today. I have had the occasion now to hear from the heads of OMB, GAO, CBO, and the Secretary of the Treasury, and there seems to be consensus among all of them that the number one fiscal challenge we face as a Nation is the pace of growth in entitlement spending.

Would you concur in that assessment that it is, indeed, our number one fiscal challenge?

Mr. BERNANKE. Yes, or, more broadly, how to deal with the aging of the population.

Mr. HENSARLING. You spoke earlier about the percentage of debt to GDP by 2030, and you mentioned, I guess, the challenges of trying to, without entitlements, reform the level of spending decreases or tax increases, some combination of the two. I think I heard you say before we are not going to grow our way out of this challenge, is that correct?

Mr. BERNANKE. That is correct.

Mr. HENSARLING. If Congress ignored any entitlement spending reforms and chose no other offsets within the Federal budget, using 2030 as our guideline—it is kind of a good placeholder for the next generation—have you looked at models on what type of tax burden would be necessary to be placed on our people to balance the budget, say, in 2030?

Mr. BERNANKE. Well, the projection would be that in 2030 the entitlement programs would be about 15 percent of GDP, which means that the entitlement programs and interest on the debt together would be something about our total budget today. So increases would have to be related to how much additional spending you would have. If you want to keep nonentitlement spending constant, you would have to raise tax rates approximately 6 or 7 percentage points of GDP, from about 18 percent now to about 25 percent of GDP, with no other changes in order to retain about the same deficit.

Mr. HENSARLING. The Comptroller General has previously testified that if that happens, in his opinion, we are on the verge of being the first generation in our Nation's history to leave the subsequent generation with a lower standard of living, less opportunity.

Would you agree with that assessment?

Mr. BERNANKE. Those are very high tax rates, and they would have adverse effects on growth.

Mr. HENSARLING. Changing subjects, Mr. Chairman, the debate about trade versus protectionism is as old as our Republic is. It is a debate that has certainly reared its head again in our Congress, many believing that somehow present trade policies have negative impacts on low income. I recently saw some Bureau of Labor statistics figures that indicate, within the last 5 years, the price of durable goods have dropped 8.7 percent, appliances 6.5 percent, toys 25.8 percent, and televisions 55.4 percent. Low-income people in the Fifth Congressional District of Texas, whom I represent, buy televisions, toys, durable goods, and appliances, and last I looked, each of these had a very heavy trade component.

If trade barriers were erected, might the cost of these actually go up instead of decrease, and might that have a detrimental impact on low-income Americans?

Mr. BERNANKE. Certainly. Yes, I agree.

Mr. HENSARLING. That was such a quick answer that I was not ready for the next question.

Mr. BERNANKE. Well, I can elaborate.

Mr. HENSARLING. No. I think I will quit while I am ahead, Mr. Chairman. I think I will quit while I am ahead.

To the extent that I have any time left, subprime lending—you mentioned that there is a great challenge in figuring out the difference between predatory and subprime. I believe the world works off of incentives.

Are subprime lenders incented to actually take back the collateral, to take back the house, to repossess it, particularly since, I think you testified, we are now in a softening real estate market, and if that is not the incentive structure might the competitive marketplace help ameliorate what we are seeing as far as some of the high foreclosure rates?

Mr. BERNANKE. To some extent, that is correct. It is certainly the case that subprime lenders, certainly the legitimate subprime lenders, are not looking to have foreclosures. It is bad for their business—they lose money—and we have seen some failures of small lenders, and we have seen credit default swaps that measure the risk of subprime mortgages, those spreads widen considerably, and so, clearly, it is not in the interest of lenders to make bad loans.

Mr. HENSARLING. I am out of time. Thank you for your testimony.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman, and Mr. Chairman.

Mr. Chairman, I also read your remarks in the Greater Omaha Chamber of Commerce that Ms. Waters spoke of. She said she was very moved in reading it. I am not sure I have ever really been moved by a speech by an economist, but I have found a fair amount to agree with in what you have said, and there were things that we had discussed earlier when you testified here before and, actually before that, things that—topics about which I had questioned Chairman Greenspan earlier.

You talked about the widening inequality, that between 1979 and 2006 the wages of the people who are right in the middle had gone up by a total of 10.5 percent, the people in the bottom quintile, the bottom 20 percent, 4 percent, and those in the top quintile had gone up 34 percent, that the share of after-tax income for the top 1 percent had almost doubled as a percentage of all wages, all compensation from 8 percent to 14 percent over a slightly lesser period of time, and that even within that 1 percent there was a widening inequality.

I asked you then about what programs we could get at, and you mentioned education again and specifically community colleges, life-long learning, job training, how to make sure that our workers have the skills to be personally responsible for increasing productivity so they might be compensated better. In the President's most recent budget, all line items for career and technical education in 2007 were $1.312 billion, and in the proposed budget it is $617 million. So it is being cut by more than half.

Does that show a commitment—is that what we need to be doing if we do recognize income inequality as a significant problem for society?

Mr. BERNANKE. One point I tried to make in my remarks was that solving these problems of retraining and job search in life are difficult, and people may differ on how best to accomplish it. I do not know from your numbers whether there were offsets in other programs or different approaches—I simply do not know—but I think there is a legitimate debate among all of us about what are the most cost-effective, effective ways, to help people overcome the skills gap so that they can get better work.

Mr. MILLER OF NORTH CAROLINA. Actually, Mr. Sherman mentioned a systematic economic approach to approaching income inequality. I think before, I just asked if you could name any program that addressed anything Congress was doing and the President was doing that seemed to be addressing economic inequality, growing differences in income, and you mentioned specifically education. That was what you talked about.

If we are serious about closing economic inequality, isn't that exactly what we should be looking to, making a real commitment to job training, to adult education, to education from pre-kindergarten all the way through life-long learning?

Mr. BERNANKE. I think we should, but I do not want to support or attack any specific program because there are many approaches to doing it. The President will, no doubt, reply that he has the No

Child Left Behind Program, which is an attempt to increase the quality of schools.

Mr. MILLER OF NORTH CAROLINA. Which has also been funded at much less the level than what was promised, dramatically less, and actually the very programs within No Child Left Behind that are most clearly directed at closing achievement gaps are the very programs that have been cut the most.

Chairman Bernanke, you also, in your speech in Omaha, talked about the kind of superstars in the world economy and how much—given what the economy is like now, relatively small differences in ability or in appeal from the very, very best and people who are just very, very good but not the very, very best—resulted in dramatic differences in income, and then you also mentioned CEO pay and said that in many cases CEO's who had failed spectacularly, who had appeared to have crashed and burned, had still done very well or were still compensated at breathtaking levels, and in earlier testimony you said that European CEO's appeared to be paid significantly less than American CEO's.

Are European companies doing significantly less well because they do not have the superstars? Is there anything that suggests, really, that there is a difference based upon skill level between American CEO's and European CEO's?

Mr. BERNANKE. I have not really studied that. I think that there are some CEO's in Europe who are paid lower levels, and probably there are fewer in sort of the same league as the American CEO's.

I think it is very important that boards of directors take shareholder interests very seriously when they make these compensation decisions, and that they try to attract the very best talent, and that they pay in a way that will motivate good performance.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for your testimony today. I appreciate your spending the time with us.

I would like to go back and begin my questioning with a topic that is of great importance to me, and we have already touched on it, at least with one series of questioning, and that is dealing with GSE reform.

On the one hand, I am pleased to see that the Administration is taking what I would say is a slightly tougher tone, if you will, on pushing for a brighter line test between what is appropriate and what is inappropriate between the primary and the secondary markets and what the GSE's are involved in. That is on the positive side.

On the negative side, from my position, I have seen something of a softening with the Treasury stance with regard to portfolio limitations, which I believe should be a true concern to us. I know that there are ongoing negotiations, if you will, between the Treasury and our esteemed and gracious chairman behind us to try to reach a compromise on this issue, and as part of the negotiations there is consideration of what has been dubbed the MTI, the mortgage tax increase, better known as the "Housing Fund," and I would be curious to have your take on an aspect of that.

I raised a similar question to you when you were here before the committee a year ago and new on board, but I know since that time you have had an opportunity to get into the weeds a little bit more on this topic. You have already testified here and before other committees with regard to the importance of the housing market in general to our boom in the economy that we have had and the slight slowness of the housing market and what impact that could have on the overall economy.

My first question to you is: What additional impact could we see if we did have a tax, if you will, on that marketplace by having a fee or an assessment on the GSE's for this new Housing Fund, or the MTI?

Mr. BERNANKE. So you are arguing that the Housing Fund would raise the cost of mortgages because we are putting a tax on the GSE's?

Mr. GARRETT. Yes. Well, we know the corporations in general do not pay their taxes in one way or another. The cost of doing business is not borne by the business but is passed on to the consumers in one sense or another.

Here, the business that it is being passed on is to the low- and moderate-income homeowner who is trying to get into the market, which is the whole idea behind GSE's.

Mr. BERNANKE. Well, I have not done any analysis of that particular issue.

I would reiterate what I said before, which is I think, that it is important for the GSE's to support affordable housing. The way I would recommend it would be to tie their portfolios to affordable housing products, for example, by holding MBS that are based on affordable housing mortgages, for example. That would seem to be a direct way to both create some limits, some limitation on the rapidity of the expansion of their portfolio, while still having a direct impact on the affordable housing.

I have not taken a position on the Housing Fund, and I am afraid, if I do so, it will be portrayed as a change in position, because the Fed is focused very much on the safety and soundness and the systemic risk implications of the portfolios, and I think that is where the Federal Reserve needs to keep its focus.

Mr. GARRETT. Do you agree with my basic economic assessment that when you have a corporation such as GSCR or any corporation in general that the taxes that we assess on them are not borne, in essence, by them, but it has to be passed on to someone?

Mr. BERNANKE. Well, it could be passed on to the shareholders in terms of a lower share price. That is another possibility. So I would have to think about the incidence of that.

Mr. GARRETT. And, of course, the economic philosophy to that is, when you put a cost onto the share price of a company where they have to get their investments from, that impacts upon the economy. We can go into that.

Can you elaborate a little bit more on the portfolio idea that you were talking about? I am limited in my time here. Are you suggesting that you allow them to increase the—or have an increase in the portfolio size of those holdings for the low- and moderate-income portfolios, and if that is the case, doesn't that go beyond what the GSE's were intended for—or what the portfolios were intended for in the first place? They were just for securitizing the loans, and they were just there to be in and out, if you will. Why would we need that to occur?

Mr. BERNANKE. I think the ideal situation would be one in which the portfolios did exactly what you said. They were to be the weigh station for securitized mortgages, and they would contain mostly liquid assets for the purpose of purchasing mortgages and then selling them back to the market.

Mr. GARRETT. Right.

Mr. BERNANKE. I would like to see a bill. I think we need to have a strong regulator in this arena, and we need to find some way that we can limit the growth of the portfolios. As a practical matter, I think that restricting portfolios to mortgages related to affordable housing might be an appropriate compromise and an appropriate approach that would provide some limitation, but the Federal Reserve has always been concerned about the size of portfolios. It never has found a substantial benefit to homeowners from large portfolios.

Mr. GARRETT. Does the Treasury have the authority—

The CHAIRMAN. Gentlemen, we are into the timing.

The gentleman from Missouri.

Mr. CLAY. Thank you, Mr. Chairman, and thank you for holding this hearing.

Mr. Bernanke, welcome. I represent the First Congressional District of Missouri, which is comprised of north St. Louis City and north St. Louis County.

Continuing with the same line of questioning as the gentleman from New Jersey about housing, in my district, and in many other districts across the country, we have a tremendous housing crisis. This must be addressed, and it must be done with urgency, especially when it comes to affordable housing.

What changes in housing policy can be made that the United States can better foster an urban housing policy that puts people in homes in the inner cities so that they can build wealth through ownership and pass it on to future generations? What are your ideas on this, and what is your approach to this housing crisis?

Mr. BERNANKE. Well, I recently had the opportunity to visit Anacostia in the District of Columbia and to see some of the projects going on there, and we saw the actions of community development financial institutions, CDFI's, who have worked together with banks, private investors, and with government sources to finance some very impressive projects, some new apartments, and some social centers for the community, with very good results, and I think that collaboration that we saw with the CDFI's, managing together with some nonprofit institutions, other nonprofit institutions, and private sector input, is a very promising approach to this.

Mr. CLAY. It sounds like we have to be creative in order to rebuild our inner cities and to come up with creative concepts so that people can take ownership of their neighborhoods, of their communities. It sounds like that is what you are saying, and you promote those policies.

Mr. BERNANKE. Ownership is very important because people then feel they have a responsibility for their community and for their home, and it is also valuable to try to develop a community, not house by house but in a broader sense, because unless you have a retail area and a school and a social area and other amenities, the house property values are not going to justify the cost. So you need to build a neighborhood rather than just an individual house.

Mr. CLAY. Thank you for that response. Let me shift over to a worker issue.

Yesterday, DaimlerChrysler, throughout the United States and particularly in St. Louis, announced plans that will affect approximately 1,300 jobs at our Fenton plant in St. Louis County. They are losing an entire shift which makes the minivans. There have been other massive layoffs by the other automakers. Additionally, these corporations are trying to do away or drastically reduce legacy cost, healthcare, retirees' benefits, and pensions. Many of these employees have lost benefits that were promised them in exchange for working their careers at their workplace. They earned them, and now, as they approach retirement, they are not there.

Do you have new approaches or plans for long-term employee healthcare, retirement benefits and pensions, and how do we address the problem facing our industrial workers in the automobile industry and manufacturing sector? We can include the airline employees and many other workers throughout this economy in that. What new systems will we put in place to replace these traditional safety nets that they have worked for and depended on all of their lives? What solution do you think we should be putting in place, and what are your thoughts on this? Could you elaborate?

Mr. BERNANKE. Well, first, if firms make promises to workers with respect to retirement benefits or healthcare benefits, we should make sure that those promises are kept. The recent legislation on pensions that Congress passed tried to toughen up the requirements for funding pensions, tried to make them more transparent, and to increase the premium paid to the Pension Benefit Guarantee Corporation. Those kinds of measures can help ensure that companies will not renege on the promises that they have made to their workers, so that is very important.

I would say, more generally, that we need to diversify, to have more than one source of retirement security. Some people rely on defined benefit pensions. We need to expand access to defined contribution plans like 401(k)s and other kinds of private savings, and then there is, of course, Social Security, which we want to make sure is on a sustainable, long-term path. So if we put all of those things together, you can help people finance a reasonable retirement.

The CHAIRMAN. The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman.

I have a question. You mentioned in your opening statement that there has been a large amount of consumer spending. We see a lot of credit card debt by individuals, a lot of higher education loan debt for young people coming out of college, also into the professions, medical school.

How are people going to be able to overcome this debt when the wages are only rising a certain percent? Do you see this as a long-term problem that seems to be concentrated—I mean, if you are a college student, you can get a credit card like that and run it up to the maximum quite quickly and pay $20 a month, probably, for the rest of your life. What kind of problem do you think that presents to our economy?

Mr. BERNANKE. Well, the incidence of delinquencies and bankruptcies for the economy as a whole remains quite low. Because the job market is pretty good and incomes have gone up, wealth has gone up, the stock market is up, and so on. Most families, many of them, have home equity built up and have been able to manage their finances pretty effectively, and as I said, we have not seen any significant increase in financial stress in the broader economy.

Now, there are pockets of problems, as I mentioned already several times, such as the variable rate subprime mortgage area. I think there are a number of approaches. The one that the Federal Reserve is particularly involved in is disclosures. We are responsible for Regulation Z, which implements the Truth in Lending Act, and it includes such things as the famous Schumer Box and other things that show to potential credit card applicants what are the terms, you know, what are the fees and so on.

We are in the process now of completely reworking Reg Z for credit cards, for revolving debt, and we anticipate going out with a proposed rule in the next couple of months, and we have worked very hard on that. In particular, one thing we have done—people find it very difficult to understand the legalese that they see in the credit card applications, the credit card contracts, and yet of course the legal information has to be there. Otherwise, it is not a legitimate contract, and so the challenge is to create disclosures that meet the legal standards but that are also understandable, and so we have gone out and done a lot of consumer focus group testing and those kinds of things to try to find disclosures that will actually work in practice, and we hope that these new disclosures we are going to put out for comment in just a couple of months will be helpful in helping people understand, you know, the terms and conditions of credit cards and make them use them more responsibly.

Mrs. CAPITO. Well, I will look forward to that, and I think it is an excellent idea, and I think that it is difficult when you turn it over and look at the fine print. I am admitting to not reading my credit card disclosures as closely as I should.

I do not often mention it, but I am from the State of West Virginia, and it is very reliant on coal, and the energy production is extremely vital to our State economy, but we also have a population that is very sensitive to gas prices, to the price of healthcare, to all of the things that hit your pocketbook immediately.

When you look at the long term, what do you see in terms of—and I know, in some of your statements, you sort of exclude the energy prices. Is that because of the volatility of that or, in trying to move from nonreliance on foreign sources of oil, do you think we are ever going to make an impact on the pocketbook of the individual citizen?

Mr. BERNANKE. Well, in the short term the demand for oil is inelastic; that is, it does not respond much to price changes, and so when there are fluctuations in the demand for oil, you get these big spikes and movements in oil prices, and we have seen quite an increase in oil prices in the last few years, as you know. Over the longer term, higher oil prices actually have a benefit, which is that they encourage conservation, and they encourage alternative supply sources. Coal, of course, is actually a very promising source. It is, of course, a traditional source of energy, but assuming we can find ways to address the environmental implications—and there are many promising directions there—coal could be a very big part of our energy diversification in the future.

So my expectation is that as long as the markets are allowed to work, together with some support for research and development from the Government, together with clear and effective regulation, that we will solve our energy problems and that solution is going to come not just from one single magic bullet; it is going to come from a wide variety of different alternative sources, including, I think, coal.

Mrs. CAPITO. Thank you.

Do I have time for one more?

The CHAIRMAN. You do. Go ahead.

Mrs. CAPITO. I have one more quick question, and this is sort of an educational question for me.

When I read your statistics and I see the large, you know, macro view that you have, living in a small State that has fluctuations always sort of at the bottom end of the economic scale in terms of per capita income, we always feel in small States that sometimes all of the statistics that we read are sort of driven by New York, California, Florida, and Texas.

When you are formulating your data that you bring before us, what kind of considerations do you make for smaller States or does just the population number drive all of your statistics?

Mr. BERNANKE. Well, we see a lot of State data, for example, unemployment rate data by State, but the other important thing about the Federal Reserve is that it is a Federal—that is, a regionalized—system, and as I am sure you know, we have 12 Reserve Banks around the country—

Mrs. CAPITO. Right.

Mr. BERNANKE. —and one of the most important elements of our monetary policy meetings is when we go around the table and ask each Bank president from each part of the country what is going on in your State, what is going on in your region, what is going on in various industries, various sectors, and various geographic areas within your Federal Reserve district; that gives us an awful lot of detailed information about what is happening in different parts of the country. This is a very large, diverse economy. The aggregate statistics really cover up a huge amount of heterogeneity in terms of economic activity and developments in the economy. So we pay a lot of attention to regional information in trying to understand what is happening in the economy.

Mrs. CAPITO. All right. Thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman, Mr. Bernanke.

We are very likely going to have as a part of the upcoming elections a great deal of divisive language based on people's concerns about immigration, and in June of 2006, 500 American economists, including 5 Nobel laureates, signed an open letter on immigration and sent it to President Bush and to Members of Congress, and in that letter we are reminded, sir, that we are a nation of immigrants, and it talks about the economic benefits of immigration and speaks to the power of immigration to strengthen America and to lift the poor out of poverty, and the consensus reached is that most Americans, contrary to what is being said on the nightly news, benefit from immigration, but there is one portion of the letter that I think is extremely significant, and if you do not mind, I will just read from the letter:

"Immigrants do not take American jobs. The American economy can create as many jobs as there are workers willing to work so long as labor markets remain free, flexible and open to all workers on an equal basis."

Now, shortly after this letter was sent to us, Jack Kemp, George Shultz, Jeane Kirkpatrick, and 30 other non-liberals, including the former RNC Chairman, signed a separate open letter on immigration, and it embraced Ronald Reagan's view of allowing open, sensible immigration, and they go on to recite Reagan's quote from Winthrop about the city on the hill.

Now, the statistics support these letters, and recent studies show that since 1980, immigrants have boosted the U.S. GDP by $10 billion per year, and during the 1990's, when the labor force grew by 16.7 million workers, 38 percent of those workers were foreign-born. In other words, at a time when U.S. unemployment was hitting record lows, immigrants filled 4 out of every 10 jobs. Now, in January of 2000, your predecessor, Chairman Greenspan, commented that easing restrictions on immigration would go a long way in solving labor shortages.

Now, without going on, I am more interested in finding out whether or not you believe that immigration has a positive or a negative impact on our economy. Do you share in the philosophy of the 500 economists, and what do you think should be done with regard to the American workforce and immigration?

Mr. BERNANKE. Well, it is certainly true, as they say, that immigrants built the country. All of my grandparents were immigrants, and they came and they had new lives, and they contributed to our economy. So immigrants have played, historically, a very important role in U.S. economic development.

I agree with you that they do not take jobs, and the labor market does adjust to the number of people available to work. We have had a lot of immigration. The unemployment rate is quite low. It is somewhat more controversial. Do they affect wages? One concern that some people have had is that because many of the more recent immigrants have relatively low skills that they compete, to some extent, with low-skilled workers in the United States and may have some effect on their wages. Most estimates are that those are pretty small effects, but there may be some effects. So I certainly agree that immigrants have played a big role. They continue to play a big role, and we need to have a national policy on that.

I think I would stop short of recommending a specific program. This is a very tough issue and one I think Congress really has to take the lead on about how many people and under what conditions we admit, but it is certainly the case today that immigrants are playing a major role in our economy. There is no question about that.

The CHAIRMAN. If the gentleman would yield, could I just ask: Would it also have implications—you have talked about the decline in the labor rate participation. Would it also have implications for our ability to deal with the entitlement issue?

Mr. BERNANKE. It goes in the right direction, but the CBO has done some simulations that suggest even fairly large increases in immigration, say from 1 million to 2 million, would not solve the problem by any means, but it does go in the right direction.

The CHAIRMAN. It alleviates it.

Mr. BERNANKE. Yes.

The CHAIRMAN. I thank the gentleman.

Mr. CLEAVER. Mr. Bernanke, have you seen the movie, "A Day Without Mexicans?"

Mr. BERNANKE. I have seen it, yes.

Mr. CLEAVER. Would you recommend that for all Members of Congress and for people running for public office?

Thank you very kindly.

The CHAIRMAN. Did you say, "A Day without Questions?"

Mr. CLEAVER. "A Day without Mexicans." It is a new motion picture that—

The CHAIRMAN. The gentlewoman from Minnesota.

Mrs. BACHMANN. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for being here before this committee.

I have appreciated your responses to the questions, and in particular, my colleague, Mr. Hensarling from Texas, had asked you about the entitlement problem that we will be having, and that is where my question is going as well. He had mentioned the Comptroller General and some of the comments that the Comptroller General had made. One of those that really captured my attention was the statistics that he gave that already our Federal Government's net liabilities exceed $43 trillion or about $350,000 for every full-time worker in the United States.

Without fundamental changes and absent any movement by the Congress on changes in our entitlement, I am just wondering, Mr. Chairman, do you believe that there is any plausible amount of tax increases that could possibly deal with the coming crisis in our entitlement programs?

Mr. BERNANKE. Well, the tax increases would have to be quite large. The Congressional Budget Office has done some simulations, assuming 25 percent tax increases, which do not quite solve the problem. So it would have to be a pretty large increase in taxes to solve it.

Mrs. BACHMANN. And that is something that, I think, haunts all of us as we are looking toward the future, especially toward 2030. We are concerned about that. I appreciate your response on that.

My next question deals with a happier subject of productivity, and that is something where the United States has been phenomenal in the area of productivity. You are quite familiar with the President's economic report that noted that between 2000 and 2005, here in America, we had a productivity increase of about 3 percent, which far outpaced the productivity growth levels in the other G7 nations. Whereas many of them suffered a slowdown in productivity growth, the United States, in fact, accelerated and is at an enviable level.

I am just wondering, sir, if you have insight into perhaps what some of the factors are that led to this remarkable productivity growth given that Western European nations as well as the other G7 nations have the same access to technological improvements as, say, the broad capital markets that we have. I am just wondering if you could state for this committee why we have seen better results here in the United States than we have seen in the other G7 countries.

Mr. BERNANKE. That is an issue that has received a lot of attention. It is a good puzzle why we have gotten differential results. I think the answer is the interaction of the technologies and the economic system.

To go back to themes we have already addressed today, technology creates change, and the system has to be able to adapt to change in order to make full use of the technology, and in the United States the combination of very deep capital markets which have been able to fund new start-up firms or venture capital support for entrepreneurial activities and a flexible labor market which has allowed for changes in the way people work and the distribution of workers across industries and across occupations has allowed these new innovations, these technological innovations and information communication technologies not only to lead to increased productivity within the narrow sphere of high technology industries but to spread out through the whole economy and to increase productivity in financial services, in retailing, in wholesaling, and in manufacturing.

As firms have been able to apply effectively these technological innovations, in some countries there is a great deal of rigidity in the structure of labor and product markets, and those rigidities have prevented the technological innovations from being applied as effectively or as quickly as in the United States.

Mrs. BACHMANN. Thank you.

My final line of questioning goes to the legislation that Congress may very soon pass, and that would be the increase in the minimum wage. We are looking at increasing perhaps at the level of 40 percent minimum wage in the upcoming bill.

First, I am wondering if you could estimate how close we are currently to full employment here in the United States. I know, in Minnesota, we have just enjoyed wonderful low levels of unemployment. I think, for 2 months last summer, we were the job creators for about 10 percent of all new jobs across the country. We have a wonderfully strong, diverse economy.

I was wondering first if you could comment, sir, on where you believe we are at in terms of full employment in this country, and second, I was wondering if you could share with us what your opinion would be on the impact of raising the minimum wage on employment. First, at the level that we are looking at now to go to $7.25, there were comments made by one of our United States Senators that he may be introducing a bill in perhaps 6 months to raise that minimum wage up to over $9 an hour.

So, if you could, just comment on the impact of raising the minimum wage on employment and where you believe we are at in terms of full employment now.

Mr. BERNANKE. On the full employment issue, I do not know precisely where full employment is or whether we have reached it or not. I do know that the economy has come a ways in the last few years in increasing the utilization of underutilized resources. The unemployment rate has come down. Capacity utilization has gone up, and so we are certainly closer than we were a year or two ago, and, indeed, as you point out, in some areas labor markets are pretty tight and skilled workers have a lot of opportunities for work.

On the minimum wage, economists generally agree that a higher minimum wage will have an adverse effect on employment of low-skilled workers, but they disagree extremely on how big that effect would be. Some are saying it would be very small. Others are saying it would be more significant. So I can only say that probably there will be some employment effect, but it is very difficult to know how big it would be. Given that a relatively small number of workers today are at the Federal minimum wage, in part because State minimum wages or many of them are higher than the Federal minimum wage, I do not think that the employment implications of the proposed bill for the Nation as a whole would be very significant one way or the other.

Mrs. BACHMANN. And—

The CHAIRMAN. We are over time.

Mrs. BACHMANN. Thank you.

The CHAIRMAN. The gentleman from Tennessee.

Mr. DAVIS OF TENNESSEE. Mr. Chairman, thank you very much. I have a comment and then a question.

We hear a lot about undocumented workers in our country, and we hear between 12 million and 15 million working today who may or may not have legal documentation to indicate that they are actually here working as authorized by the certain laws that we have in this country, and then I hear that we have 4½ percent unemployment. The 4½ percent unemployment means we have roughly 6 million people in this country not working—is that about right?—135 million people working.

So, if we were to round up those 15 million undocumented workers and send them back wherever they came from, would we have a deficit of 9 million employees to work in America's job market? What would that do to our economy?

Mr. BERNANKE. Well, it is certainly true that where we are today is that there are a lot of immigrant workers, many of them undocumented, who are working in various industries ranging from manufacturing to agriculture to leisure and hospitality and construction and other areas, and if they were all to leave immediately then there would be obviously a disruption in those industries and labor shortages in those industries.

Mr. DAVIS OF TENNESSEE. I ask that mainly to make a point.

We have a lot of folks out here today who have a lot of ideas about America's economy, and we have a lot of ideas about some of the comments that have been made by many about the illegal immigration situation.

My real question to you is this: As I go back from about the 1970's, late 1960's, up through about right now, we have gone from having a balance of trade in our favor to where we have gradually gone to a whole other level, over $700 billion for the last 2 or 3 years in deficits in trade. Now that means that we are sending $700-some billion more out of America's economy to other nations of the world that are holding that money. They are our dollars. It is a part of our capital assets of this country that is showing that up, and when I look at that, I get kind of frightened at it, and I look at the district that I represent and I see a Saturn plant in Spring Hill that has temporary layoffs, perhaps, and I fear that they may become more permanent than temporary, those 5,000 or 6,000 jobs that we may be losing. The Carrier Corporation just left my district.

So when I look at my Congressional district, which is the fourth most rural in America, this great booming economy that we seem to have throughout America does not exist in my district, and it does not exist I believe, perhaps, in most rural areas of America.

As to the trade deficits and the budget deficits that we continue to elevate, are we just looking for a train wreck to happen, and are we sitting here in Congress kind of like Nero did in Rome as it burned, doing nothing about it? How do we stop this bleeding of huge deficit spending? Because we have seen us grow from 18.5 percent in a gross domestic spending percentage of government to about 20 percent in the last 5 or 6 years. We have seen an increase in spending, a dramatic increase, and our revenues have gone down to fund government as the Congress for the last 5 or 6 years has seen fit to spend.

So, in essence, there are two or three problems that I have, and I think it is hurting a lot of the more rural areas and maybe not the more urban areas, but we have lost 3 million industrial jobs. We are no longer producing. In export and production, we are consuming someone else's production. So how do the trade deficits, the budget deficits impact us, and when will we be in a situation where we no longer enjoy the great economy supposedly that we have, and when will it become a threat even to the world economy if that does happen?

Mr. BERNANKE. That is a very wide-ranging question. I think I would like to separate that into two issues. One is the trade aspect, and the other is the budget/current account deficit issue.

On trade, as I have discussed several times today, trade can create painful dislocations, painful changes. Competition from abroad, movements of firms out of the country, can cause people to lose jobs, and that is a serious problem. On the other hand, trade also creates a lot of benefits to the country. It creates a lot of jobs both in terms of exports, and in terms of transplants. Like you mentioned Saturn. Well, there are also transplanted auto firms that hire Americans here in the United States, and as someone mentioned here, it does allow Americans to purchase goods and services at a lower price than they otherwise would. So there are disruptions caused by trade. There are also a lot of benefits from trade, and one of the messages I have been trying to convey is that the right solution is not to stop trade or to block trade but, rather, to try to find ways to help people adjust or to retrain as necessary to deal with these very real—and I take them very seriously—dislocations and problems that arise because of this changing, dynamic economy we have.

A somewhat different question is about the trade deficit and the current account deficit, and to some extent, it is related to the budget deficit in the sense that, as I have indicated, the current account deficit reflects the fact that our savings rate is low relative to our investment, and therefore we have to borrow the difference abroad. In order to mitigate that situation over time, we need to raise our national saving, and that could be done either in terms of private saving or it could be done in terms of reducing budget deficits or increasing surpluses at both the Federal and the State and local government levels. That is going to take some time. I think, you know, we do not have to solve this problem overnight, but we should be, I think, working to reduce the current account deficit over time and at the same time that we continue to allow trade and technology to help our economy grow more quickly.

Mr. DAVIS OF TENNESSEE. We have actually tripled our budget—

The CHAIRMAN. I am sorry. The gentleman's time is up. We cannot ask a new question.

The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Bernanke, I thank you for being here. I would also like to thank you for the cooperation of the Federal Reserve in the new dollar gold coin which we passed through this particular committee. I happen to be the sponsor of it. I think this is the issuance date today, as a matter of fact. Although we did something with the Treasury and the Mint people with George Washington and the Statue of Liberty on the other side, but your acquisition of $300 million is a nice start. We hope to make some $5 billion. So this is something that actually produces revenue for the U.S. Government.

Going to a subject I want to ask you a question about, though, this committee, in a bipartisan way, passed the Sarbanes-Oxley Act in 2002, and you have heard, I am sure, a lot of criticism on that law—and I have read about it—and some praise of it one way or another, but they talk about the rising cost of regulation, and this, according to some people, is creating an incentive for firms to be listed on foreign markets or to withdraw from public markets altogether. We have more private capital and that kind of thing going on in the United States of America now, and there are other measures besides Sarbanes-Oxley that are attributed with those problems.

In your opinion, has rising regulatory costs or other regulatory blocks of some kind or another weakened the international competitive position of our stock exchanges, and do they pose a threat to our competitiveness in the future?

Mr. BERNANKE. To some extent, the declining relative position of the American exchanges reflects the natural growth and development of exchanges abroad, in London, in Asia and so on, and as those economies, those exchanges become larger, more efficient, and deeper; that is actually not a bad thing because it gives, for example, American companies more alternatives for raising money.

On the other hand, to the extent that business is being driven offshore by high regulatory costs, which was the conclusion of these two recent studies on capital market competitiveness, then that is a problem and we need to begin to address those costs.

The Sarbanes-Oxley issue that you raised earlier has been cited by a number of these studies, and the SEC and the Public Company Accounting Oversight Board have recently issued a new audit standard which will attempt to reduce the costs of implementing Sarbanes-Oxley's Section 404 on internal controls and, in particular, to make it more focused on the most important matters rather than on trivial matters and also more appropriate for smaller and less complex firms. So I think that is going to be an important step in reducing that particular set of costs.

There are many other issues, some of which Congress could address—issues of tort reform and litigation, the CFIUS bill about foreign investment coming to the United States, and striking the appropriate balance there between keeping a flow of foreign investment into the United States versus appropriate national security considerations. The Federal Reserve is working on the Basel II bank capital accord regulation, and we are working on that, and we want to make sure that does not put American banks at a capital disadvantage in the capital markets.

So it is certainly important for us across a whole variety of regulatory areas to try to keep those costs down and to keep working to reduce the burden of regulation on American public companies.

Mr. CASTLE. Well, thank you. I do not mean to speak for our chairman or ranking member here, but I think these issues are of great importance to this particular committee. So, hopefully, we can be kept informed.

Changing subjects, I am looking at page 2 of your testimony in which it says that the Federal Open Market Committee has maintained Federal fund rates, etc., of 5¼ percent, and it says that, more or less, the risk of inflation is not overwhelming at this point. Then it goes on to say—and again, you have indicated this—the "predominant policy concern is the risk that inflation will fail to ease as expected and that it is prepared to take action to address inflation risks if developments warrant." I suppose I should have learned this in Economics 101, but in addition, if there is an addition to dealing with interest rates, are there other things that the Federal Open Markets Committee can do with respect to that issue?

Mr. BERNANKE. No. That is the basic tool.

The CHAIRMAN. If the gentleman would yield.

Mr. CASTLE. I yield.

The CHAIRMAN. He said he could not speak for me, but he just asked essentially the same question I asked. So, on those two questions about the congruity of those two statements, I agree with the gentleman.

Mr. CASTLE. And I also apologize for being absent and not here when you asked, Mr. Chairman. I had a good reason for it, though.

The CHAIRMAN. Submit it in writing.

Mr. CASTLE. I have last year introduced legislation about transparency in hedge funds. I am concerned about hedge funds. You answered this yesterday in Senate testimony and basically indicating that the liquidity of hedge funds could be very important. I don't have a problem with that either, but I do have a problem in terms of what hedge funds could do with respect to commodity markets and a variety of things they get into because of the enormity of it and the number of them that have opened in recent years and where they are going.

I am not one who looks for overregulation or overtransparency, if there is such an expression, but I think proper transparency is in order. I would like your thoughts, if you could, about where we are with respect to hedge funds, and what do you think the role of the—regulatory role or perhaps our committee role in this area should be.

Mr. BERNANKE. Well, the approach that regulators have taken since the report of the President's Working Group after the LTCM crisis has been a market-based approach, an indirect regulation approach, whereby we put a lot of weight on good risk management by the counterparties to the hedge funds such as the prime dealers, the lenders, as well as the good oversight of the investors, the institutions and so on that invest in hedge funds. And we found that is a very useful way to control leverage and to provide market discipline on those funds.

The original report of the President's Working Group also suggested disclosures, and that never went anywhere in Congress, and I think part of the problem was it was difficult to agree upon what should be disclosed and what would be useful. The hedge funds are naturally reluctant to disclose proprietary information about their trading strategies and approaches, and their positions change very quickly, and so therefore position information can be overwhelming and perhaps not very useful.

I think it is important to continue to think about hedge funds. They certainly play an important role in our financial system. Exactly, you know, what a disclosure regime would look like, though, is not yet clear to me how that best would be organized.

The CHAIRMAN. The Chair is about to recognize the gentleman from Minnesota. I do want to thank the Chairman. It is the first time in my memory that freshman members of this extremely large committee are able to ask questions because—I appreciate the chairman being around because we are going to be able to accommodate our four remaining members, but the ranking member had one very specific brief question he wanted to ask, and if there is no objection, I will recognize him for that.

Mr. BACHUS. Mr. Chairman, this is more of a concern. Governor Susan Bies recently announced her retirement. I am very concerned about that in that she was expert on not only risk management, but on Basel, and I felt like under her leadership we made tremendous strides in Basel. She had real banking experience with a regional bank. And with Mark Olsen gone, too, I am just concerned that as that process goes forward—you know, he has a community banking background—that we had people who were bankers that we deal with as this process goes forward, because those are two major losses.

Mr. BERNANKE. We will miss Governor Bies, as well. She was an extraordinary colleague and very, very knowledgeable about banking matters, as you indicate.

I think we will have good continuity. We have the skills at both the Board level and at the staff level to continue to move forward effectively with Basel II. And we will, of course, wait for the President to nominate two people to the Board.

The CHAIRMAN. I would like to say to the Chairman that I hope that you can, in fact, bring the Basel process to a conclusion and I never have to think about it again for about 6 years.

The gentleman from Minnesota.

Mr. ELLISON. Thank you, Mr. Chairman.

And thank you, Mr. Chairman.

Mr. Chairman, in your remarks on page 2, you noted that real hourly compensation rose at an annual rate of about 3 percent in the latter half of 2006.

Could you describe how the longer period of time, for example, over the past 10 or, say, 15 years, what have real wages looked like?

Mr. BERNANKE. I don't know the exact number over the last 10 years, but there has been a pattern, we have seen this time and we saw before, in the late 1990's, when productivity picked up quickly during that period in the late 1990's, real wages lagged behind productivity for a while, and then they began to catch up to it.

I think in the current episode a couple of things have been at work. One is that the labor market remains somewhat weak even after the recession ended in 2001. A second concern has been the oil price increases, given nominal wage increases, modest nominal wage increases, when oil prices go up so much that it takes away from the buying power of real wages. And then thirdly I think it is, again, somewhat normal for real wages to catch up later in the business cycle to—and particularly when there have been periods of increased productivity growth as we have seen in the last 3 years.

So I am encouraged to see this increase in real wages. Barring new shocks, new increases in oil prices, I would think we would see further increases in real wages going forward. And I would just add that the 3 percent number is for the whole nonfarm business sector, but you get about the same number for average hourly earnings for production workers, which is more representative of the broader middle of the middle distribution.

Mr. ELLISON. I am encouraged by the increase in real wages, too, since the middle of 2006, but I have heard people describe the real wages over the longer period, maybe 20 years or so, as flat. And so I don't know if that conflicts with what you are saying or if it is—or if what you are saying is more descriptive of more recent events.

Mr. BERNANKE. The behavior of real wages depends on the skill levels. I have some discussion of this in this speech that Representative Waters referred to on inequality. Over the last 25, 30 years, we have seen really modest increases in real wages for those with less than a high school education, much more significant increase in real wages for those who have a college education or better, and intermediate increases for high school graduates. So it depends very much on where you are in the wage scale.

Mr. ELLISON. Thank you.

I want to ask you a little about loans. What is your best prescription or recommendation to fix what I would generally describe as predatory loans? And I am not only referring to the mortgage market, but what could also—some phenomena in the credit card area?

It sounds like what you are saying what we need is more disclosure to the consumer. Did I understand your views accurately on that?

Mr. BERNANKE. Well, I indicated that it is very difficult. And I am not just trying to hedge here, because we want to eliminate predatory and abusive lending, but we don't want to shut down the legitimate subprime market. And that is sometimes a difficult task, and that is why I was praising some of the State efforts that represent good experiments along those lines.

So approaching that I think involves disclosure, it may involve barring certain practices as well. The Federal Reserve, I should say, is very much involved in trying to control predatory lending. We are responsible for the Home Mortgage Disclosure Act. We recently added information requirements there on pricing so we can find out whether pricing is varying across, for example, minorities and nonminorities. We are responsible for the Home Ownership Equity Protection Act and other things, Regulation Z. So we are very much involved in that from the Federal level.

But again, I think there is still a lot of creativity we can see at the State level to try to understand better how to address this problem.

Mr. ELLISON. Thank you, Mr. Chairman. I only have 5 minutes. So is the proposal—the rule proposal regarding regulation Part D, is that basically a rule—do you anticipate that rule focusing on disclosure, or will it include barring certain practices?

Mr. BERNANKE. Did you say Regulation Z?

Mr. ELLISON. Yes.

Mr. BERNANKE. Yes. That is part of the Truth in Lending Act. By nature of the act, it is focused on disclosures, and it will be focused on short-term credit like credit cards.

Mr. ELLISON. Do you have any views on things like universal default? This is a credit card practice I am sure you are familiar with. If you default, if you are late on one credit card, a credit card company you are not late on can jack up your rate. Do you have any views on that practice and how Congress might approach that kind of phenomena?

Mr. BERNANKE. That is a difficult one. We don't want to rule out the possibility that when someone's creditworthiness drops for a variety of reasons, that their creditors get that information and use it.

However, I think some of the concern about universal default provisions is that people don't get enough warning or notice that this condition is going to kick in. So that might be one direction to go, which is to increase the amount of warning that consumers get when their credit histories deteriorate and when that may affect their pricing and their credit cards.

Mr. ELLISON. Thank you.

The CHAIRMAN. The gentleman from Illinois.

Mr. ROSKAM. Thank you, Mr. Chairman.

Mr. Chairman, I am a new Member of Congress and a new member of the committee, and I appreciate the detailed questions that my colleagues have asked. I guess I would ask a broader question, and that is, you know, it seems to me that economic strength and weakness, success and failure is mysterious in a lot of ways, and it is difficult for somebody outside of this arena to gaze in and really discern all the factors that go into a good, successful mix. And I realize there is really nobody who can do that.

But for purposes of this committee and future committees that have this responsibility of oversight for you, Mr. Chairman, and the Fed, what are the things that you are responsible for? What are the tools that you have at your disposal? And can you sort of, and maybe in an Econ 101 sort of fashion, in the remaining 4 minutes just break that down and say, look, maybe start—these are the things that we frankly have no influence over, that are just off the table. I think that would help me and maybe some other members of the committee in the future.

Mr. BERNANKE. Well, the Federal Reserve has multiple responsibilities. The one that is best known is our responsibility for monetary policy, which we use to pursue the Congressional mandate of price stability and maximum sustainable employment.

It is important that the Federal Reserve be independent and be able to make independent decisions about interest rates in order to preserve the credibility of the central bank. However, it is also important that Congress exert oversight over the Federal Reserve to make sure that we are following our stated mission, and that we are pursuing coherent and rational plans.

The other areas include banking supervision, where we are involved in developing the new capital accord, providing various guidances and regulations together with the other banking agencies, and there we are more like the other agencies in terms of the kinds of responsibilities we have.

We have considerable responsibility in the consumer protection area—that has come up a lot today—for various regulations that provide disclosures to consumers on credit cards, on mortgages, and that provide some tools to address predatory lending, or high-cost lending. And there, like other agencies, we are given instruction by the Congress, by the law, in terms of what the Congress wants us to achieve and with what instruments. And then it is our job to implement the regulations that will most effectively accomplish Congress's goals.

So we have a range of activities, all of which fall into the underside of Congress obviously.

The CHAIRMAN. I thank the gentleman. The Chair will now exercise his prerogative. We have four Members left who haven't asked questions. We have about a half hour. That is going to be the end of it. So I will go to the gentleman from Colorado, the gentleman from Ohio, the gentleman from Indiana, and the gentlewoman from Wisconsin. Anyone who is within the sound of my voice or whose staff is here, don't bother to show up because we are going to end it at this. And the gentleman of Ohio is recognized—I am sorry the gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman, and Chairman Bernanke, thank you for your stamina and patience. I have several questions.

The CHAIRMAN. What about mine?

Mr. PERLMUTTER. Well, yours has been remarkable, Mr. Chairman. Thank you.

On page 2 of your report, you say that consumer spending continues to be the mainstay of the current economic expansion.

Where are we on consumer debt? I mean, have you seen a trend in that, and can you tell me where we are?

Mr. BERNANKE. Consumer debt has risen quite a bit. It is rising more slowly recently mostly because home mortgages aren't rising as quickly due to the flattening out of prices and the slower amount of home purchase.

Generally speaking, though, as we said in the testimony, households are in reasonable financial shape. Offsetting their debt is an increase in wealth; the stock market is up. House prices over the last few years have gone up a lot, and so many people have a considerable amount of equity in their home. And moreover, the strength of the labor market means that the job availability, incomes, wages are also pretty strong. So for the larger part of the population, finances seem reasonably good relative to historical norms.

Now, of course, there are always some people who are having problems, and as I noted in testimony, there are some sectors, notably the subprime lending sector, where we were seeing some distress, and we are watching that very carefully.

Mr. PERLMUTTER. So no alarm bells in the trend of consumer debt, because I guess my perception has been that we have had significant increase to consumer debt really as compared to over the last 10 years, and that there have been some concerns about that.

Mr. BERNANKE. There have been increases in consumer debt. There have been even larger increases in consumer assets, and so our wealth has grown. Our wealth is now at the highest level ever.

So, again, for most people there is a reasonable balance between assets and liabilities.

Again, there are some pockets of concern, but I don't think that at this point that they have significant implications for the behavior of the overall economy, although we obviously have to watch the individual sectors.

Mr. PERLMUTTER. Okay. Any exact pro or con by the recent changes in the Bankruptcy Code now that we have had a year, year-and-a-half under our belts? And, you know, if you don't, if it is too early to tell, then that is fine, too.

Mr. BERNANKE. It is a bit early to tell. We saw a big spike in bankruptcy filings in advance of the law because people, if they were thinking of going bankrupt, they wanted to get that done before the law change. Since then we have seen a moderate rate of bankruptcy, I think somewhat lower than in the past, but whether that is due to the change in the law or just to generally good financial conditions in the last few years is hard to say. Again, we have seen, for example, very few delinquencies in consumer credit or in mortgages outside the subprime market, so there has been a generally good credit situation in the last couple of years, and that seems to be reflected in a relatively low rate of bankruptcies.

Mr. PERLMUTTER. Speaking of the subprime market, last week the bottom kind of fell out of that market, or there was a tremendous drop in that market. Has that leveled off? I haven't read anything since Friday, but it seems there was a tremendous loss of value in that market.

Mr. BERNANKE. There have been a few small companies that have gone out of business, and others that have lost money. Nowadays, mortgages are not just made and held by individual firms, they are then securitized and sold into the general financial markets. And so we can look at financial market prices and see what the market more broadly thinks is happening in this area. And the value of subprime-mortgage-backed securities has dropped pretty significantly, suggesting that financial market investors are concerned about the loss probabilities in this area.

Mr. PERLMUTTER. My last question, I had a number of organizations, interest groups, approach me on the issue of banks getting into the real estate business as opposed to remaining in the lending business. Does the Fed have an opinion on that, or do you have an opinion on that?

Mr. BERNANKE. The Federal Reserve is charged, along with the Treasury, in determining whether allowing banks to enter the real estate brokerage business is consistent with Gramm-Leach-Bliley. However, the Congress every year has essentially forbidden that consideration, so we have not yet had an opportunity to consider whether, based on the law, that should be allowed, so we have not had the opportunity to try to evaluate that.

Mr. PERLMUTTER. Do you have an opinion on it, or if the answer is no, it is premature, that is fine.

Mr. BERNANKE. Since I am charged with making a determination, it would certainly be inappropriate for me to speak about it until such time as I have a chance to look at the information and data.

The CHAIRMAN. The gentleman from Ohio.

Mr. GILLMOR. Thank you, Mr. Chairman, and also thank you, Mr. Chairman, for spending so much time with us.

I want to touch on the question of ILC's. As you know, a lot of retail firms are trying to make an end run around the banking laws. Chairman Frank and I have had legislation in now for three Congresses. In the past you have always—also your predecessor, Mr. Greenspan, made comments in favor of closing that loophole. Would that still be your opinion?

Mr. BERNANKE. Yes, it would.

Mr. GILLMOR. Let me ask you another question regarding the economy, which has been generally good by all historical standards and when you have a good economy for a long time, you have low interest rates, thank goodness. We are all happy to see that. You see some of the economic commentators talking about whether it is time for the Fed to take the punch bowl away, and I guess my question is while the party is still going good economically, do you think we are still sober enough to leave the punch bowl there? So my question is what are you going to do with the punch bowl?

Mr. BERNANKE. We are going to conduct monetary policy so as to satisfy the chairman and meet our congressionally mandated responsibility for maximum employment and price stability.

Mr. GILLMOR. Thank you.

One other question, and I don't know if you are familiar with this recent report, but many of us are worried about America's global competitiveness, and the World Economic Forum recently released its Global Competitiveness Report in which the United States dropped from first to sixth.

I guess my question is, do you agree with that assessment and the recommendations made therein?

Mr. BERNANKE. First, I think that notion of competitiveness between countries is a little bit deceiving. It is not quite the same as GM and Ford. Any country that is successful in increasing its productivity will increase its wages and living standards independent of whether other countries are doing the same.

I have looked at that report. It seems to me that the change in ranking is based on relatively small changes in the numbers. Some macroeconomic factors like our savings rate have entered into that calculation. So I don't take that in particular as an alarm bell. I don't think it is particularly significant, but, as always, we need to find ways to improve our macropolicies, improve our regulatory policies, and keep the country as productive and efficient as possible.

Mr. GILLMOR. Thank you very much, Mr. Chairman, and thanks again for spending so much time with us.

Mr. BERNANKE. Thank you.

The CHAIRMAN. And thanks to the gentleman from Ohio for dropping in.

Mr. GILLMOR. I was on the Floor, Mr. Chairman.

The CHAIRMAN. The gentleman from Indiana.

Mr. DONNELLY. Thank you, Mr. Chairman.

Thank you, Chairman Bernanke.

My district has Chrysler plants, Delphi plants, and small manufacturers, the heartland of this country, and in your testimony you talked about painful changes that are taking place. What the people of my district have asked me to tell you is that the changes are even more painful when the competition isn't fair. And we see China manipulating their currency, having no labor standards, no environmental standards, and intellectual piracy. And I guess my question to you, Mr. Chairman is do you see this as unfair competition, and if so, why do we let this continue?

Mr. BERNANKE. Well, I have spoken about the yuan, about the Chinese currency, and I think that it is undervalued. And I think that the Chinese ought to allow it to be more market-determined, that they should move in that direction.

I also think that we should continue to work with them to enforce their intellectual property rights and to make sure that both sides are living up to trade agreements.

So going forward, I agree that trade agreements need to be enforced, and intellectual property rights are important, and we should continue to apply pressure to China on those issues.

Mr. DONNELLY. I appreciate that. There is a feeling back home and on my part that the Chinese don't take us seriously in that respect—that we talk and we talk and we talk, and while we talk, more jobs leave my district from manufacturers who have shaved every corner they can, who have put in all the computer integration they can, and they see product coming into this country at costs they can't even touch to manufacture.

And so there is a feeling that you are the home team, our Treasury Secretary, he is the home team. He was over in China recently, and there is a dispiritedness both on Republicans and Democrats, this is bipartisan, that the home team has walked away. Our own coaches have left us on the field all by ourselves. And so when I go back and say, well, they are talking, my manufacturers laugh and say, well, they will talk us until our doors are closed. So what do I tell them about that, Mr. Chairman?

Mr. BERNANKE. The Chinese have recognized that the large trade surplus is, in fact, a problem for them as well, and they understand that there is a risk of reaction, protectionism perhaps, and they have made it part of their official economic plan to try to reduce the trade surplus that they currently have.

Greater exchange rate flexibility is part of the way to do that, but in addition, the Chinese are currently trying to increase the reliance of their economy on domestic consumption, domestic spending, and reduce reliance on exports. If they can make that adjustment towards a domestically driven economy, reduce their export reliance, that will help more, I think, even than some other measures to create a better global balance. So that is one step that they are taking.

I would also say in terms of our conversations in discussions with the Chinese that I think that while the exchange rate is a very, very important issue, there is a wide range of issues that we as Americans have to discuss with the Chinese including issues of trade; you mentioned intellectual property rights and trade agreements, but things like the environment. For example, I think there is a lot of mutual benefit if, for example, we were able to provide equipment and technology to the Chinese to help them clean up their air, that would be beneficial to both parties. Similarly energy security is another interest we have in common.

So another way to look at this is that, yes, we have to keep working on the exchange rate, but we also have a lot of other things that we need to be talking about, and I think it is important to keep that conversation going.

Mr. DONNELLY. And I guess I would ask you to discuss with the Chinese when you talk to them, and the Secretary of Treasury when he talks to them, that the folks back home who are running these shops, who are supplying families with the money to purchase their home, and we have increasingly high foreclosures back home, have said to me, Joe, we sent you there to do something about this, and if the Treasury Secretary and the Fed and the President aren't willing to do it, then we are looking to Congress to step up and take the steps necessary to make this a fair ballgame, again because they feel it is a rigged game, and our team won't step up for the people at home.

Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Wisconsin.

Ms. MOORE OF WISCONSIN. Well, thank you very much, Mr. Chairman, and thank you very much, Mr. Chairman, for your patience here today.

Thank you, Mr. Chairman. I did have an opportunity to review your testimony before the committee, and I do want to thank you. I have a reached some conclusions, which I guess I want to sort of vet with you.

As others have mentioned, you mention several times in your testimony that consumer spending continues to be the mainstay in the current economic expansion, and you also seem to indicate that the resilience of this consumer spending is important towards sustaining our economic growth.

You also indicate that increase in people's compensation accounts for this, and that our higher labor productivity and perhaps a narrowing of corporate profits might offset the higher labor productivity and that narrowing—I am sorry—profit margins of companies might prevent higher prices from occurring, and people might experience a real higher compensation.

A couple of questions come to mind when I review this testimony. First of all, I guess I want to ask you if you account for this stronger gain in personal income as many of us do, foresee that it is all aggregated kind of at the top, that this increase in consumer spending is a very narrow number of consumers, and that imposes some kind of risk unless we spread the purchasing and consumer spending power a little bit broader.

And secondly, leading into that sort of executive compensation, if we were to—again, if we are depending—if our economy is depending on consumer spending, wouldn't it be better if we sort of spread the wealth a little bit and, in keeping with your testimony, resist raising prices by narrowing corporate prices, profits?

Mr. BERNANKE. Well, as I discussed, there has been a long-term trend toward increased inequality in the United States that has been going on for a long time, but it is certainly an issue. I think most recently there has been some improvement just in terms of general earnings in the broader economy. I mentioned the statistic of the average hourly earnings which are for production workers, so that does not exclude the top 20 percent of wage earners, and that has grown recently at a pretty reasonable pace. So I think that real wage gains currently are going to help support consumption spending. But I agree that we want to see a broad-based consumption in order to make this sustainable.

Ms. MOORE OF WISCONSIN. I am glad that you mentioned, because there seems to be a lot of resistance toward things like raising the minimum wage. I think we talk a lot about minimum-wage workers, but there are people who don't make the minimum wage that could benefit and would spend if they had more so-called disposable income. And I think your testimony really contributes a great deal to the discussion of how important it is to support our economy through elevating people's wages, and that is what I took away from your testimony. Thank you.

Mr. BERNANKE. Thank you.

Ms. MOORE OF WISCONSIN. I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentlewoman, and I want to thank the Chairman, and I want to say that I thank the members of the committee. This has been a very thoughtful discussion. I appreciate the Chairman. I think these are issues that we will continue to talk about. And the hearing is adjourned.

[Whereupon, at 1:50 p.m., the hearing was adjourned.]

APPENDIX

February 15, 2007

Statement and Questions for Humphrey-Hawkins Hearing
Rep. Randy Neugebauer, Deputy Ranking Member
House Financial Services Committee
February 15, 2007

Chairman Frank, Ranking Member Bachus, thank you for holding this important hearing. Chairman Bernanke, thank you for appearing before the committee today and for your thoughtful testimony.

Mr. Chairman, over the past several years, smart fiscal policies, including tax relief and spending restraint, have contributed to tremendous economic growth and deficit reduction. In short, our economy is strong.

With 111,000 new jobs created in January, and more than 2.1 million new jobs created over the past 12 months, our workforce continues to grow. Since August 2003, more than 7.4 million jobs have been created – more jobs than all the other major industrialized countries combined. In addition, our economy grew by a solid 3.4 percent last year.

This economic growth has generated increased tax revenues and has dramatically improved the budget outlook. If Congress continues to show restraint in spending, and our economy continues to climb as a result of extended tax cuts, we will eliminate the budget deficit in five years, and reap a surplus in the year 2012.

Despite the successes we have enjoyed, however, more needs to be done. In order to sustain economic growth, entitlement spending must be restrained. It is imperative that we make meaningful reforms to control the rapid growth of these outlays, and I am pleased President Bush's budget proposal includes several reform options for Congress to consider.

It is also important for Congress to promote a stable housing market. As our nation's housing market continues to show tremendous resiliency and strength, we must work to ensure that Government Sponsored Enterprises, such as Fannie Mae and Freddie Mac, are financially and ethically sound.

In addition, we must work to reform our health care system, diversify our energy resources, and promote a more balanced trade position. We must also focus on the fiscal education of America's youth, and work with state and local leaders to implement common sense education priorities that promote a basic understanding of finance.

With these things in mind, I would like to ask you three unrelated questions:

1. The personal savings rate of Americans has recently fallen to a 73-year low. In your estimation, how does this impact our current housing situation?
2. Can you give me an indication of your level of concern about the default rates on home mortgages – especially as it applies to subprime mortgages?
3. In your estimation, has Congress shown adequate concern about the growth of entitlement spending?

Again, thank you for your testimony. I look forward to reading your responses to my questions.

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COMMITTEE ON FINANCIAL SERVICES

HEARING TO RECEIVE TESTIMONY of the CHAIRMAN, BEN BERNANKE,

OF THE FEDERAL RESERVE BOARD OF GOVERNORS

THURSDAY, FEBRUARY 15, 2007

Good morning. Mr. Chairman and ladies and gentlemen, it has been exactly one year since we first heard from the then-new Chairman of the Federal Reserve Board of Governors, Ben Bernanke. Mr. Bernanke, I want to congratulate you on this milestone and thank you for your willingness to work closely with the Members of the Committee on Financial Services. Indeed, I have watched you during this first year of your tenure as the Chairman of the Fed and have been most interested in your ideas about income inequality, investment in education, community investment and other economic issues.

As you know, when you appeared before the Committee in July 2006 to present your midyear report to Congress, you identified three issues that you felt could influence the economy—energy prices, stagnation of the housing market and resources utilization. In July 2006, the price of a barrel of oil was $ 78.00, representing a 30 percent increase from six months earlier when oil was $55.00. The current price of oil is approximately $59.00 per barrel, but oil price volatility must be factored into any predictions about the future of the U.S. economy. The U.S housing market has slowed considerably. Scarce resources are being stretched even thinner because of worldwide demand for those resources, led by China, India and other growth economies. Chairman Bernanke, you were undoubtedly correct in identifying the three issues that would impact the U.S. economy moving forward. And here we are six months later with what could be the beginning stages of a major slowdown in the U.S. economy because housing is no longer robust, oil prices are likely to increase, and resources are not unlimited. Something has to give, and maybe it is the end of the ride for this economic growth cycle.

It has been more than five years since the expansion began in November 2001, and working Americans are still waiting for their share. According to some reports, "the economy is showing remarkable parallels to the situation of a decade ago." The first five years of the expansion in the

1990s brought with it record corporate profits, a robust stock market, and increased wealth for the very few. That expansion would ultimately last for ten years.

Wage increases have been almost nonexistent for the American worker. In December 2006, five years after the economy started to grow, the wages of the American worker were approximately 1.7 percent higher, adjusted for inflation, than when the economy sank in November of 2001. Most of the gains experienced by workers were realized in the last few months of that expansion. In April 1996, five years after that expansion, wages were actually worth four tenths of a percent less than when the expansion began. In addition, we have to take into account that productivity growth for 2006 was 2.1 percent and has not been that low since 1997. These two indicators might suggest to some that we are in for along ride unless you believe that we will have five uninterrupted years of growth in both productivity and wages.

These economic indicators tell us a lot about why there is growing income inequality in the U.S. I am afraid that if the economy continues to turn in the opposite direction from where it has been these last five years, income inequality will increase. As income inequality grows, we will see more people slip into poverty, while unemployment will add to the economic woes of the already strapped American worker.

Finally, Chairman Bernanke, I am really interested in the policy debate around the U.S. trade imbalance. We have had a trade imbalance for the last five years. Just two days ago we learned that the trade deficit of $763.3 billion for 2006 - a 6.5 percent increase over 2005 - is the largest in our history. Imported oil and vast amounts of consumer goods from China and other major importers account for the large part of the U.S. trade imbalance. We hear that trade deals are good and that trade deals are bad.

Whatever view you accept, it is clear that U. S. exports are not substantial enough to offset the imbalance, although we increased exports over last year by 13 percent. Of course, we know that the Administration is pro-Free Trade and believes that the loss of American jobs is solely a result of technology, rather than to flood of inexpensive goods coming into the country from
abroad. Unemployment is extremely high in communities affected by the loss of manufacturing jobs. Some of the

unemployment is intractable, and many of the unemployed for years instead on months.

As Chairman now for one year, what can you tell us about the role of the Federal Reserve in addressing these problems? Is it just a matter of monetary and fiscal policy, or are is there a real policy fix for the problems that we are facing in the US? What will we experience if the current expansion has come to an end and growth slows? Once again, I am extremely pleased to be able to hear your views and prescriptions for our economy, particularly the neglected segments of the population --- the poor, the unemployed and underemployed. Many of these people missed out on the benefits of the recent expansion. Thank you.

For release on delivery
10:00 a.m. EST
February 15, 2007

Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 15, 2007

Chairman Frank, Representative Bachus, and other members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress.

Real activity in the United States expanded at a solid pace in 2006, although the pattern of growth was uneven. After a first-quarter rebound from weakness associated with the effects of the hurricanes that ravaged the Gulf Coast the previous summer, output growth moderated somewhat on average over the remainder of 2006. Real gross domestic product (GDP) is currently estimated to have increased at an annual rate of about 2-3/4 percent in the second half of the year.

As we anticipated in our July report, the U.S. economy appears to be making a transition from the rapid rate of expansion experienced over the preceding several years to a more sustainable average pace of growth. The principal source of the ongoing moderation has been a substantial cooling in the housing market, which has led to a marked slowdown in the pace of residential construction. However, the weakness in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other sectors of the economy. Consumer spending has continued to expand at a solid rate, and the demand for labor has remained strong. On average, about 165,000 jobs per month have been added to nonfarm payrolls over the past six months, and the unemployment rate, at 4.6 percent in January, remains low.

Inflation pressures appear to have abated somewhat following a run-up during the first half of 2006. Overall inflation has fallen, in large part as a result of declines in the price of crude oil. Readings on core inflation--that is, inflation excluding the prices of food and energy--have improved modestly in recent months. Nevertheless, the core inflation rate remains somewhat elevated.

In the five policy meetings since the July report, the Federal Open Market Committee (FOMC) has maintained the federal funds rate at 5-1/4 percent. So far, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing of core inflation. However, in the statement accompanying last month's policy decision, the FOMC again indicated that its predominant policy concern is the risk that inflation will fail to ease as expected and that it is prepared to take action to address inflation risks if developments warrant.

Let me now discuss the economic outlook in a little more detail, beginning with developments in the real economy and then turning to inflation. I will conclude with some brief comments on monetary policy.

Consumer spending continues to be the mainstay of the current economic expansion. Personal consumption expenditures, which account for more than two-thirds of aggregate demand, increased at an annual rate of around 3-1/2 percent in real terms during the second half of last year, broadly matching the brisk pace of the previous three years. Consumer outlays were supported by strong gains in personal income, reflecting both the ongoing increases in payroll employment and a pickup in the growth of real wages. Real hourly compensation--as measured by compensation per hour in the nonfarm business sector deflated by the personal consumption expenditures price index--rose at an annual rate of around 3 percent in the latter half of 2006.

The resilience of consumer spending is all the more striking given the backdrop of the substantial correction in the housing market that became increasingly evident during the spring and summer of last year. By the middle of 2006, monthly sales of new and existing homes were about 15 percent lower than a year earlier, and the previously rapid rate of house-price appreciation had slowed markedly. The fall in housing demand in turn prompted a sharp slowing in the pace of construction of new homes. Even so, the backlog of unsold homes rose from about four-and-a-half months' supply in 2005 to nearly seven months' supply by the third quarter of last year. Single-family housing starts have dropped more than 30 percent since the beginning of last year, and employment growth in the construction sector has slowed substantially.

Some tentative signs of stabilization have recently appeared in the housing market: New and existing home sales have flattened out in recent months, mortgage applications have picked up, and some surveys find that homebuyers' sentiment has improved. However, even if housing demand falls no further, weakness in residential investment is likely to continue to weigh on economic growth over the next few quarters as homebuilders seek to reduce their inventories of unsold homes to more-comfortable levels.

Despite the ongoing adjustments in the housing sector, overall economic prospects for households remain good. Household finances appear generally solid, and delinquency rates on most types of consumer loans and residential mortgages remain low. The exception is subprime mortgages with variable interest rates, for which delinquency rates have increased appreciably. The labor market is expected to stay healthy, and real incomes should continue to rise, although the pace of employment gains may be slower than that to which we have become accustomed in recent years. In part, slower average job growth may simply reflect the moderation of economic activity. Also, the impending retirement of the leading edge of the baby-boom generation, and an apparent leveling out of women's participation rate in the workforce, which had risen for several decades, will likely restrain the growth of the labor force in coming years. With fewer jobseekers entering the labor force, the rate of job creation associated with the maintenance of stable conditions in the labor market will decline. All told, consumer expenditures appear likely to expand solidly in coming quarters, albeit a little less rapidly than the growth in personal incomes if, as we expect, households respond to the slow pace of home-equity appreciation by saving more out of current income.

The business sector remains in excellent financial condition, with strong growth in profits, liquid balance sheets, and corporate leverage near historical lows. Last year, those factors helped to support continued advances in business capital expenditures. Notably, investment in high-tech equipment rose 9 percent in 2006, and spending on nonresidential structures (such as office buildings, factories, and retail space) increased rapidly through much of the year after several years of weakness. Growth in business spending slowed toward the end of last year, reflecting mainly a deceleration of spending on business structures; a drop in outlays in the transportation sector, where spending is notably volatile; and some weakness in purchases of equipment related to construction and motor vehicle manufacturing. Over the coming year, capital spending is poised to expand at a moderate pace, supported by steady gains in business output and favorable financial conditions. Inventory levels in some sectors--most notably at motor vehicle dealers and in some construction-related manufacturing industries--rose over the course of last year, leading some firms to cut production to better align inventories with sales. Remaining imbalances may continue to impose modest restraint on industrial production during the early part of this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad helped spur a robust expansion in U.S. real exports, which grew about 9 percent last year. The pattern of real U.S imports was somewhat uneven, partly because of fluctuations in oil imports over the course of the year. On balance, import growth slowed in 2006, to 3 percent. Economic growth abroad should support further steady growth in U.S. exports this year. Despite the improvements in trade performance, the

U.S. current account deficit remains large, averaging about 6-1/2 percent of nominal GDP during the first three quarters of 2006 (the latest available data).

Overall, the U.S. economy seems likely to expand at a moderate pace this year and next, with growth strengthening somewhat as the drag from housing diminishes. Such an outlook is reflected in the projections that the members of the Board of Governors and presidents of the Federal Reserve Banks made around the time of the FOMC meeting late last month. The central tendency of those forecasts--which are based on the information available at that time and on the assumption of appropriate monetary policy--is for real GDP to increase about 2-1/2 to 3 percent in 2007 and about 2-3/4 to 3 percent in 2008. The projection for GDP growth in 2007 is slightly lower than our projection last July. This difference partly reflects an expectation of somewhat greater weakness in residential construction during the first part of this year than we anticipated last summer. The civilian unemployment rate is expected to finish both 2007 and 2008 around 4-1/2 to 4-3/4 percent.

The risks to this outlook are significant. To the downside, the ultimate extent of the housing market correction is difficult to forecast and may prove greater than we anticipate. Similarly, spillover effects from developments in the housing market onto consumer spending and employment in housing-related industries may be more pronounced than expected. To the upside, output may expand more quickly than expected if consumer spending continues to increase at the brisk pace seen in the second half of 2006.

I turn now to the inflation situation. As I noted earlier, there are some indications that inflation pressures are beginning to diminish. The monthly data are noisy, however, and it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated. Recent declines in overall inflation have primarily reflected lower prices for crude oil, which have fed through to the prices of gasoline, heating oil, and other energy products used by consumers. After moving higher in the first half of 2006, core consumer price inflation has also edged lower recently, reflecting a relatively broad-based deceleration in the prices of core goods. That deceleration is probably also due to some extent to lower energy prices, which have reduced costs of production and thereby lessened one source of pressure on the prices of final goods and services. The ebbing of core inflation has likely been promoted as well by the stability of inflation expectations.

A waning of the temporary factors that boosted inflation in recent years will probably help foster a continued edging down of core inflation. In particular, futures quotes imply that oil prices are expected to remain well below last year's peak. If actual prices follow the path currently indicated by futures prices, inflation pressures would be reduced further as the benefits of the decline in oil prices from last year's high levels are passed through to a broader range of core goods and services. Nonfuel import prices may also put less pressure on core inflation, particularly if price increases for some other commodities, such as metals, slow from last year's rapid rates. But as we have been reminded only too well in recent years, the prices of oil and other commodities are notoriously difficult to predict, and they remain a key source of uncertainty to the inflation outlook. The contribution from rents and shelter costs should also fall back, following a step-up last year. The faster pace of rent increases last year may have been attributable in part to the reduced affordability of owner-occupied housing, which led to a greater demand for rental housing. Rents should rise somewhat less quickly this year and next, reflecting recovering demand for owner-occupied housing as well as increases in the supply of rental units, but the extent and pace of that adjustment is not yet clear.

Upward pressure on inflation could materialize if final demand were to exceed the underlying productive capacity of the economy for a sustained period. The rate of resource utilization is high, as can be seen in rates of capacity utilization above their long-term average and, most evidently, in the tightness of the labor market. Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in certain occupations. Measures of labor compensation, though still growing at a moderate pace, have shown some signs of acceleration over the past year, likely in part the result of tight labor market conditions.

The implications for inflation of faster growth in nominal labor compensation depend on several factors. Increases in compensation might be offset by higher labor productivity or absorbed by a narrowing of firms' profit margins rather than passed on to consumers in the form of higher prices; in these circumstances, gains in nominal compensation would translate into gains in real compensation as well. Underlying productivity trends appear favorable, and the markup of prices over unit labor costs is high by historical standards, so such an outcome is certainly possible. Moreover, if activity expands over the next year or so at the moderate pace anticipated by the FOMC, pressures in both labor and product markets should ease modestly. That said, the possibility remains that tightness in product markets could allow firms to pass higher labor costs through to prices, adding to inflation and effectively nullifying the purchasing power of at least some portion of the increase in labor compensation. Thus, the high level of resource utilization remains an important upside risk to continued progress on inflation.

Another significant factor influencing medium-term trends in inflation is the public's expectations of inflation. These expectations have an important bearing on whether transitory influences on prices, such as those created by changes in energy costs, become embedded in wage and price decisions and so leave a lasting imprint on the rate of inflation. It is encouraging that inflation expectations appear to have remained contained.

The projections of the members of the Board of Governors and the presidents of the Federal Reserve Banks are for inflation to continue to ebb over this year and next. In particular, the central tendency of those forecasts is for core inflation--as measured by the price index for personal consumption expenditures excluding food and energy--to be 2 to 2-1/4 percent this year and to edge lower, to 1-3/4 to 2 percent, next year. But as I noted earlier, the FOMC has continued to view the risk that inflation will not moderate as expected as the predominant policy concern.

Monetary policy affects spending and inflation with long and variable lags. Consequently, policy decisions must be based on an assessment of medium-term economic prospects. At the same time, because economic forecasting is an uncertain enterprise, policymakers must be prepared to respond flexibly to developments in the economy when those developments lead to a re-assessment of the outlook. The dependence of monetary policy actions on a broad range of incoming information complicates the public's attempts to understand and anticipate policy decisions.

Clear communication by the central bank about the economic outlook, the risks to that outlook, and its monetary policy strategy can help the public to understand the rationale behind policy decisions and to anticipate better the central bank's reaction to new information. This understanding should, in turn, enhance the effectiveness of policy and lead to improved economic outcomes. By reducing uncertainty, central bank transparency may also help anchor the public's longer-term expectations of inflation. Much experience has shown that well-anchored inflation expectations tend to help stabilize inflation and promote maximum sustainable economic growth. Good communication by the central bank is also vital for ensuring appropriate accountability for its policy actions, the full effects of which can be observed only after a lengthy period. A transparent policy process improves accountability by clarifying how a central bank expects to attain its policy objectives and by ensuring that policy is conducted in a manner that can be seen to be consistent with achieving those objectives.

Over the past decade or so, the Federal Reserve has significantly improved its methods of communication, but further progress is possible. As you know, the FOMC last year established a subcommittee to help the full Committee evaluate the next steps in this continuing process. Our discussions are directed at examining all aspects of our communications and have been deliberate and thorough. These discussions are continuing, and no decisions have been reached. My colleagues and I remain firmly committed to an open and transparent monetary policy process that enhances our ability to achieve our dual objectives of stable prices and maximum sustainable employment. I will keep members of this Committee apprised of developments as our deliberations move forward. I look forward to continuing to work closely with the members of this Committee and your colleagues in the Senate and House on the important issues pertaining to monetary policy and the other responsibilities with which the Congress has charged the Federal Reserve.

Thank you. I would be happy to take questions.

For use at 10:00 a.m., EST
Wednesday
February 14, 2007

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

February 14, 2007

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

February 14, 2007

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., February 14, 2007

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

Contents

Monetary Policy Report to the Congress

Report submitted to the Congress on February 14, 2007, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy turned in another solid performance in 2006, although the pattern of growth was uneven. After rebounding in the early part of the year from hurricane-related disruptions in the autumn of 2005, the pace of expansion during the remaining three quarters averaged somewhat below that of the preceding two years, responding in part to the removal of monetary policy accommodation since 2004. The housing market cooled substantially, and, in the latter part of 2006, the production of light motor vehicles also stepped down. Elsewhere in the economy, activity remained strong. Consumer spending increased vigorously in 2006 as households' real income made strong gains. Business investment rose at a solid rate for the year as a whole, although it decelerated late in the year in part because of some softening in purchases of equipment related to construction and motor vehicle manufacturing. Demand for U.S. exports rose at a robust pace in 2006, supported by strong economic activity abroad. Against this backdrop, businesses continued to add jobs at a steady rate, and the unemployment rate decreased further.

Total consumer price inflation declined in 2006 from its elevated pace in 2005, as energy prices fell, on net, after rising rapidly over the preceding couple of years. Crude oil prices rose during the first half of 2006 but turned down sharply later in the year. As a result, consumer price inflation climbed in the first half of the year before slowing in the second half. The sharp movements in prices of crude oil appear to have affected not only prices of gasoline and other petroleum-based types of energy but also prices of a broader range of goods and services that use petroleum-based inputs. Partly as a result, consumer price inflation excluding food and energy—so-called core consumer price inflation—moved up during the first half of the year but eased subsequently. On balance, core inflation was a bit higher over the four quarters of 2006 than in 2005. Measures of long-term inflation expectations, however, remained well anchored.

The monetary policy decisions of the Federal Open Market Committee (FOMC) in 2006 were intended to foster sustainable economic expansion and to promote a return to low and stable inflation. In that regard, the economic outlook for this year and next appears favorable. Although the contraction in homebuilding has been a drag on growth, that restraint seems likely to diminish over 2007. Further gains in real wages as well as ongoing increases in employment should support a solid rise in consumer spending. In addition, at the beginning of 2007, households' balance sheets appeared to be in good shape. Whereas gains in home prices slowed last year, household net worth increased moderately as stock market wealth grew and households lessened their accumulation of debt. Delinquency rates on consumer loans and on most types of mortgages remained low, although they increased markedly for subprime mortgages with variable interest rates. As for businesses, balance sheets are quite liquid, credit quality is good, and most firms enjoy ready access to funds. These favorable financial conditions, along with further expansion in business output, user costs of capital equipment that remain attractive, and the potential for further gains in efficiency, should continue to spur business investment. In addition, sustained expansion in foreign economies ought to maintain demand for U.S. exports. On balance, growth of real gross domestic product in the United States appears likely to run slightly below that of the economy's potential over the next few quarters and then to rise to a pace around that of the economy's long-run trend.

Regarding inflation, increases in core consumer prices are expected to moderate, on balance, over the next two years. Along with inflation expectations that are well anchored, some of the factors that boosted inflation in recent years seem likely to lessen. In particular, the paths for prices of energy and other commodities embedded in futures markets suggest that the impetus to core inflation from these influences will diminish further. In addition, the outsized increases in shelter costs that boosted core inflation last year are not expected to persist. Although unit labor costs in the nonfarm business sector have been rising, the average markup of prices over such costs is high by historical standards. The relatively high markup suggests that further increases in costs could be absorbed, at least to some extent, by a narrowing of firms' profit margins rather than by passing on the costs in the form of higher consumer prices, especially if pressures on resources ease modestly as anticipated.

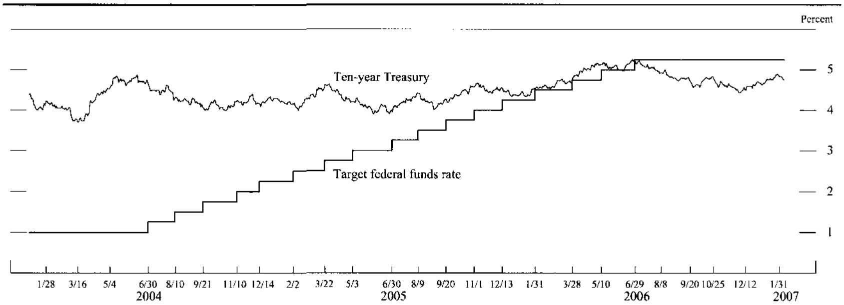
The outlook for real economic activity is uncertain. An upside risk is that consumer spending, which has been especially buoyant in recent months, may continue to expand at a pace that would ultimately lead to an escalation of pressures on resources and prices. Alternatively, prospects for residential construction, which are difficult to assess, may pose some downside risks. Although residential real estate markets have shown some recent signs of stabilizing, homebuilders' inventories of unsold homes remain elevated. Further cutbacks in construction to reduce inventories toward more-comfortable levels could become steeper and more persistent than currently anticipated. Moreover, if home values were to depreciate sharply, the resulting erosion of household wealth could impose appreciable restraint on consumer spending.

Whether inflation will moderate gradually as expected is also uncertain. On the one hand, the nation's potential to produce could increase more rapidly than anticipated, or product and input markets could work efficiently at higher rates of utilization, either of which could lead to a lower trajectory for inflation than currently forecast. On the other hand, expanding global demand and threats to supply from actual and potential disruptions pose upside risks for energy prices. In addition, brisk world demand for non-energy materials and commodities could lead to further upward pressures on business costs. Also, if inflation were to persist around the elevated average level of the past three years, longer-run inflation expectations could deteriorate, particularly if pressures on resources were to intensify. At recent meetings, the FOMC indicated that the risk that inflation will fail to moderate as expected is its predominant policy concern.

Monetary Policy, Financial Markets, and the Economy in 2006 and Early 2007

The FOMC firmed the stance of monetary policy 25 basis points at each of its four meetings over the first half of 2006. The Committee raised its target for the federal funds rate at its January and March meetings as available information pointed to accumulating pressures on inflation and solid economic growth. Although readings on core inflation had remained favorable, increases in energy prices and the relatively high level of resource utilization threatened to add to existing inflation pressures. Meanwhile, underlying aggregate demand, supported by robust consumer spending and accelerating business investment, appeared to be growing at a solid rate. By the time of the May and June meetings, data pointed to a moderation in the growth of consumer spending and a further cooling in the housing market. However, core consumer prices had risen more rapidly. Although the Committee judged inflation expectations still to be contained, it was mindful that the rising prices of energy and other commodities could impart greater inflationary momentum. Against this backdrop, the FOMC voted to increase the policy rate a further 25 basis points at both the May and June meetings, bringing the federal funds rate to 5¼ percent. In the statement accompanying its June decision, the FOMC indicated that it believed that the moderation in economic activity would help to limit inflationary pressures over time but also noted that some upside inflation risks remained. As

Selected interest rates, 2004–07



NOTE The data are daily and extend through February 7, 2007 The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities The dates on the horizontal axis are those of FOMC meetings

SOURCE Department of the Treasury and the Federal Reserve it had in its May statement, the FOMC made clear in June that the extent and timing of additional firming would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

In the second half of the year, a further slowdown in residential construction activity and a contraction in motor vehicle production created a significant drag on economic activity. However, consumer spending held up, and employment rose at a solid pace. Meanwhile, energy prices reversed much of their increases of the first half of the year, sending headline inflation lower. Core inflation also eased somewhat, albeit to a rate above its year-earlier level. Against this backdrop, the FOMC left the stance of policy unchanged at its final four meetings of 2006. Committee discussions in those meetings focused in part on developments in the housing market and their implications for the broader economy. Although the housing market was weakening throughout this period, the Committee judged that the downturn had not spilled over significantly to consumer spending. The economy was expected to expand over coming quarters at a rate close to or a little below its long-run sustainable pace. At the same time, FOMC members noted that, even though core inflation had slowed from the very rapid rates of the spring and summer, current rates remained undesirably high. Most members expected core inflation to moderate gradually, but they were uncertain about the likely pace and extent of that moderation. Thus, in statements accompanying each rate announcement over this period, the FOMC reiterated that inflation risks remained and that the extent and timing of any additional policy firming would depend on the outlook for both inflation and economic growth implied by incoming information.

Over the period between the December 2006 and January 2007 FOMC meetings, incoming data on inflation and economic activity were generally more favorable. Core inflation receded further from the elevated levels reached in early 2006, and some indicators suggested that the demand for housing might be stabilizing. Business investment had softened in the fourth quarter, and industrial production decelerated sharply in the fall, but consumer spending posted robust gains in the final months of 2006. At its January 2007 meeting, the Committee again decided to leave its target for the federal funds rate unchanged, reiterated concern about inflation risks, and again cited the role of incoming data in determining the extent and timing of any additional firming.

In recent years, the FOMC has worked to improve the transparency of its decisionmaking process, and the Committee continues to examine whether further changes would improve its communications with the public. In spring 2006, the Chairman appointed a subcommittee to help the FOMC organize the discussion of a broad range of communication issues. The FOMC began its consideration of these issues at its August meeting and has discussed them at several meetings since then.

Economic Projections for 2007 and 2008

In conjunction with the FOMC meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008. The projections indicate that the participants expect sustainable expansion of real economic activity during the next two years, assuming an appropriate course for monetary policy. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2½ percent to 3 percent over the four quarters of 2007 and 2¾ percent to 3 percent over the four quarters of 2008. The central tendency of their forecasts for the civilian unemployment rate is 4½ percent to 4¾ percent in the fourth quarter both of this year and of 2008. For inflation, the central tendency of the forecasts anticipates an increase in the price index for personal consumption expenditures excluding food and energy—the so-called core PCE price index—of 2 percent to 2¼ percent over

Economic projections of Federal Reserve Governors and Reserve Bank presidents for 2007 and 2008

Percent

Indicator	MEMO 2006 actual	2007		2008	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	5 9	4¾–5½	5–5½	4¼–5½	4¾–5¼
Real GDP	3 4	2¼–3¼	2½–3	2½–3¼	2¾–3
PCE price index excluding food and energy	2 3	2–2¼	2–2¼	1½–2¼	1¾ 2
Average level, fourth quarter					
Civilian unemployment rate	4 5	4½–4¾	4½ 4¾	4½–5	4½–4¾

1 Change from average for fourth quarter of previous year to average for fourth quarter of year indicated

the four quarters of 2007 and 1¾ percent to 2 percent over the four quarters of 2008.

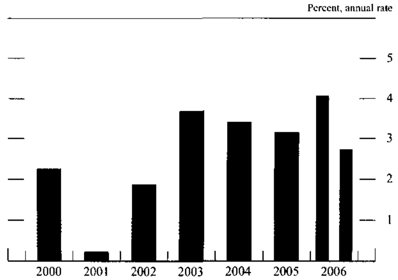
The economy is projected to expand at a moderate rate. Although the cooling of the housing market continues to damp economic activity, the drag on economic growth from declining construction activity is expected to diminish later this year. Household spending for goods and services should rise at a solid pace, in part as a result of ongoing gains in real wages and employment and of generally strong household balance sheets. Business outlays for new equipment and software are expected to increase at a rate consistent with a moderate expansion in business output and to be supported by continuing declines in the user cost of high-technology capital equipment and by favorable financial conditions. In addition, the solid expansion of economic activity abroad should maintain the rising demand for U.S. exports of goods and services.

Decreased pressures from the costs of energy and other commodities, in an environment of moderate economic expansion and well-anchored longer-run inflation expectations, are expected to contribute to further easing in inflation. In addition, increases in productivity should help to limit cost pressures.

Economic and Financial Developments in 2006 and Early 2007

The especially brisk pace of economic activity in early 2006 primarily reflected a rebound after hurricane-related disruptions in the autumn of 2005. During the rest of the year, however, economic activity slowed to a pace somewhat below the average rate of recent years. Real GDP

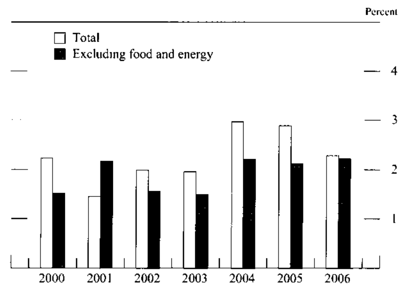
Change in real GDP, 2000–06



NOTE Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period

SOURCE Department of Commerce, Bureau of Economic Analysis

Change in PCE chain-type price index, 2000–06



NOTE The data are for personal consumption expenditures (PCE)

SOURCE Department of Commerce, Bureau of Economic Analysis

is reported to have increased at an average annual rate of 2¾ percent over the final three quarters of 2006, down from the average 3¼ percent pace in 2004 and 2005. The slowdown principally was the result of the contraction in residential construction, which intensified later in the year, and the marked decline in production of light motor vehicles in the second half of the year as manufacturers took steps to trim dealers' inventories. In other sectors of the economy, consumer spending remained strong as employment and income made further solid gains, and business outlays for new structures and equipment rose considerably over much of the year. Financial market conditions were generally supportive of economic expansion in 2006. Equity markets recorded sizable gains, and long-term interest rates rose only modestly from historically low levels. Risk spreads on corporate bonds remained narrow or declined further. Overall economic conditions were such that businesses maintained a steady pace of hiring, and the unemployment rate moved down further.

Consumer price inflation, as measured by the rise in the PCE price index, moved down in the second half of 2006 after having stepped up in the first half. Energy prices, which rose during the first half and turned sharply downward later in the year, played an important role in shaping the contour of total consumer price inflation. In addition, core PCE price inflation eased modestly over the second half of 2006. Apparently influenced by incoming data on inflation and economic activity, measures of long-term inflation expectations rose early in the year but ended the year slightly lower than at the beginning. Nonetheless, core PCE price inflation for the year as a whole—at 2¼ percent—was a bit higher than in the preceding year, which perhaps reflected in part the high level of resource utilization.

The Household Sector

Consumer Spending

The rapid increase in consumer spending in 2006 was supported by rising employment, gains in real income, increases in household wealth, and favorable financial conditions. Over the four quarters of 2006, real PCE rose 3¾ percent—faster than in 2005 and at roughly the same rate as in 2004. The rise in consumer outlays was particularly robust in the first quarter of 2006 but then moderated in the middle of the year, when households' gains in real income slowed and consumer sentiment softened. Consumer spending rose briskly again in the fourth quarter of the year as gains in real income picked up and consumer confidence improved.

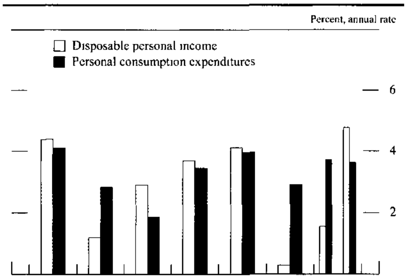
Household spending for new motor vehicles slowed in 2006; sales of 16.5 million new light vehicles (cars, sport-utility vehicles, and pickup trucks) were below the average of nearly 17 million sold in the preceding two years. Moreover, households' apparent concerns about elevated gasoline prices, particularly early in the year, shifted the composition of light vehicle sales toward more fuel-efficient autos and away from light trucks and SUVs. The shift helped boost the share of total sales captured by foreign producers because they tend to offer more fuel-efficient vehicles.

Real PCE for goods other than motor vehicles rose 4¾ percent over the four quarters of 2006, about in line with the brisk average pace in the preceding two years. Households increased their spending for a broad range of consumer goods, though the rise was particularly strong for electronic equipment and other durables. Real spending on gasoline remained about constant in the first half of the year but increased in the second half as prices fell. Consumer spending for services maintained a moderate pace of growth; expenditures in this category rose 2¾ percent in 2006, about the same average pace as in 2004 and 2005.

In 2006, real household income was boosted by gains in wage and salary income and the increased purchasing power resulting from the deceleration in overall consumer prices. Labor income received by households rose both because of gains in real hourly wages and because of sustained increases in employment. However, the pickup in real after-tax income was damped because tax payments made by households increased at a rate greater than that for income. The acceleration in tax payments likely reflected, at least in part, several factors: tax payments on larger capital gains realizations, which are excluded from income in the national income and product accounts (NIPA); gains in real income that moved some households into higher tax brackets; and possibly a further shift in the distribution of income toward high-income households that typically face higher tax rates. All told, real after-tax income rose 3 percent over the four quarters of 2006, up from the negligible gain posted in 2005 but a little below the average rate of increase in 2003 and 2004.

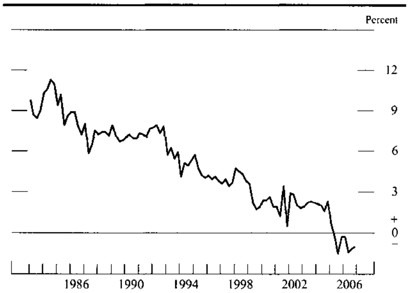
The rise in after-tax income in 2006 was outpaced by increases in household spending. As a result, the personal saving rate declined further in 2006 and averaged negative 1 percent for the year as a whole. Households apparently were inclined to increase their spending further above their disposable income, at least in part, because their wealth continued to rise. The ratio of household net worth to income, which has been trending higher since 2003, inched up further in 2006. Although increases in the value of homes slowed significantly, the value of corporate equities held by households both indirectly—such as in mutual funds and retirement accounts—and directly appreciated considerably.

Change in real income and consumption, 2000–06



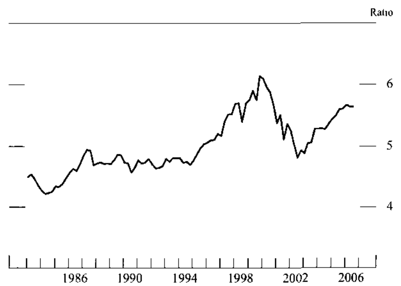
SOURCE Department of Commerce, Bureau of Economic Analysis

Personal saving rate, 1983–2006



NOTE The data are quarterly and extend through 2006 Q4
SOURCE Department of Commerce, Bureau of Economic Analysis

Wealth-to-income ratio, 1983–2006

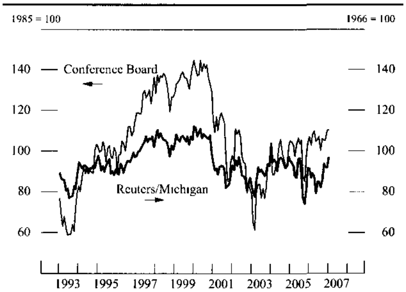


NOTE The data are quarterly and extend through 2006 Q3 The wealth-to-income ratio is the ratio of household net worth to disposable personal income

SOURCE For net worth, Federal Reserve Board, flow of funds data, for income, Department of Commerce, Bureau of Economic Analysis

Consumer sentiment deteriorated in the first half of 2006, according to the Reuters/University of Michigan Surveys of Consumers (Reuters/Michigan). In the spring, consumer confidence had moved to its lowest level for the year, probably in part because energy prices had surged. The subsequent decline in energy prices, along with the rise in the stock market and reductions in the unemployment rate, boosted consumer confidence in the second half of the year. On net, the Reuters/Michigan index of consumer sentiment was a shade higher at the end of 2006 than at the beginning of the year; sentiment moved up further in early 2007 to near the upper end of its range since 2003.

Consumer sentiment, 1993–2007



NOTE The data are monthly and extend through January 2007

SOURCE The Conference Board and Reuters/University of Michigan Surveys of Consumers

Residential Investment

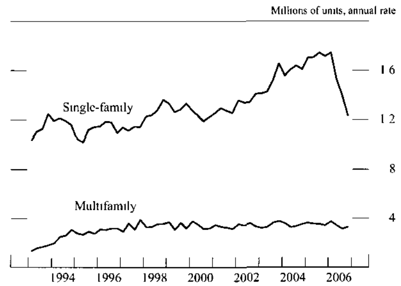
The deterioration of conditions in the housing market played a significant role in restraining the pace of economic expansion in 2006. The demand for new and existing homes began to weaken in the middle of 2005, and the subsequent decline steepened through the first half of 2006. As a result, the inventory of unsold new homes relative to sales rose sharply. Apparently prompted by lower demand and excessive inventories, homebuilders began to cut back on the pace of new construction near the beginning of 2006, and the decline in activity continued throughout the year. Later in the year, however, some indicators were hinting that the demand for housing was starting to stabilize.

By the middle of 2006, sales of both new and existing homes had fallen dramatically to a pace that was about 15 percent below that of a year earlier. Concurrently, inventories of unsold homes relative to sales rose considerably above the level that had prevailed during the period of robust housing demand from the late 1990s into 2005. By the third quarter of 2006, the backlog of unsold new homes had reached 6¾ months' supply, and the stock of existing homes for sale had risen to about 7 months' supply—both well above the average of about 4½ months' supply of new and existing homes in 2005. By the end of 2006, however, there were tentative signs that the demand for homes was stabilizing. The decline in sales of new and existing homes appeared to bottom out in the summer, and sales were roughly constant over the later part of the year. In the fourth quarter, builders' inventories of unsold new homes were reported to have edged down a bit from their third-quarter level, while the stock of existing homes for sale remained about the same as in the third quarter. Despite these developments, the extent of any improvement in the inventories of unsold homes is obscured by the failure of these figures to account for recorded sales of new homes that are subsequently canceled.

The drag on new residential construction in 2006 imposed by the contraction in home sales and the buildup of inventories was significant. Both the number of permits issued for new single-family homes and the number of home starts dropped sharply. As of the fourth quarter of 2006, new single-family homes were started at an annual rate of 1.23 million units, almost 30 percent below the average pace in 2005; permits were down by a similar amount. In contrast to the marked slackening in construction of new single-family homes, the rate of starts of new multifamily homes in 2006, at 337,000 units, was about the same as in the preceding several years.

Housing activity, as measured by real expenditures on residential structures in the NIPA, trimmed ¼ percentage point from the rate of real GDP growth in the first half of 2006, but the drag intensified to subtract about

Private housing starts, 1993–2006



NOTE The data are quarterly and extend through 2006 Q4
SOURCE Department of Commerce, Bureau of the Census

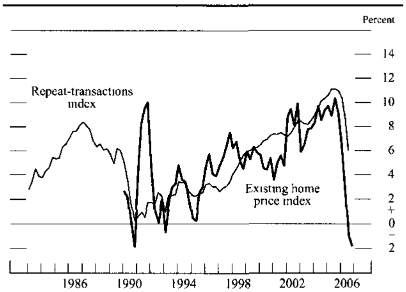
Mortgage rates, 2002–07

NOTE The data, which are weekly and extend through February 7, 2007, are contract rates on thirty-year mortgages
SOURCE Federal Home Loan Mortgage Corporation

1¼ percentage points from the annual rate of increase in real GDP in the second half. For 2006 as a whole, the contraction in real residential investment lowered the annual rate of growth in real GDP ¾ percentage point after having added ½ percentage point, on average, to the rate from 2003 through 2005.

The rate of house-price appreciation slowed substantially in 2006 after several years of very rapid gains. The repeat-transactions index of home prices published by the Office of Federal Housing Enterprise Oversight (OFHEO) increased at an annual rate of only 1½ percent in the third quarter of 2006, down substantially from average gains of about 10 percent in 2004 and 2005. The OFHEO index attempts to control for the quality of existing single-family homes sold by using prices of homes involved in repeat transactions. The increase in the OFHEO house-price index over the four quarters ending in the third quarter of 2006 (a calculation that smoothes through some of the quarterly volatility in the data) was 6 percent, the smallest four-quarter increase since the late 1990s. The average price of existing single-family homes sold, which is published by the National Association of Realtors (NAR) and does not control for the types of homes sold, declined about 2 percent over the four quarters of 2006, compared with average gains of roughly 9 percent in 2004 and 2005. The outright decline in the NAR index of home prices relative to the deceleration in the constant-quality OFHEO home-price index suggests that the composition of existing homes sold shifted toward lower-priced homes.

Change in prices of single-family houses, 1983–2006



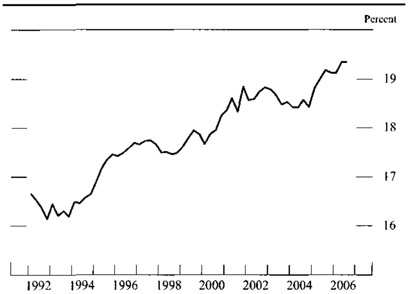
NOTE The data are quarterly, and change is from one year earlier The repeat-transactions index extends through 2006 Q3 For the years preceding 1991, that index includes appraisals associated with mortgage refinancings, beginning in 1991, it includes purchase transactions only The existing home price index extends through 2006 Q4
SOURCE For repeat transactions, Office of Federal Housing Enterprise Oversight, for existing home prices, National Association of Realtors

The cost of mortgage financing increased in the first half of 2006, but rates decreased in the second half. The average rate for a thirty-year fixed-rate mortgage was 6¼ percent at the end of 2006, about the same as at the beginning of the year. The average for a one-year adjustable-rate mortgage declined also in the second half and stood at 5½ percent at the end of 2006, about ¼ percentage point above the level at the start of the year. According to respondents to the Reuters/Michigan survey, relatively low mortgage rates and the perception that purchase prices were more favorable improved their assessment of homebuying conditions in the second half of 2006.

Household Finance

Household sector debt is estimated to have slowed from the robust 11¾ percent increase posted in 2005 to a still-vigorous 8¼ percent in 2006. The deceleration reflected a drop in the pace of mortgage debt growth from about 14 percent in 2005 to less than 9 percent in 2006. Despite

Household financial obligations ratio, 1992–2006



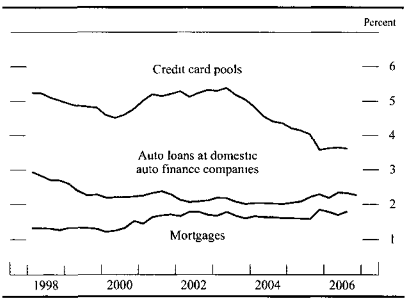
NOTE The data are quarterly and extend through 2006 Q3 The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowner's insurance, and property taxes, all divided by disposable personal income

SOURCE Federal Reserve Board

the reduction in mortgage borrowing, home equity lending remained active, and the gross volume of cash-out refinancing exceeded 2005 levels. Meanwhile, consumer debt expanded only moderately in 2006.

Although household indebtedness increased less rapidly in 2006 than in 2005, it still outpaced the growth of disposable personal income. In addition, the rise in interest rates contributed to higher debt service payments, and the household financial obligations ratio continued its upward trend of the past decade to reach a record high. Evidence to date suggests that most households have been able to meet their debt service obligations, although there are indications of growing strains among some borrowers. Delinquency rates on subprime residential mortgages with variable interest rates have increased markedly; still, delinquency rates on other mortgages and consumer loans have remained low. Household bankruptcy filings during 2006 ran at a pace well below the average of the preceding several years. Bankruptcies likely were damped in 2006 by the decisions of some households to file before the implementation of more-stringent bankruptcy requirements in October 2005. However, even allowing for such an effect, the recent pace is low relative to pre-reform norms.

Delinquency rates on selected types of household loans, 1998–2006



NOTE The data are quarterly The data for credit card pools and mortgages extend through 2006 Q3, the rate for auto loans extends through 2006 Q4

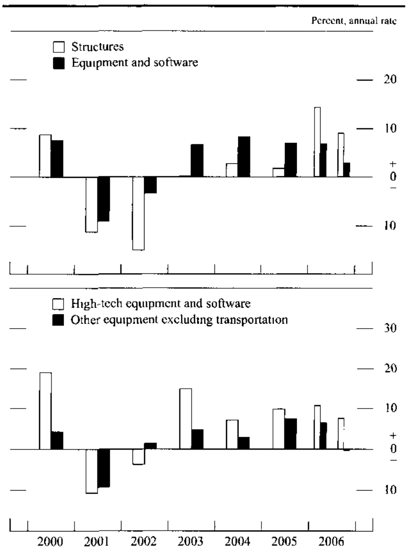
SOURCE For credit cards, Moody's Investors Service, for auto loans, the financing subsidiaries of the three major U S automobile manufacturers, for mortgages, Mortgage Bankers Association

The Business Sector

Fixed Investment

Total real business fixed investment rose 6¾ percent over the four quarters of 2006, up from a 5½ percent increase in 2005 and about the same pace as in 2004. In general, the fundamentals supporting business capital

Change in real business fixed investment, 2000–06



NOTE High-tech equipment consists of computers and peripheral equipment and communications equipment

SOURCE Department of Commerce, Bureau of Economic Analysis

spending remained favorable in 2006: The strong rise in profits continued to help firms maintain substantial liquid assets, user costs for equipment declined further, and interest rates and credit spreads remained relatively low. Although the pace of real business outlays for equipment and software slowed somewhat in 2006, investment in nonresidential structures rose 11¾ percent. Capital spending was quite robust during most of the year, adding about 1 percentage point to the annual rate of increase in real GDP over the first three quarters, but it decelerated sharply in the fourth quarter. The deceleration reflected, in part, a slowing in spending for business structures from its brisk pace earlier in the year, a drop in outlays for transportation equipment, and some weakness in purchases of equipment related to construction and motor vehicle manufacturing.

Real investment in high-technology equipment rose 9 percent in 2006, about the same average annual pace as in the preceding two years. Further decreases in the prices of high-technology equipment continued to reduce the user cost of this type of equipment. Real business spending for computing equipment increased 14½ percent, and software spending posted an 8 percent gain, both roughly comparable to their average rates of increase in the previous two years. Business outlays for communications equipment rose almost 7 percent in 2006. Spending for communications equipment was particularly robust in the early part of the year and was likely boosted in part by spending to replace equipment damaged by the hurricanes in the autumn of 2005. Investment in communications equipment last year continued to be supported by demand from telecommunications service providers that were expanding their broadband networks.

Real business investment in transportation equipment—typically a volatile category of investment—was about unchanged on net in 2006. For motor vehicles, business spending increased less than 1 percent over the year. Purchases of light vehicles weakened, partly because of cutbacks in sales to rental companies. In contrast, business outlays for medium and heavy trucks accelerated in 2006, reportedly in anticipation of new emissions regulations by the Environmental Protection Agency that went into effect at the beginning of 2007. New orders for medium and heavy trucks reached new highs early in 2006, and production and sales remained strong through the end of the year. Outlays for new aircraft were brisk in early 2006, but they were depressed over the remainder of the year; all told, aircraft investment declined more than 15 percent for the year as a whole.

Real investment in equipment other than high-tech and transportation goods—a broad category that represents about half of total nominal business spending for equipment and software—rose at an average annual rate of 5½ percent during the first three quarters of 2006. However, spending for these capital goods softened in the final quarter of the year. Although the declines in the fourth quarter were generally broad based, they were led by decreases in spending for equipment related to construction and motor vehicle manufacturing. However, the backlog of orders for capital goods such as industrial machinery and other types of heavy equipment remained substantial at the end of 2006, and it should sustain production and shipments of these items in early 2007.

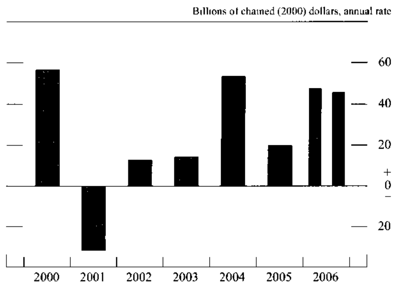
Real outlays for nonresidential construction increased 11¾ percent in 2006 after having been little changed since 2003. However, the rise in business construction spending slowed near the end of 2006 from its rapid pace earlier in the year; outlays increased at an annual rate of only about 3 percent in the fourth quarter. For 2006 as a whole, sizable gains were posted for office, retail, and industrial buildings. In addition, outlays for drilling and mining structures associated with energy exploration were strong. At the end of 2006, forward-looking indicators for nonresidential construction activity appeared to be favorable: Vacancy rates for buildings in both the office and industrial sectors, which peaked a few years ago, continued to drift down, and the vacancy rate for retail buildings remained at the low level that has prevailed since 2000.

Inventory Investment

In the first half of 2006, dealer stocks of motor vehicles rose noticeably as sales slowed, particularly for light trucks. The increase in the prices of gasoline earlier in the year appeared to have reduced consumers' demand for light trucks and SUVs, which tend to be less fuel efficient. Dealers' inventories of these vehicles reached an elevated 90 days' supply at the end of the second quarter. As a result, motor vehicle manufacturers scaled back the production of light trucks over the second half of 2006, which helped to reduce dealers' inventories during that period. Nonetheless, at the end of 2006, inventories of light vehicles still appeared to be above desired levels. Manufacturers cut production further in January of this year, helping them make additional progress in reducing the stock overhang.

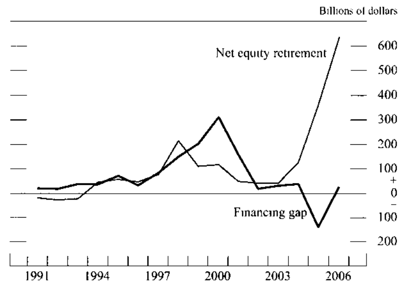
Excluding motor vehicles, inventories held by businesses in the manufacturing and trade sectors appeared generally to be well aligned with sales in the first half of 2006. However, later in the year, a variety of indicators suggested that some businesses accumulated an undesired level of stocks. The book value of manufacturing and trade inventories (excluding motor vehicles) rose relative to sales from September through November. The increases were particularly noticeable for firms that supply the construction and motor vehicle sectors, although increases

Change in real business inventories, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Financing gap and net equity retirement at nonfinancial corporations, 1991–2006



NOTE: The data are annual; the observations for 2006 are based on partially estimated data. The financing gap is the difference between capital expenditures and internally generated funds, adjusted for inventory valuation. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued by domestic companies in public or private markets. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.

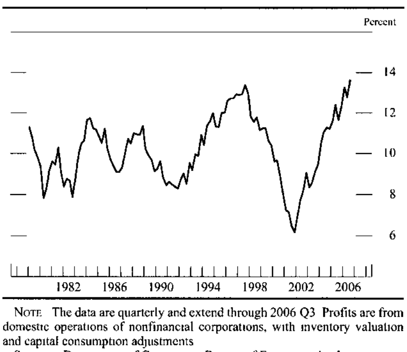
SOURCE: Federal Reserve Board, flow of funds data.

were apparent in a few other sectors as well. Survey data also suggested that inventories for some businesses were viewed as too high. However, manufacturers outside of the motor vehicles sector appear to be making relatively prompt adjustments to their production, which to date seem to be limiting the extent of undesired stockbuilding.

Corporate Profits and Business Finance

Profits of nonfinancial corporations extended their upward move, pushing the ratio of before-tax profits to income in this sector to nearly 14 percent, the highest level reached since 1969. In the third quarter, operating earnings per share for S&P 500 firms came in 20 percent above levels of a year earlier. About two-thirds of firms in the S&P 500 have reported earnings for the fourth quarter. Current market estimates of earnings per share for S&P 500 firms call for roughly 10 percent growth in the fourth quarter over year-earlier levels. Earnings growth was widespread across sectors in 2006 but was particularly strong for financial firms.

Before-tax profits of nonfinancial corporations as a percent of sector GDP, 1979–2006



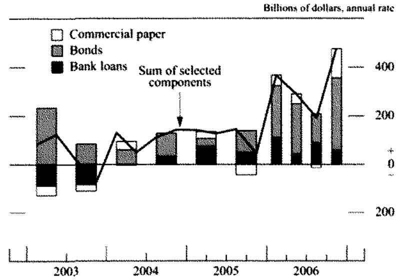
NOTE: The data are quarterly and extend through 2006:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

Firms' capital expenditures exceeded internal funds raised in 2006, an indication that businesses funded investments not only with current cash flow but also with external funds and liquid assets. Borrowing by nonfinancial firms picked up in 2006 in association with increased real investment as well as with extensive retirements of equity, which resulted from record share repurchases and heavy merger and acquisition activity. Net bond issuance proceeded at a faster clip than in the past several years. Similarly, commercial paper issuance was the strongest it had been since 2000, and commercial and industrial lending by banks was rapid as well. The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices revealed that a significant net fraction of respondents to that survey eased credit standards and terms on commercial and industrial loans during 2006. Bankers indicated that they were responding to more-aggressive competition and greater liquidity in the secondary market for such loans. Loan officers also reported that a contributing factor was an increased tolerance for risk.

The expansion of commercial mortgage debt in 2006 remained rapid by historical standards but fell off from the swift pace of 2005. The deceleration likely reflected

Selected components of net financing for nonfinancial corporate businesses, 2003–06



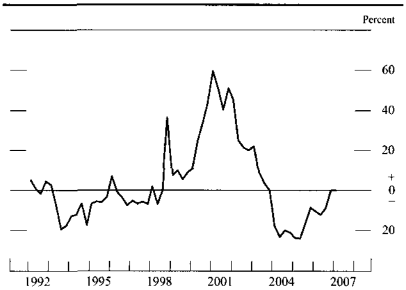
NOTE The data for the components except bonds are seasonally adjusted The data for the sum of selected components are quarterly The data for 2006 Q4 are estimated

SOURCE Federal Reserve Board, Securities Data Company, and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report)

the rise in mortgage rates and a net tightening of credit standards for these loans—an explanation consistent with responses to the loan officer survey.

Gross public issuance of equity by nonfinancial corporations in 2006 roughly maintained the moderate pace of the past couple of years, and private equity issuance appears to have risen a bit to finance buyouts and other restructurings. Still, net equity issuance turned more negative as equity retirements from cash-financed

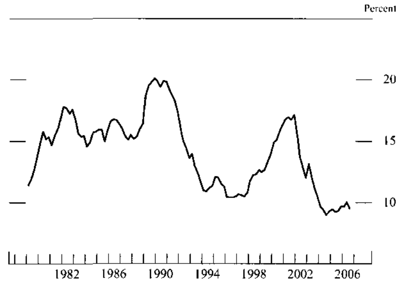
Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized borrowers, 1992–2007



NOTE The data are drawn from a survey generally conducted four times per year, the last observation is from the January 2007 survey, which covers 2006 Q4 Net percentage is the percentage of banks reporting a tightening of standards less the percentage reporting an easing The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have sales of $50 million or more

SOURCE Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices

Net interest payments of nonfinancial corporations as a percent of cash flow, 1979–2006



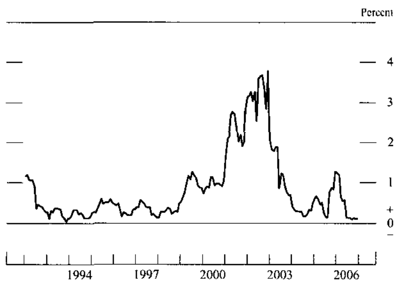
NOTE The data are quarterly and extend through 2006 Q3

SOURCE Department of Commerce, Bureau of Economic Analysis

mergers and acquisitions and share repurchases increased considerably.

On balance, despite increased borrowing and net equity retirements, the strength of corporate earnings growth has left the credit quality of nonfinancial firms solid. Balance sheet liquidity remains high, and corporate leverage is near historical lows. In addition, net interest payments relative to cash flow remained near the low end of the range seen over the past two decades. The six-month trailing bond default rate fell during the first half of the year as defaults by some large firms in the troubled airline and automobile sectors in late 2005 dropped out of the series, and it was near zero throughout the second half of 2006. Delinquency rates on business loans remained quite low.

Default rate on outstanding corporate bonds, 1992–2006



NOTE The data are monthly and extend through December 2006 The rate for a given month is the face value of bonds that defaulted in the six months ending in that month, multiplied by two to annualize the defaults and then divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the six-month period

SOURCE Moody's Investors Service

The Government Sector

Federal Government

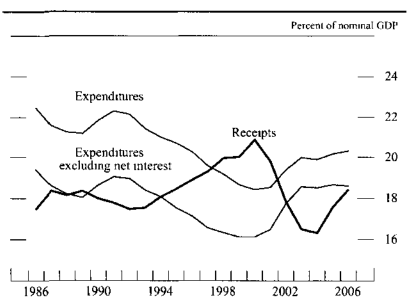
The deficit in the federal unified budget narrowed further during the past year. The unified budget recorded a deficit of $248 billion in fiscal year 2006—$70 billion smaller than in the previous fiscal year. The federal deficit in fiscal 2006 was a bit less than 2 percent of nominal GDP, significantly lower than its recent fiscal year peak of more than 3½ percent of GDP in 2004. In fiscal 2006, outlays rose about in line with nominal GDP, but receipts increased at a faster pace. From October through December—the first quarter of fiscal 2007—the federal deficit was almost $40 billion less than in the same period a year earlier, as the rise in receipts continued to outpace the growth in outlays. The latest projections from the Congressional Budget Office and the Administration anticipate that the unified deficit in fiscal 2007 will be smaller as a percentage of nominal GDP than it was in fiscal 2006. Although the unified deficit has improved recently, the federal budget will face the mounting pressures of providing Social Security and health benefits to a rapidly growing number of beneficiaries as the baby-boom generation ages in coming years.

In fiscal 2006, nominal federal receipts rose 11¾ percent and were equivalent to almost 18½ percent of nominal GDP, substantially higher than their recent fiscal year low of 16¼ percent of GDP in 2004. Income tax receipts from individuals outpaced the rise in taxable personal income (as measured in the NIPA), while surging corporate tax payments about matched the robust growth in profits. As noted above, the increase in individual income tax liabilities relative to taxable income in the NIPA appears to have reflected, at least in part, taxes on larger capital gains realizations (which are excluded from NIPA income), the effect of some taxpayers moving into higher tax brackets as their real incomes increased, and possibly a further shift in the distribution of income toward high-income households that typically face higher tax rates. In the first quarter of fiscal 2007, revenues were more than 8 percent greater than in the same period a year earlier, as both individual and corporate tax payments continued to rise briskly.

Nominal federal outlays increased about 7½ percent in fiscal 2006 and were about 20¼ percent of nominal GDP, well above their most recent fiscal year low of less than 18½ percent of GDP in 2000. Net interest payments increased 23 percent in fiscal 2006, as interest rates rose and federal debt continued to grow. Outlays for Medicare increased 10½ percent, reflecting in part new benefits payments associated with the Part D prescription drug program, which started in January 2006. At the same time, outlays for Medicaid declined a bit, to some extent because of a shift of some Medicaid payments to Medicare Part D. Spending for disaster relief and national flood insurance was almost $28 billion greater in fiscal 2006 than in the previous fiscal year, primarily owing to the federal government's response to the hurricanes in the autumn of 2005. Outlays for defense in fiscal 2006 slowed to their lowest rate of increase since fiscal 2001, although the rise was still about 6 percent. In the first quarter of fiscal 2007, total federal outlays were only 1 percent greater than those in the same period a year earlier; in this period, defense spending was 12 percent above its year-earlier level, but outlays related to disaster relief and flood insurance were markedly lower than they were a year earlier.

As measured in the NIPA, real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of real GDP—

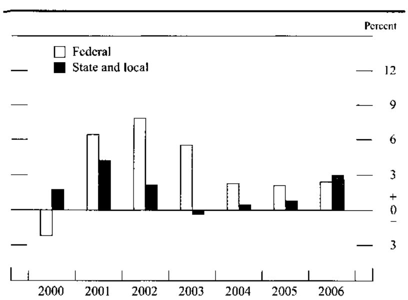
Federal receipts and expenditures, 1986–2006



NOTE The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3

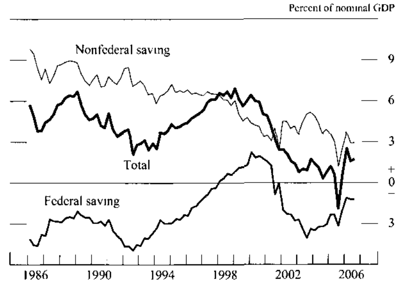
SOURCE Office of Management and Budget

Change in real government expenditures on consumption and investment, 2000–06



SOURCE Department of Commerce, Bureau of Economic Analysis

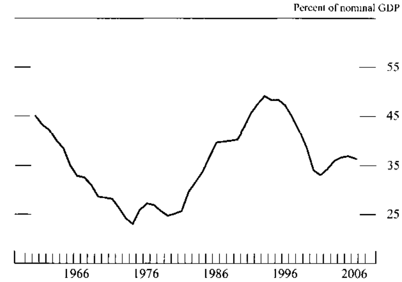
Net saving, 1986–2006



NOTE The data are quarterly and extend through 2006 Q3 Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments

SOURCE Department of Commerce, Bureau of Economic Analysis

Federal government debt held by the public, 1960–2006



NOTE The final observation is for 2006 Q3 For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate Excludes securities held as investments of federal government accounts

SOURCE Federal Reserve Board, flow of funds data

increased 2½ percent over the four quarters of calendar year 2006 and contributed about ¼ percentage point to the growth rate of real GDP in that year. The increase was the result of a pickup in real defense purchases, which rose more than 4 percent during calendar 2006 after two years of smaller increases. At the same time, real nondefense purchases declined more than 1 percent after having risen, on average, about 2 percent per year over the preceding two years.

The reduction in the unified deficit in the past two years implies that the federal government required less national saving to finance its operations. However, nonfederal saving, which excludes borrowing by the federal government from total net national saving, remained relatively low. Although the saving rate for private business and state and local governments has increased in recent years, the improvement has been offset by declines in the personal saving rate. Total national saving, net of depreciation, was 2 percent of nominal GDP in the third quarter of 2006. The recent national saving rate is an improvement from the lows of a few years ago, but it has been insufficient to avoid an increasing reliance on borrowing from abroad to finance the nation's capital spending.

Federal Borrowing

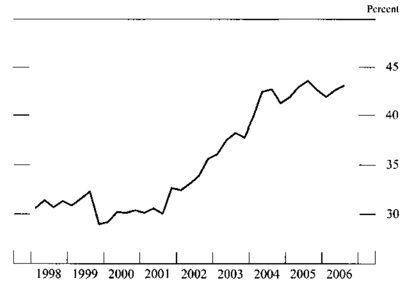
The Treasury responded to the reduction in the federal deficit in 2006 by paying down Treasury bills over the course of the year and by trimming the gross issuance of marketable Treasury coupon securities. As of the third quarter of 2006, the quantity of federal debt held by the public as a percentage of nominal GDP had declined about ½ percentage point, to about 36 percent.

Early in the first quarter of 2006, federal debt subject to the statutory limit reached the then-current ceiling of $8.2 trillion. The Treasury employed various methods to avoid breaching the limit until the Congress increased it to nearly $9 trillion in March. As of the end of December, the total amount of federal debt subject to the limit was $8.6 trillion.

In February, the Treasury auctioned thirty-year bonds for the first time since 2001. The offering was apparently well received, as was the reopening of the issue in August. The Treasury announced in August that it would issue thirty-year bonds on a quarterly basis beginning in 2007.

The acquisition of Treasury debt by foreigners slowed further in 2006 from its peak in 2004. However, out-

Treasury securities held by foreign investors
as a share of total outstanding, 1998–2006



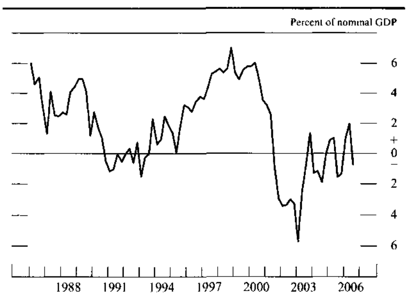
NOTE The data are quarterly and extend through 2006 Q3

SOURCE Federal Reserve Board, flow of funds data standing Treasury debt also grew more slowly, leaving the share of outstanding debt held by foreign investors little changed, on balance, from its average level over the preceding two years. According to Treasury data on international capital flows, foreigners (official and other) purchased considerably fewer U.S. Treasury coupon securities in 2006 than in 2005. The average proportion of nominal coupon securities purchased by foreign and international investors at auctions in 2006 about matched the average from the previous year at 16 percent, but it was down noticeably from an average level of 25 percent in 2004.

State and Local Government

The fiscal positions of state and local governments improved further in 2006. Apart from federal grants-in-aid, revenues rose at an annual rate of 7 percent over the first three quarters of 2006 after posting relatively strong gains in the preceding two years. Receipts from taxes on retail sales and on individual and corporate incomes continued to rise at a brisk pace; however, decreasing gains in house prices slowed the rise in property tax revenues in the third quarter of 2006 from the rapid pace in the previous two years. The sustained strength in total revenues, along with the efforts of states and localities to restrain spending for health care, has enabled these jurisdictions to step up spending on other programs and still rebuild their reserve funds. As measured in the NIPA, net saving by state and local governments excluding social insurance funds—a measure that is broadly similar to the surplus in an operating budget—was almost $4 billion during the first three quarters of 2006. States and localities generally have seen improvement in their fiscal positions recently, but in coming years most governments will have to face the budget pressures of providing pension and health benefits to an expanding number of retired employees, and the states' costs for Medicaid are expected to rise substantially as the baby-boom generation ages.

State and local government net saving, 1986–2006



NOTE The data, which are quarterly, are on a national income and product account basis and extend through 2006 Q3 Net saving excludes social insurance funds

SOURCE Department of Commerce, Bureau of Economic Analysis

Real expenditures by state and local governments on consumption and gross investment, the component of these governments' spending that enters directly into the calculation of real GDP, rose 3 percent over the four quarters of 2006. That increase was the largest since 2001 and contributed about ¼ percentage point to the change in real GDP during the year. Real expenditures for investment rose 4¾ percent, largely because of a strong increase in real construction spending in the first half of the year. Spending for current consumption in real terms increased 2½ percent over the four quarters of 2006. Hiring by state and local governments stepped up last year. Of the cumulative increase in employment of 254,000 in 2006, about two-thirds of the jobs were in education.

State and Local Government Borrowing

Borrowing by state and local governments dropped below its rapid 2005 pace amid improved fiscal positions and fewer advance refunding issues. Nonetheless, bond issuance for new capital expenditures, particularly for education and transportation, boosted long-term borrowing. Credit quality in the state and local sector rose substantially in 2006, as the number of credit-rating upgrades far exceeded the small number of downgrades.

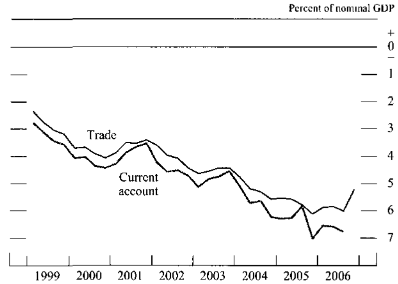
The External Sector

The U.S. current account deficit averaged $875 billion at an annual rate, or about 6½ percent of nominal GDP, in the first three quarters of 2006 (the latest available data). The deficit was wider than in 2005, partly because of a larger deficit on trade of goods and services. In addition, net investment income, which turned negative in the fourth quarter of 2005, remained negative in the first three quarters of last year, further expanding the current account deficit.

International Trade

After widening through most of 2005, the nominal trade deficit leveled out in the first half of 2006, rose to a record high in August, and then narrowed noticeably through November (the latest available data). On average, the

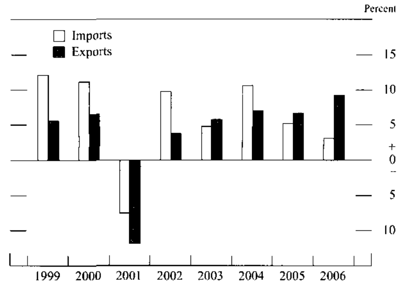
U.S. trade and current account balances, 1999–2006



NOTE The data are quarterly For the trade account, the observation for 2006 Q4 is estimated The data for the current account extend through 2006 Q3

SOURCE Department of Commerce

Change in real imports and exports of goods and services, 1999 2006



SOURCE Department of Commerce

nominal trade deficit was wider in 2006 than in the previous year. Nominal imports of goods grew more slowly than exports did early last year and, after reaching late-summer peaks, dropped because of declines in both the price and volume of imported oil. Meanwhile, imports of services decelerated sharply in the second half of last year. In contrast, nominal exports of goods and services pushed upward steadily throughout the year and grew significantly faster than did nominal imports. Given that the level of exports was smaller than the level of imports, the faster export growth during 2006 was not enough to narrow the nominal trade deficit. Although the nominal trade deficit last year (through November, annualized) was wider in dollar terms, the trade deficit as a share of GDP, at just under 6 percent, was about the same as in 2005.

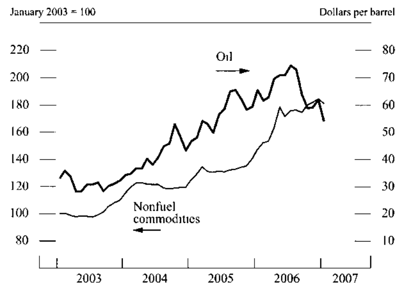
Real exports of goods and services grew a robust 9¼ percent last year. In the first quarter, growth was boosted by a catch-up of exports affected by hurricane damage in late 2005. Throughout the year, exports were supported by strong foreign economic activity. Real exports of goods rose 10¼ percent last year, a little faster than in the previous year. Export growth was spread fairly evenly across all major end-use categories, though exports of computers and semiconductors expanded noticeably more slowly than in 2005. By destination, exports to China and other emerging Asian economies grew very rapidly, as did those to South America. Exports to Mexico and western Europe rose at a more modest pace. Real exports of services were up a solid 6¾ percent for the year, double the pace of 2005.

Prices of exported goods rose at a 3½ percent rate last year, a little faster than their pace in 2005. Reflecting the effects of very large jumps in prices of industrial supplies, particularly fuels and metals, export prices moved up sharply in the second and third quarters; they decelerated toward the end of the year as prices of exported fuels retreated from their high levels and as prices of exported metals moved up more slowly.

Real imports of goods and services rose 3 percent last year, more slowly than in the previous year. As with the growth in real exports, real import growth got off to a quick start last year amid robust domestic growth. But import growth slowed, on average, in the middle quarters of the year, along with U.S. real GDP growth, and real imports fell in the fourth quarter as a result of a sharp drop in oil and natural gas imports. Despite some fourth-quarter declines, for the year imports increased in every major end-use category except petroleum and natural gas. Imports of services rose more than 5 percent last year, a step-up from the previous year's sluggish pace.

Prices of imported non-oil goods increased less than 1 percent, on balance, in 2006 despite some wide gyrations. After falling in the first quarter, prices reversed course, surged upward, and then cooled in the fourth quarter. The quarterly pattern was driven by movements in nonfuel commodity prices, which soared in the second and third quarters before leveling off in the fourth quarter.

Metals figured prominently among the nonfuel commodities that boosted trade prices last year. Prices for a variety of metals—including copper, aluminum, nickel, and zinc—skyrocketed in the second quarter. Factors contributing to the surge in prices included growing demand, particularly from developing countries, low levels of inventories for some metals, and perhaps increased speculative demand. Prices for nickel and zinc continued to move up throughout the year. In the second half of the year, aluminum prices trended sideways, and copper prices moved down from their peaks as inventory and supply conditions improved somewhat. For most of these metals, Prices of oil and of nonfuel commodities, 2003–07



NOTE The data are monthly and extend through January 2007 The oil price is the spot price of West Texas intermediate crude oil The price of nonfuel commodities is an index of forty-five primary-commodity prices
SOURCE For oil, the Commodity Research Bureau, for nonfuel commodities, International Monetary Fund

those price trends have continued this year. An exception is zinc, the price of which has plummeted.

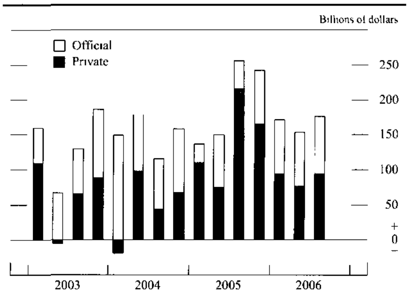
The spot price of West Texas intermediate crude oil averaged $66 per barrel in 2006, nearly $10 per barrel higher than in 2005; moreover, crude oil prices were especially volatile last year. The spot price climbed from around $61 per barrel at the end of 2005 to a peak of $77 per barrel in August as violence in the Middle East, a shutdown of the Prudhoe Bay oil field in Alaska, and forecasts of an active hurricane season led to increased demand. In the event, oil supply was affected far less than anticipated by these factors, and oil prices declined over the next few months as demand dropped and elevated petroleum inventories were drawn down. Oil demand for heating was depressed by above-average temperatures in the Northern Hemisphere in the fourth quarter and in the early weeks of 2007, and the spot price fell further, to around $50 per barrel in mid-January, before moving back up to $58 per barrel at the end of the month. Far-dated futures prices began last year at about $60 per barrel, moved in a pattern similar to spot prices throughout most of the year, and averaged just over $61 per barrel in January 2007.

Notwithstanding the decrease of global oil prices since August, several factors continue to support these prices at historically elevated levels. Ongoing violence has diminished oil production in Iraq and Nigeria. The continuing dispute with Iran over its nuclear program threatens a possible curtailment of Iranian exports. Energy investment by international oil companies has been hampered in some countries, such as Russia and Venezuela, by increased government control of domestic energy industries. Moreover, in response to the recent decline in oil prices, OPEC has reduced its crude oil production to the lowest level since 2004. Oil demand over the past year has also increased modestly in developing countries despite high prices.

The Financial Account

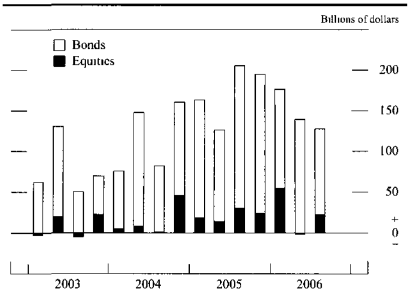
Foreign official inflows in the first three quarters of 2006 were above their 2005 pace but remained below the record levels of 2004. Most of these official inflows were attributable to Asian central banks and took the form of purchases of U.S. government securities, primarily bonds and mortgage-backed securities issued by government-sponsored enterprises (GSEs). Preliminary data indicate a slight easing of official purchases in the fourth quarter of 2006. Net private inflows slowed in the first quarter but have changed little since then.

U.S. net financial inflows, 2003–06



NOTE The data are quarterly and extend through 2006 Q3
SOURCE Department of Commerce

Net private foreign purchases of long-term U.S. securities, 2003–06



NOTE The data are quarterly and extend through 2006 Q3
SOURCE Department of Commerce

Foreign private purchases of U.S. securities in the second and third quarters of 2006 slowed slightly from the extraordinary pace set in the second half of 2005 and early 2006, but preliminary fourth-quarter data show recent demand to have been strong. More than half of private flows last year took the form of purchases of corporate bonds, and most of the remainder went toward investment in GSE bonds and corporate equities. On net, private foreigners purchased few U.S. Treasuries. Foreign direct investment flows into the United States remained robust.

Net purchases of foreign securities by U.S. residents, a financial outflow, set a record pace in the first three quarters of 2006. Preliminary data show a further surge in net purchases in the fourth quarter. Demand for foreign bonds by U.S. residents slightly exceeded that for foreign equities. After the expiration of the partial tax holiday implemented in the Homeland Investment Act of 2004, U.S. direct investment abroad dropped back to more normal levels.

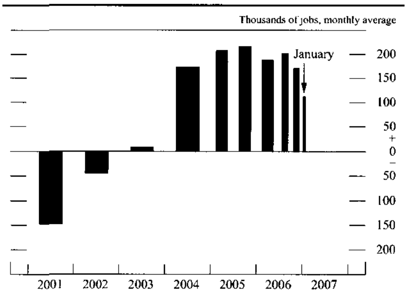
The Labor Market

Employment and Unemployment

Labor markets remained strong in 2006. Nonfarm payroll employment increased 186,000 per month, on average, during the second half of 2006, a rate essentially the same as in the first half of the year. Employment rose 111,000 in January of 2007. The unemployment rate in the fourth quarter of last year—4½ percent—was at its lowest quarterly level since 2001, and it was little changed in January 2007.

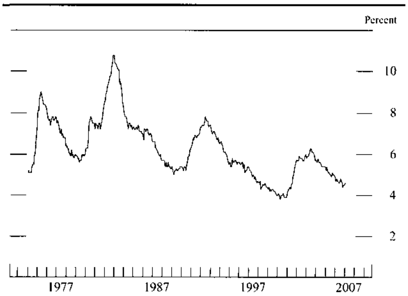
In response to the contraction in homebuilding, hiring in the construction sector slowed considerably in the

Net change in payroll employment, 2001–07



NOTE Nonfarm business sector
SOURCE Department of Labor, Bureau of Labor Statistics

Civilian unemployment rate, 1974–2007



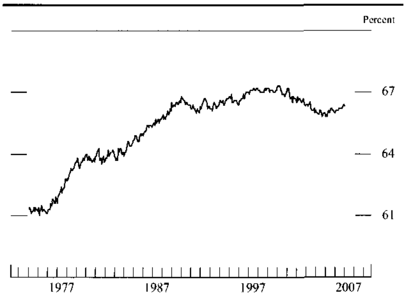
NOTE The data are monthly and extend through January 2007
SOURCE Department of Labor, Bureau of Labor Statistics

second and third quarters of 2006, and this sector shed workers in the fourth quarter. Although hiring for nonresidential building construction remained brisk for most of the year, the steep decline in housing starts curtailed the overall demand for construction workers. Employment in the manufacturing sector, which rose in the first half of 2006, declined in the second half as factory output slowed. From July to December, many of the factory layoffs were at makers of motor vehicles and parts and at producers closely tied to the construction industry. Outside of the construction and manufacturing sectors, employment generally increased at a solid pace in the second half of 2006, and hiring was particularly rapid in a number of service industries—especially those providing education and health services, professional and technical business services, and financial services.

As a result of the continued expansion of labor demand in 2006, the unemployment rate fell further. After remaining around 4¾ percent in the first three quarters of 2006, the unemployment rate edged down to 4½ percent in the fourth quarter. The tighter labor market was associated with a noticeable increase in employment among individuals who had not been participating in the labor force. In line with this cyclical tightening of the labor market, the labor force participation rate ticked up during 2006, from 66 percent in the first quarter to 66¼ percent in the fourth quarter, after a ¼ percentage point rise during 2005. The recent rise in the participation rate follows a period of decline beginning in the late 1990s that in part reflected some longer-term secular trends in labor force behavior. Those trends included a leveling off in the participation rate of women and an increase in the proportion of the workforce in older age groups, which have lower average participation rates.

Other indicators also suggest that labor market conditions remained generally favorable during the second half

Labor force participation rate, 1974–2007



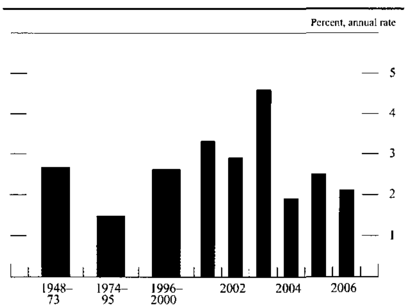
NOTE The data are monthly and extend through January 2007
SOURCE Department of Labor, Bureau of Labor Statistics

of 2006. Layoffs remained low as new claims for unemployment insurance fluctuated around a relatively subdued level of 315,000 per week. In addition, data reported by the Bureau of Labor Statistics showed a further increase during the later part of the year in the rate of job openings as a percentage of private-sector employment.

Productivity and Labor Compensation

The growth rate of labor productivity in the nonfarm business sector, which had slowed in 2004 and 2005 from an exceptionally rapid pace earlier in the decade, remained relatively subdued in 2006. Over the four quarters of 2006, output per hour of work in the nonfarm business sector increased 2 percent, compared with about a 3 percent average annual rate of increase during the first half of this decade and the second half of the 1990s. During that earlier period, productivity gains were spurred by the rapid pace of technological change, the growing ability of firms to use information and other technology to improve the efficiency of their operations, and increases in the amount of capital per worker. Despite the recent slowing in productivity growth, these underlying factors do not appear to have waned. Accordingly, the recent slowdown in labor productivity may be at least in part a temporary cyclical response to the moderation in the pace of economic activity in 2006 rather than a meaningful downshift in the longer-run trend.

Change in output per hour, 1948–2006

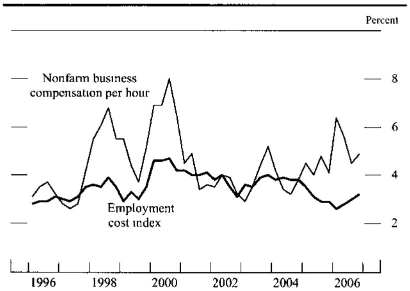


NOTE Nonfarm business sector Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period
SOURCE Department of Labor, Bureau of Labor Statistics

As the labor market tightened in 2006, the rise in hourly labor compensation, which includes both wages and employer payments for employee benefits, stepped up for workers in the nonfarm business sector. In nominal terms, compensation per hour increased almost 5 percent over the four quarters of 2006, compared with an average 4 percent rise in the preceding two years. After adjusting compensation for increases in the PCE price index, real compensation per hour rose 3 percent in 2006, up from an average gain of about 1 percent in 2004 and 2005.

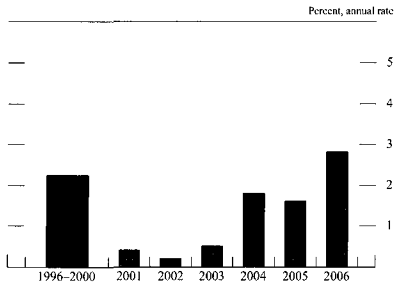
An alternative measure of employee compensation is the employment cost index (ECI) for private nonfarm businesses, which is based on a survey of firms conducted by the Bureau of Labor Statistics. According to this measure, nominal hourly compensation increased 3¼ percent in 2006, ¼ percentage point faster than in 2005. In real terms, the ECI for hourly compensation rose 1¼ percent last year after averaging a ½ percent increase over the

Measures of change in hourly compensation, 1996–2006



NOTE The data are quarterly and extend through 2006 Q4 For nonfarm business compensation, change is over four quarters, for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter The nonfarm business sector excludes farms, government, nonprofit institutions, and households The sector covered by the ECI used here is the same as the nonfarm business sector plus nonprofit institutions A new ECI series was introduced for data as of 2001, but the new series is continuous with the old
SOURCE Department of Labor, Bureau of Labor Statistics

Change in unit labor costs, 1996–2006



NOTE Nonfarm business sector The change for 1996 to 2000 is measured from 1995 Q4 to 2000 Q4
SOURCE Department of Labor, Bureau of Labor Statistics

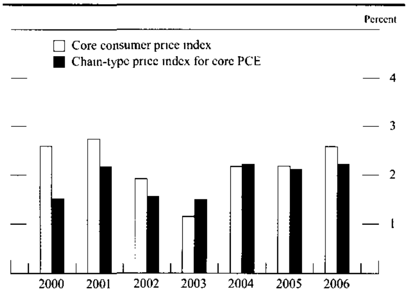
preceding two years. The nominal wages and salaries component of the ECI rose 3¼ percent in 2006, while the benefits component advanced 3 percent.

From the perspective of employers, the acceleration in hourly compensation in the nonfarm business sector last year boosted the average labor costs associated with producing a unit of output 2¾ percent, up from increases of about 1¾ percent in both 2004 and 2005. Although the rise in unit labor costs increased, firms' profit margins appeared to remain elevated in 2006 relative to longer-run standards.

Prices

Headline inflation slowed in 2006. The PCE chain-type price index rose 2 percent over the four quarters of

Change in core consumer prices, 2000–06



SOURCE For core consumer price index, Department of Labor, Bureau of Labor Statistics, for core PCE price index, Department of Commerce, Bureau of Economic Analysis

Alternative measures of price change, 2004–06
Percent

Price measure	2004	2005	2006
Chain-type			
Gross domestic product (GDP)	3.2	3.1	2.5
Gross domestic purchases	3.7	3.6	2.2
Personal consumption expenditures (PCE)	3.0	3.1	1.9
Excluding food and energy	2.2	2.1	2.3
Market-based PCE excluding food and energy	1.7	1.8	2.0
Fixed-weight			
Consumer price index	3.3	3.7	1.9
Excluding food and energy	2.1	2.1	2.6

NOTE Changes are based on quarterly averages of seasonally adjusted data
SOURCE For chain-type measures, Department of Commerce, Bureau of Economic Analysis, for fixed-weight measures, Department of Labor, Bureau of Labor Statistics

2006, a step-down from the 3 percent increase recorded in 2005. The drop in energy prices in the latter part of 2006 accounted for the deceleration in the headline number. Core inflation moved higher in the first part of 2006 but then eased toward the end of the year. On balance, core PCE prices rose about 2¼ percent over the four quarters of 2006, a little faster than the 2 percent increase in 2005. The market-based component of the core PCE price index—which excludes imputed prices that are not observed in market transactions and that often change irregularly—increased 2 percent in 2006, about ¼ percentage point more than in the previous year.

Energy prices recorded dramatic swings during 2006. PCE energy prices increased at an annual rate of about 15 percent in the first half of the year and declined at an annual rate of almost 17 percent in the second half. The sharp movements in consumer energy prices in 2006 were associated primarily with fluctuations in prices for crude oil. The changes in energy prices also were amplified by a widening in the margin of the retail price of gasoline over the associated cost of crude oil in the first half of the year and by some narrowing of that margin in the second half. On balance, the PCE energy price index decreased 4 percent over the four quarters of 2006.

Food price inflation remained fairly moderate in 2006. The PCE index for food and beverages increased 2¼ percent, roughly the same pace as in the preceding year. Retail prices of meat and poultry rose modestly for 2006, as robust demand was met by ample supplies of meat. Prices of wheat rose over the course of the year, and prices of corn and soybeans spiked at the end of the year in the wake of downward revisions to estimates of crop production. Prices of corn also were boosted during the year by increased demand for corn to produce ethanol. But the small share of wheat, corn, and soybeans in the total value of food production limited their effect on retail food prices. Prices for food consumed away from home, which are influenced importantly by the costs of labor, energy, and other business inputs, increased 3¼ percent in 2006, a more rapid pace than that for prices of food consumed at home.

The core PCE price index accelerated to an annual rate of about 2½ percent in the first half of 2006 on the strength of pickups in the price indexes for both goods and services. In the spring, increases in housing rents were particularly sharp. The rise may have reflected in part a shift in demand toward rental housing as rising mortgage rates and lofty home prices made home purchases less affordable. The pass-through of higher energy costs to a broad range of goods and services also probably contributed to the acceleration in core consumer price inflation in the first half of 2006.

In the second half of 2006, core PCE price inflation edged down to an annual rate of just below 2¼ percent. The deceleration was the result of a decrease in core goods prices, which likely reflected in some measure the waning influence of energy prices. In contrast, core services inflation in the second half of the year remained at about the same pace as in the first half. Although housing rents rose more slowly in the second half of the year, their effect on the PCE for core services was mostly offset by faster price increases for medical care and a number of other services.

The swings in energy costs in 2006 were apparent in the prices of inputs used in the production and sale of final goods and services, especially of items for which energy costs represent a relatively large share of total production costs, including industrial chemicals, plastics, fertilizer, and stone and clay products. In addition, the prices of some commodities, such as a variety of metals, rose significantly in 2006 in response to strong worldwide demand. As a result, the core producer price index for intermediate goods, which excludes food and energy, rose 5¼ percent in 2006, up from the 4¾ percent increase in 2005. The index increased at an annual rate of 7¼ percent in the first half of 2006, but it decelerated to an annual rate of about 3¼ percent in the second half as energy costs declined.

For the year as a whole, measures of long-term inflation expectations remained well anchored, although short-term expectations were heavily influenced by fluctuations in energy prices. The Reuters/Michigan survey measure of the median expectation of households for inflation over the next twelve months was about 3 percent in December, down from its peak of 3¾ percent in August. Longer-term inflation expectations recorded in the Reuters/Michigan survey showed less variability. The median survey respondent in December expected the rate of inflation during the next five to ten years to be 3 percent, down from its peak of 3¼ percent in August. Other indicators

TIPS-based inflation compensation, 2003–07

NOTE. The data are daily and extend through February 7, 2007. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) with the nominal off-the-run Treasury yield curve.

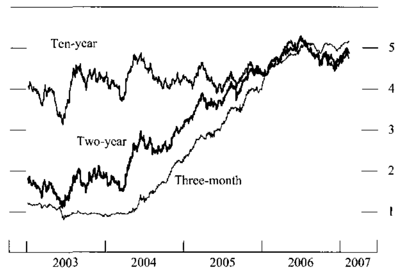
SOURCE. Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays.

likewise suggest that longer-run inflation expectations have remained contained. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained at 2½ percent in 2006, a level that has been essentially unchanged since 1998. In addition, inflation compensation implied by the spread of yields on nominal Treasury securities over their inflation-protected counterparts stayed within the relatively narrow range of 2 percent to 2¾ percent during the year.

U.S. Financial Markets

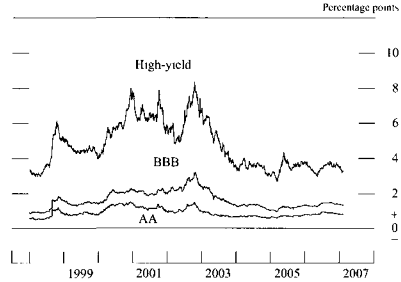
Financial conditions in the United States supported economic growth in 2006. Yields on long-term Treasury securities climbed a bit, on balance, but stayed low by historical standards, while strong corporate profits helped fuel substantial gains in equity markets. Liquid corporate balance sheets and low corporate leverage helped keep risk spreads on corporate bonds narrow. Meanwhile, business borrowing picked up to a rapid pace, spurred in part by a rise in merger and acquisition activity. In the residential real estate sector, mortgage borrowing slowed markedly, as house prices decelerated, especially in the second half of the year. Consumer credit expanded at a moderate pace. Nonetheless, household debt growth outpaced the growth of disposable personal income, and the financial obligations of households inched higher. Although households generally appeared able to meet their obligations, signs of financial strain were apparent in subprime variable-rate mortgages. The M2 monetary aggregate expanded at a moderate pace in 2006.

Interest rates on selected Treasury securities, 2003–07



NOTE: The data are daily and extend through February 7, 2007
SOURCE: Department of the Treasury

Spreads of corporate bond yields over comparable off-the-run Treasury yields, 1998–2007



NOTE: The data are daily and extend through February 7, 2007 The ten-year high-yield, ten-year BBB, and ten-year AA indexes are compared with the ten-year Treasury yield
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data

Interest Rates

Market interest rates rose modestly, on balance, in 2006—yields on two- and ten-year nominal Treasury securities increased about 40 and 30 basis points respectively. Changes in interest rates seemed largely tied to changes in the outlook for economic growth and inflation. Rates across the maturity spectrum increased notably over the first half of the year, as incoming data on activity and inflation came in higher than markets had expected and as the FOMC raised the target federal funds rate 25 basis points at each of its first four meetings. At the time of the June FOMC meeting, interest rate futures market quotes indicated that market participants perceived considerable odds of an additional rate tightening by year-end. However, market interest rates declined, on net, over subsequent months in response to incoming data suggesting that inflation pressures were moderating and that economic growth was slowing. Market expectations for the trajectory of the federal funds rate over the next several years shifted down considerably during the second half of the year. More recently, market participants have backed away from expectations of a substantial easing of monetary policy as incoming data on economic activity have been stronger than expected. Investors now expect the FOMC to ease policy only slightly over the next two years. Although investors modestly revised their medium-term policy expectations over the course of the year, the Committee's interest rate decisions were largely anticipated in financial markets by the time of each meeting. Throughout the year, forward-looking measures of uncertainty about monetary policy inferred from interest rate options remained near the low end of historical ranges.

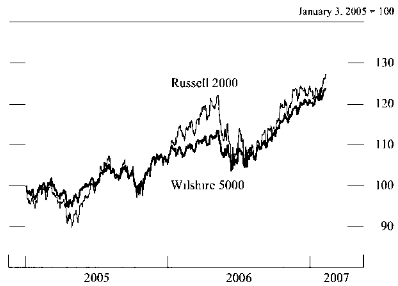
Yields on inflation-indexed Treasury securities increased about as much as those on their nominal counterparts in 2006. Medium- and long-term inflation compensation—measured from spreads between yields on nominal and inflation-indexed securities—were about unchanged to a little lower, on net, and during the year these measures exhibited only modest swings in response to incoming inflation data and oil price movements.

In the corporate bond market, yields on investment-grade securities moved about in line with those on comparable-maturity Treasury securities. In contrast, yields on speculative-grade securities fell slightly, pulling risk spreads lower in that segment of the market. The narrowness of investment- and speculative-grade spreads seems to reflect investors' sanguine perceptions of corporate credit quality over the medium term, which likely reflect in large part the strength of business balance sheets and a benign economic outlook. The term structure of forward risk spreads for corporate bonds supports this view, as forward spreads one and two years ahead are low, while the spreads further out the curve are more in line with historical norms.

Equity Markets

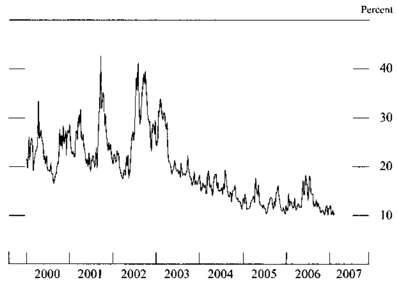
Broad equity indexes soared 10 percent to 20 percent in 2006, boosted by strong growth in corporate earnings. Share prices rose across a wide range of sectors, but increases in telecommunications and security brokerage stocks were especially noteworthy. The difference between the twelve-month forward earnings–price ratio for the S&P 500 and the long-term real Treasury yield—a crude measure of the premium that investors require for holding equity shares—was little changed on balance. The

Stock price indexes, 2005–07



NOTE The data are daily and extend through February 7, 2007
SOURCE Frank Russell Company, Dow Jones Indexes

Implied S&P 500 volatility, 2000–07



NOTE The data are weekly and extend through February 9, 2007 The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices
SOURCE Chicago Board Options Exchange

implied volatility of the S&P 500 calculated from options prices spiked temporarily in the late spring in connection with a period of strain in several markets but remained near historical lows for the remainder of the year. Net inflows into domestic equity mutual funds were quite modest in 2006, while inflows into international equity funds were exceptionally strong.

Market Functioning and Financial Stability

Overall, financial markets functioned smoothly over the year and proved resilient to several shocks. Equity markets in the United States and currency and fixed-income markets in several emerging-market economies experienced heightened volatility late in the second quarter, but the turbulence was short lived. The liquidation of a few sizable hedge funds attracted considerable attention for a time but had little discernible effect on the broad functioning of markets. Even the liquidation of Amaranth—a hedge fund that was wound down in the fall after reporting a loss in excess of $6 billion, mostly in energy trades—left little imprint on financial markets, although it raised some concerns about risk-management practices. Implied volatilities, risk spreads, and various other potential measures of financial stress generally stayed at very low levels throughout the year, suggesting that investors were comfortable taking on risk, likely in part because they were confident about the economic and financial outlook.

Throughout the year, bid–ask spreads on the most actively traded Treasury securities remained within narrow ranges. Some instances of questionable trading activities occurred in the secondary market for Treasury securities over the course of the year. The Interagency Working Group for Treasury Market Surveillance monitored these situations closely.[1] In November, the Federal Reserve Bank of New York arranged a meeting with all primary dealers to discuss developments in Treasury markets and to encourage the firms to review their internal oversight of trading operations. Subsequently, a private-sector group sponsored by the Federal Reserve Bank of New York released a draft report laying out a set of best practices for firms active in the Treasury market on topics such as appropriate trading strategies and internal controls.

In July, the Federal Reserve Board implemented a revision to the treatment of GSEs and certain international organizations under its Policy on Payments System Risk. Under the change, interest and redemption payments on securities issued by these institutions are now released only when the issuer's Federal Reserve account contains sufficient funds to cover the payments; that is, these institutions no longer may employ daylight credit to fund such payments. The Board of Governors determined that the change represents an appropriate risk-management policy for the central bank and is consistent with the general practices of private issuing and paying agents. In addition, GSEs and international organizations are now subject to a penalty fee for daylight overdrafts resulting from general corporate payment activity (activity other than interest and redemption payments). This change aligns the policy for GSEs and international organizations with that for other Federal Reserve account holders that do not have regular access to the Federal Reserve's discount window and thus are not eligible for intraday credit. The transition to the

1 The group was established in 1992 and includes representatives from the Board of Governors of the Federal Reserve System, the Treasury, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Reserve Bank of New York

new policy occurred smoothly with minimal effects on the functioning of the payments system and no notable adverse effects on short-term funding markets.

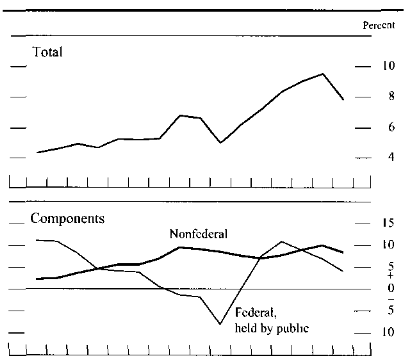
Following up on a meeting with the Federal Reserve Bank of New York in the fall of 2005, the largest participants in the fast-growing market for credit derivatives agreed to a series of steps to strengthen that market's infrastructure. Over the course of 2006, credit derivatives dealers phased out the practice of transferring positions to a different counterparty without first obtaining the consent of the original counterparty. They also reduced by 85 percent the number of trade confirmations outstanding more than thirty days; they doubled the share of trades that are confirmed via an electronic platform, to 80 percent of total trade volume; and they agreed upon a new protocol for the settlement of such derivatives after a credit event.

Debt and Financial Intermediation by Banks

Total debt of the domestic nonfinancial sectors expanded an estimated 7¾ percent in 2006, well below the pace in 2005 but still faster than that of nominal income. Debt growth slowed markedly in the household and government sectors, but business debt accelerated.

About 30 percent of the growth in nonfinancial sector debt in 2006 was intermediated by the banking sector. This share is about even with the average over the past ten years and is about 5 percentage points above the average observed in the 1980s and early 1990s. Commercial bank credit expanded 9½ percent in 2006, supported by brisk growth in loans to businesses. Bank credit also was boosted in the autumn by a consolidation of a substantial volume of thrift assets onto a commercial bank's balance sheet that had resulted from an internal reorganization at a large bank holding company.

Change in domestic nonfinancial debt, 1991–2006



NOTE For 2006, change is from 2005:Q3 to 2006:Q3 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of components shown. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

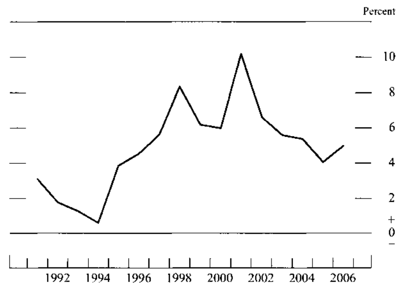
Bank lending to businesses through commercial and industrial loans increased at a rapid pace last year. The growth was fueled by vigorous merger and acquisition activity, rising outlays for investment goods, ongoing inventory accumulation, and an accommodative lending environment. Bank loans secured by commercial real estate, though strong, decelerated over the course of the year. The moderation in commercial real estate lending was consistent with responses by large and medium-sized banks to the Senior Loan Officer Opinion Survey on Bank Lending Practices, which pointed to slowing demand and a net tightening of credit standards for such loans in the second half of the year. Consumer loans and residential mortgages held by banks grew at a moderate rate for the year as a whole. However, excluding the effects of the thrift consolidation, residential real estate lending slowed considerably in the fourth quarter, no doubt reflecting in part the downturn in the housing market.

Commercial bank profits as a percentage of average assets were strong in 2006 and rose slightly above 2005 levels. Net interest margins declined a bit further, likely in response to continued competitive pressures and a modest inversion of the yield curve, but bank profitability was supported by growth in non-interest income and by well-contained costs. Continued strong asset quality also helped to support profitability in 2006 by allowing banks to reduce their loan-loss provisioning. Robust asset quality was reflected in loan delinquency and charge-off rates that remained at low levels through the end of 2006.

The M2 Monetary Aggregate and Reserves

M2 expanded at a 5 percent rate last year, somewhat faster than in 2005. Typically, as short-term interest rates rise, deposit rates lag somewhat, increasing the opportunity cost of holding money. In 2006, this effect apparently slowed money growth less than would have been expected on the basis of historical norms, and the velocity of M2 rose only about ¾ percent. Retail money market mutual funds and small time deposits, components of M2 whose yields move most closely with market rates, grew rapidly. However, liquid deposits, which constitute the largest component of M2, and whose yields adjust more gradually, were about flat on net. Currency expanded a modest

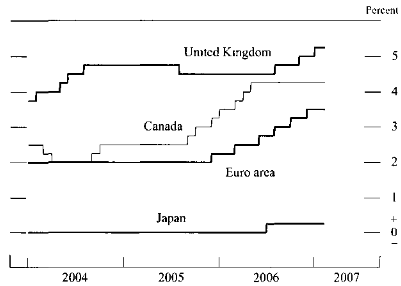
M2 growth rate, 1991–2006



NOTE The data are annual on a Q4 over Q4 basis M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds

SOURCE Federal Reserve Board, Statistical Release H 6, "Money Stock Measures"

Official or targeted interest rates in selected foreign industrial countries, 2004–07



NOTE The data are daily The last observation for each series is February 7, 2007 The data shown are the overnight rate for Canada, the refinancing rate for the euro area, the call money rate for Japan, and the repurchase rate for the United Kingdom

SOURCE The central bank of each area or country shown

3½ percent, an increase similar to that in 2005, reflecting weak, possibly negative, net demand from overseas.

Part of the Financial Services Regulatory Act of 2006 gave the Federal Reserve authority, beginning in October 2011, to pay interest on reserve balances and to further reduce or eliminate reserve requirements. At the October FOMC meeting, the Chairman asked the staff to prepare for the implementation of this legislation.

International Developments

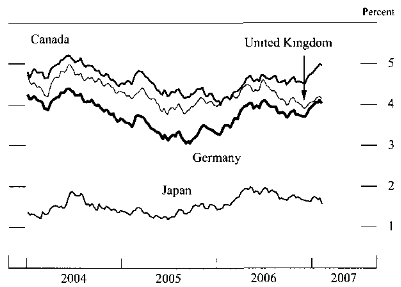
Foreign economic growth was generally strong in 2006, as expansion continued in all major regions of the world. The Japanese economy decelerated somewhat but maintained positive growth, and the pace of activity in the euro area picked up. Labor market conditions in both areas improved. Emerging-market economies also recorded solid growth last year and experienced no apparent lasting ill effects from the brief period of financial market volatility that hit some of them particularly hard in the late spring. Although there are signs that steps taken to slow growth of investment in China have been effective, the Chinese economy continued to grow rapidly. Rising energy prices boosted consumer price inflation in many areas of the world early last year, but monetary tightening appears to have prevented inflation from moving significantly higher, and the effects of higher energy prices on core prices were modest.

Industrial countries tightened monetary policy in 2006. Some countries paused around the same time as the Federal Reserve, and others continued to tighten throughout the year. After ending its policy of quantitative easing in the spring, the Bank of Japan (BOJ) raised its policy rate 25 basis points in July. Weak consumer spending and low inflation have apparently deterred the BOJ from tightening since then. With growth in the European economies firming, concerns over inflationary pressures prompted the European Central Bank to raise its policy rate five times last year, to 3.5 percent. The Bank of Canada tightened 75 basis points in several steps over the first half of the year but has left the overnight rate unchanged since then. After keeping its policy rate constant in the first half of the year, the Bank of England tightened policy 25 basis points in August and November 2006 and in January 2007. The statements accompanying each tightening cited the upside risks to inflation posed by low levels of spare capacity.

During the first half of 2006, ten-year sovereign yields in the euro area, Canada, and Japan rose sharply on balance: Increases ranged from 45 basis points in Japan to 75 basis points in Germany. Yields on inflation-protected long-term securities in these economies also rose during the first half of 2006 but not as much as nominal yields and thus implied a noteworthy rise in inflation compensation. These developments occurred largely in reaction to continuing upward pressures on inflation, which stemmed from a further run-up in energy prices and indications that global economic growth remained robust.

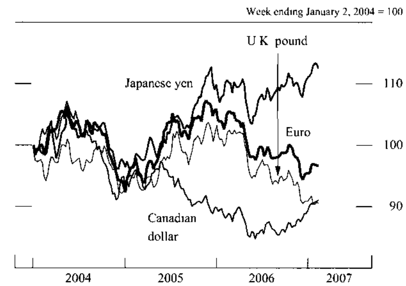
From their midyear highs, nominal government benchmark bond yields fell noticeably until about the beginning of December in most major advanced economies, as investors reacted to moves in U.S. rates and evaluated the implications for the global economy of the economic slowdown that seemed to be under way in the United States. Over this period, yields on ten-year nominal bonds declined by amounts that ranged from about 25 basis

Yields on benchmark government bonds in selected foreign industrial countries, 2004–07



NOTE The data are for ten-year bonds and are weekly The last observation for each series is the average for February 5 through February 7, 2007
SOURCE Bloomberg L P

U.S. dollar exchange rate against selected major currencies, 2004–07

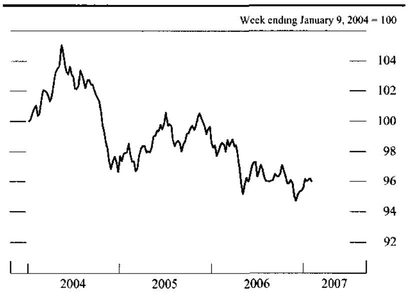


NOTE The data are weekly and are in foreign currency units per dollar The last observation for each series is the average for February 5 through February 7, 2007
SOURCE Bloomberg L P

points in the United Kingdom to about 70 basis points in Canada. Yields on inflation-indexed securities declined less; modest declines in inflation breakeven rates were attributed in part to lower energy prices in the second half of the year.

Since the beginning of December, however, nominal and indexed government bond yields have risen once again in most advanced economies, partly because new data releases appeared to alleviate investors' concerns that global economic growth might slow appreciably. Yields on both ten-year nominal and indexed securities have risen 15 basis points in Japan and 25 to 50 basis points in the euro area, the United Kingdom, and Canada since their December lows. As a result, inflation breakeven rates have been little changed.

U.S. dollar nominal exchange rate, broad index, 2004–07



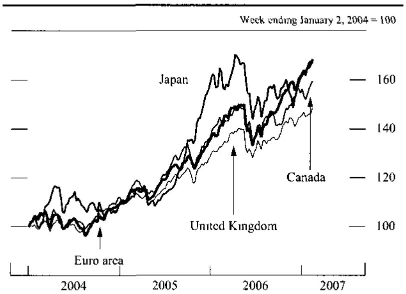
NOTE The data are weekly and are in foreign currency units per dollar The last observation is the average for February 5 through February 7, 2007 The broad index is a weighted average of the foreign exchange values of the U S dollar against the currencies of a large group of the most important U S trading partners The index weights, which change over time, are derived from U S export shares and from U S and foreign import shares
SOURCE Federal Reserve Board

The Federal Reserve's broadest measure of the nominal trade-weighted exchange value of the dollar declined 3¾ percent from the beginning of last year through early February of this year. Over that period, the dollar appreciated 2¼ percent against the yen and 1½ percent against the Canadian dollar, but it depreciated about 9 percent, on net, against the euro, almost 13 percent against sterling, and 4 percent against the Chinese renminbi. The renminbi's rate of appreciation stepped up in late 2006 and early 2007, but daily fluctuations in the dollar–renminbi exchange rate were very small.

Most of the dollar's overall decline in 2006 occurred between mid-April and early May. During this period, market participants reportedly sensed that the FOMC was approaching the end of its series of policy tightenings, and interest rate differentials moved against the dollar. Traders also refocused on the large and persistent U.S. current account deficit, which was further boosted by crude oil prices that had moved above $70 per barrel. To date in 2007, the dollar's broad nominal exchange value has risen 1 percent on balance.

In the wake of strong advances in 2005, major global equity indexes posted solid gains, on balance, in 2006 and in early 2007. After rising 5 percent to 10 percent in the first quarter of 2006, most global indexes fell sharply beginning in early May to reach intra-year lows in mid-June. Market participants attributed the drops in share prices to increased uncertainty about prospective inflation, caused in part by the run-up in energy prices, and to a retreat from risk-taking. Broad-based gains in stock prices since midsummer appear to be associated with a scaling

Equity indexes in selected foreign industrial countries, 2004–07



NOTE The data are weekly The last observation for each series is the average for February 5 through February 7, 2007
SOURCE Bloomberg L P

back of expectations for future tightening of monetary policy in several countries and with declines in energy prices. Since mid-June, broad stock market indexes have gained 10 percent to 20 percent in Europe, Japan, and Canada.

Industrial Economies

After increasing at an annual rate of roughly 2 percent in the first half of 2006, Japanese real GDP grew only ¾ percent in the third quarter, largely because of slower growth of consumption. Capital spending was an important contributor to growth of output throughout the year, supported by strong corporate profitability. Labor market conditions continued to improve; the unemployment rate was about 4 percent in December, its lowest level since 1998, and the ratio of job offers to applicants remained close to a thirteen-year high. However, wage growth was very subdued, as firms controlled cost increases, and unit labor costs continued to fall. In 2006, consumer prices started to rise again, posting small twelve-month increases after June, and land prices in Japan's six largest cities rose for the first time since 1991. However, the GDP deflator continued to decline slowly.

Real GDP in the euro area accelerated somewhat in 2006, posting average growth of 3¼ percent at an annual rate over the first three quarters. Output growth was supported in part by strong consumer spending, which grew substantially faster than in 2005. The stronger performance of the economy was reflected in improving labor market conditions: The unemployment rate in the euro area fell 0.8 percentage point during the year to reach 7.5 percent in December, continuing a downward movement that began in 2004. Wages and salaries in the manufacturing and services sector grew at an average annual rate of 2¼ percent in the first three quarters of the year—a bit lower than their rate of growth in 2005. Higher energy prices boosted euro-area consumer price inflation, which rose to about 2½ percent in the first half of 2006; late in the year, it dropped below the European Central Bank's target ceiling of 2 percent. Core inflation remained near 1½ percent.

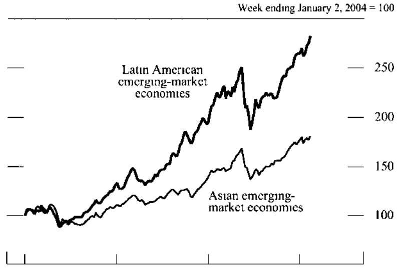
Real GDP in the United Kingdom grew 3 percent last year, and real GDP in Canada grew 3 percent, on average, through the first three quarters. Despite declining consumer confidence in the United Kingdom, the pace of consumption growth over the year was slightly higher than in 2005, and consumer spending in Canada, supported by moderate employment growth, also remained robust. Declines in energy prices brought Canadian consumer price inflation down after the middle of the year to a twelve-month change of about 1½ percent in December, below the Bank of Canada's 2 percent inflation target. Inflation in the United Kingdom edged up throughout the year, partly because of increases in electricity and natural gas prices that were implemented in the fall.

Emerging-Market Economies

Real GDP growth in China remained strong but moderated a bit in the second half. The mild slowdown suggests that the administrative measures put in place by the Chinese authorities to cool investment have had an effect. The trade surplus recorded a substantial increase in 2006. Four-quarter inflation picked up near the end of last year to over 2 percent, reflecting higher food prices.

Elsewhere in emerging Asia, economic performance was generally solid in 2006. In Korea, GDP growth slowed from the strong pace registered in 2005, partly because of monetary tightening, and consumer price inflation remained modest. The pace of growth in other countries stayed strong throughout 2006 as a result of robust exports and, in some cases, strengthening domestic demand. Four-quarter inflation moderated across the region. That moderation resulted from the waning effects of earlier reductions or removals of domestic fuel subsidies, but the previous tightening of monetary policy in the region and an appreciation of exchange rates also made a contribution. Capital inflows into several Asian emerging-market economies—particularly Thailand—in late 2006 and early this year put upward pressure on local currencies. Measures taken by Thai authorities seemed to succeed in limiting upward movement of the baht, but share prices in the Thai stock market fell sharply. Financial markets in other countries in the region were less affected

Equity indexes in selected emerging-market economies, 2004–07



NOTE The data are weekly The last observation for each series is the average for February 5 through February 7, 2007 The Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela The Asian economies are China, India, Indonesia, Malaysia, Pakistan, the Philippines, South Korea, Taiwan, and Thailand, each economy's index weight is its market capitalization as a share of the group's total

SOURCE Morgan Stanley Capital International (MSCI) index

and showed no noticeable spillovers from events in Thailand.

Output growth in Mexico was exceptionally strong in the first half of last year, especially in the manufacturing, construction, and services sectors. Growth stepped down in the second half; construction activity remained robust but was offset by a slowdown in exports of manufactured goods to the United States. Mexican consumer price inflation was elevated during the second half by higher food prices and reached rates above the 4 percent upper limit of the central bank's inflation target range; at year-end, inflation was still at the top end of the range.

Brazilian output growth was solid in the first quarter but slowed noticeably later in the year, partly because of weak manufacturing performance. Brazilian four-quarter inflation fell markedly, from almost 6 percent at the end of 2005 to just over 3 percent in December. In Argentina, steady growth in investment and consumption kept real GDP on a solid uptrend throughout 2006. The Argentine government continued to attempt to bring down inflation through voluntary price agreements with producers in several sectors; although inflation had edged down to the single-digit range by year-end, it was still high.

BOARD OF GOVERNORS
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BEN S. BERNANKE
CHAIRMAN

March 5, 2007

The Honorable Rubén Hinojosa
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the February 15 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to questions received from Congressman Rubén Hinojosa in connection with the February 15, 2007, hearing before the House Financial Services Committee:

Q.1. On the Education and Labor Committee, on which I serve as Chairman of the Higher Education Subcommittee, we constantly struggle to set the parameters of the student loan programs to provide the lowest costs to student borrowers and to the government while ensuring that there is sufficient capital either through subsidizing private lenders or through direct loans from the Department of Education.

It is very difficult for the Congress to receive information from the Department of Treasury and Education Department as to their true costs of subsidizing private lenders versus direct loans. Do you or your staff know why this is the case? And, can you please speak to the issue of subsidized private loans versus direct loans.

A.1. The student loan programs are quite complex and well outside the range of expertise and operational responsibility of the Federal Reserve. The complexity of the programs substantially complicates the analysis of the relative cost of the loan guarantee program versus the direct lending program. One very recent paper that undertakes that analysis is by Deborah Lucas of the Kellogg School of Management at Northwestern University and Damien Moore of the Congressional Budget Office. It is entitled "Guaranteed vs. Direct Lending: The Case of Student Loans," and can be found at http://www.kellogg.northwestern.edu/research/risk/federal/lucas_moore.pdf.

Q.2. Chairman Bernanke, as Chairman Frank noted during his opening remarks, our economy is becoming increasingly global in nature every day. In light of this situation, some countries will benefit from globalization more than others.

At present, the United States has a large trade deficit with China, a country that helps finance our national debt, which I believe is now approaching $8.5 trillion.

I realize that China, in turn, has its own trade deficit with its neighbors, but overall, it is my understanding that China still has a trade surplus with a majority of the world. Am I correct in this assertion?

A.2. In 2006, China's bilateral trade surplus in goods with the United States was $233 billion, based on U.S. Census Bureau data. Although China ran a trade deficit with many of its neighbors, China's overall multilateral balance (as reported in Chinese customs basis statistics) was a surplus of $177 billion. Chinese data show a significantly smaller bilateral surplus between China and the United States than do U.S. data, reflecting, among other factors, differences in the treatment of shipments through Hong Kong. However, either source of data suggests that trade with the United States accounts for a very large portion of China's overall multilateral balance, and China's trade with the rest of the world excluding the United States is accordingly much closer to balance.

Q.3. Recently, I learned that South Africa has fairly large investments in China. In fact, South Africa has more investments in China than China has in South Africa, which seems to be unique.

Given all that I have pointed out, and please correct me if some of the data I have cited is incorrect, it would be helpful if you would compare and contrast the amount of investment the United States has in China with the investments South Africa and India have in China.

Just how powerful economically is South Africa compared to India and China?

A.3. Data on bilateral flows between China and other countries are not generally available for portfolio investment, that is, transactions in financial instruments such as stocks or bonds. However, such data are available for bilateral flows of direct foreign investment. They show that South African foreign direct investment into China amounted to $130 million U.S. dollars in 2005 (the latest available year), well above Chinese direct investment flows into South Africa of $45 million in that year. Even so, inflows from South Africa have represented less than a percent of total Chinese direct investment inflows in recent years. Inflows from India have been even smaller, at roughly $20 million in 2005. In contrast, the United States' direct investment inflows into China have been averaging 10 percent of total Chinese direct investment inflows in recent years ($3 billion in 2005).

South Africa is not unique in channeling more direct foreign investment flows into China than it is receiving from China. The same is true of many countries.

There is no common standard for measuring a country's economic power, nor even for defining what economic power might mean. One candidate for measuring economic power might be a country's gross domestic product (GDP) as a share of world GDP. Using this measure, South Africa represents only ½ percent of world GDP. (South African GDP was about $240 billion U.S. dollars in 2005, measured at market exchange rates.) This is about one third of India's share, and an even smaller proportion of China's 5 percent share (Chinese nominal GDP was $2,244 billion in 2005). By comparison, U.S. GDP was $12,456 billion U.S. dollars in 2005, 28 percent of world GDP.

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 29, 2007

The Honorable Albio Sires
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my response to your additional question following the February 15 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to a written question received from Congressman Albio Sires in connection with the February 15, 2007, hearing before the Committee on Financial Services:

Small banks play a large role in this renewed commitment to our communities and I want to ensure that our small community banks are stabilized.

Chairman Bernanke, can you please tell me what the FED is doing to ensure that our community banks stay strong?

The Federal Reserve firmly believes that community banks play an important role in the U.S. economy, as they have throughout our history. Although significant consolidation in the banking industry has occurred over the past two decades, community banks continue to thrive by providing traditional relationship banking services to members of their communities. Their local presence and personal interactions give community bankers an advantage in providing financial services to customers for whom information remains difficult and costly to obtain by large out-of-market institutions, despite technological advances.

The Federal Reserve and the other federal banking agencies maintain a robust supervision program for community banks that is far more proactive than the programs in place during the late 1980s and early 1990s. The agencies today practice "risk-focused" supervision, which focuses on identifying weaknesses in bank practices and processes (e.g., underwriting, credit administration) so that corrective action can be taken before any such weaknesses are manifested in poor financial performance. Every community bank is subject to a full-scope, on-site examination at least once every 18 months, and at least once every 12 months if the bank has assets of $500 million or more. This asset threshold limit was recently raised from $250 million to $500 million. The Federal Reserve is sensitive to the regulatory burden on community banks, and has supported relief from this and other regulatory requirements over the past few years, consistent with safe and sound banking principles.

The Federal Reserve also maintains extensive surveillance systems to identify specific institutions whose financial performance may have changed between examinations, as well as to identify any trends in financial performance across various regions and nationally. If surveillance information detects possible issues with a specific institution, supervisory follow-up is initiated, which may include an on-site review or acceleration of the regularly scheduled examination. As a result of these efforts and the aforementioned risk-focused approach, issues are generally identified at an earlier stage when they are more easily corrected. While some banks do encounter more serious financial difficulties, to date, these have been a very small proportion.

Overall, the financial condition of community banks in the United States remains strong. The condition of community banks tends to reflect that of the local economies in which they operate. Should economic conditions in those markets encounter adverse change, the Federal Reserve is prepared to expand and accelerate normal supervisory programs to assure that communities remain served by healthy financial institutions.