1807

S. HRG. 110–111

THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MARCH 28, 2007

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

35–905 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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THE ECONOMIC OUTLOOK

WEDNESDAY, MARCH 28, 2007

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met at 10:30 a.m., in room 216 of the Hart Senate Office Building, the Honorable Charles E. Schumer, Chairman of the Joint Economic Committee, presiding.

Senators present: Bennett, Brownback, Casey, DeMint, Klobuchar, Schumer, Sununu, and Webb.

Representatives present: Brady, Hinchey, Maloney, Paul, and Saxton.

Staff present: Katie Berne, Chris Frenze, Nan Gibson, Colleen Healy, Robert Keteher, Israel Klein, Jeff Schlagenhauf, Chad Stone, Robert Weingart, and Adam Wilson.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Chairman Schumer. The hearing will come to order. I want to welcome Federal Reserve Chairman Ben Bernanke to this hearing of the Joint Economic Committee on the Economic Outlook.

This Committee has a broad mandate to study and make recommendations about economic policy, and we frequently seek the views of the Federal Reserve Chairman as we carry out that mandate.

Chairman Bernanke, we live in interesting times, and you face a number of important challenges in setting a course for monetary policy that will achieve the multiple goals of high employment, balanced economic growth, and reasonable price stability.

Those challenges are all the more complicated by what's turning out to be an emerging crisis for homeowners all over the country, the subprime market fallout.

Today is the first time that we will hear Chairman Bernanke say that the wave of defaults we are witnessing in the subprime market, quote, "Casts serious doubt on the adequacy of underwriting standards for these loans."

And today, we will take his words as a further indication that there must be a response on the Federal level. When so many mortgage brokers are able to deceive our most vulnerable families into loans that they could never afford without anyone batting an eye, that part of the housing finance system is broken.

I will be introducing a bill that would establish a national regulatory system for all mortgage brokers, including those at non-bank

companies. To me, it makes very little sense that there should be one standard for banks and another standard for non-banks.

We will also establish a suitability standard for borrowers, so that they will never issue a loan that the borrower can't afford.

The wave of subprime foreclosures that we've seen so far could well be the tip of the iceberg, and we all know what these foreclosures do to families that fall victim to them. It's on the front page of our national papers every day.

Here's a story about Newark, in the New York Times, and the number of foreclosures, just in Newark, is astounding and troubling. Now, the question, of course, that is—you have two hats here as Federal Reserve Chairman: One is what the Federal Reserve should do to deal with the subprime market, and we're going to ask you some questions about that. You mention, again, a little bit about it in your statement which I welcome.

Second, of course, is the systemic risk that this might cause. They are two separate issues, and you make clear that we need to do something in the former, but the verdict is out on how much the latter is going to create systemic risk.

What I worry about is the layering-on of the risk that the subprime market reflects in our broader economy. In other words, if it were just one issue and everything else were hunky-dory, you would not worry much about systemic risk.

But there is a very low personal savings rate, record high debt levels, trade imbalances, and vulnerability to sharp currency depreciation if the rest of the world forecloses on us.

And you add the subprime problems here that, who knows, might spread to the prime market—might not—it creates some problems.

Just as families, teased into unsuitable subprime loans, are signing over their economic security, the Nation is at risk of mortgaging away our economic future if we don't deal with these problems and start investing in our own future growth.

There are times when the direction of monetary policy is clear. This does not appear to be one of those times.

It looks like the Fed has become more neutral about the Federal direction of monetary policy, and I think this is prudent for a number of reasons: First, the typical American family has been left behind so far in the recovery from the 2001 recession.

Productivity growth has been strong, but workers' earnings haven't kept up with the growth. Profits have risen sharply—so have the salaries and bonuses of top management—but middle-class families have not seen their paychecks keep up with rising healthcare premiums, college costs, gas prices, just to name a few expenses squeezing families today.

It would be cruel injustice if this recovery were to be cut short before workers' earnings began to reflect their productivity and before families' real incomes more closely followed the trajectory of economic growth.

Another reason to be open to an easing of monetary policy is the concern that the housing market adjustment is far from over. Recent housing data have offered little encouragement that the market might be stabilizing, so it is still too early to tell if the worst is over for the housing market.

I, personally, don't think the worst is over for the housing market because of all of the problems we are reading about in the subprime market—and those will clearly get worse, at least in terms of their effects on average families.

Just to mention a few statistics here: 52,000 families foreclosed on their homes last year in New York alone, so this is a serious problem. It's a terrible instance where lack of oversight has led to a Wild-West mentality among unscrupulous lenders, and frankly, the exploitation of large numbers of financially unsophisticated borrowers.

It's bad that entire corporations built on this faulty business plan and investors who funded those schemes will be out of business or out of money, and those failures will lead to some adjustment in the market.

But the real tragedy here is that 2.2 million homeowners face the real possibility of losing their homes because they were misled or just plain swindled by modern-day bandits. This Committee will be very interested in your testimony, Chairman Bernanke, and in your answers to our questions about the causes and consequences of the trouble in the subprime market and their effects on the overall economy.

Problems in the housing market are at the forefront of my concerns about overall economic outlook but, as I mentioned, there are other issues that we are also focused upon.

The new Congress is beginning to take real steps to get the budget deficit under the control, in the wake of the budget excesses of the last 6 years but those excesses have brought us or helped bring about a large trade deficit, low national savings, and a mounting debt to the rest of the world.

I hope, Chairman Bernanke, that you agree with me that the current trade deficit is unsustainably large. It's critically important that we take steps to bring it down. I look forward to your testimony on the Economic Outlook and to a discussion of how we can best meet the economic challenges we face, and finally, how we can better protect millions of American families from being robbed in this lawless Wild West of exotic home loans sometimes called "Liar Loans."

Normally, I encourage all of our members to make opening statements, but we're going to have votes on the floor. I think the last time they said was 11:30, so I'm going to ask our Vice Chairman and the Senate and House Ranking Members to make opening remarks, and would ask the indulgence of others, if we could submit statements to the record.

With that, let me call on my colleague, Jim Saxton.

[The prepared statement of Senator Schumer appears in the Submissions for the Record on page 33.]

STATEMENT OF HON. JIM SAXTON, RANKING MINORITY, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Mr. Chairman, thank you very much. Chairman Bernanke, it's a pleasure to be here to welcome a fellow New Jerseyian, a Princetonian, to the Committee this morning.

As the Federal Reserve has noted, the U.S. economy has performed well in recent years. Economic growth has been strong, un-

employment stands at about 4.5 percent, and 7.6 million jobs have been created since August of 2003.

Further, long-term inflation pressures are under control and long-term interest rates remain at low levels. According to the Federal Reserve's Monetary Policy Report submitted to Congress last month, the economic outlook for this year and next appears favorable.

The report notes that the drag on the economy from the decline in homebuilding may lessen during 2007; real wage and job gains should continue to boost consumer spending; and financial conditions for business, appear to be quite good.

In addition, U.S. exports are expected to make a positive contribution to growth. The risks to the economy going forward include the potential impact of unsound prime lending, continued weakness in housing, and slower growth of business investment.

Nevertheless, taking these and other factors into account, the Federal Reserve Board has projected that U.S. economic growth will range somewhere between 2.5 and 3 percent during the year 2007.

The economic growth projected by the Fed in 2007 is in line with that of the Blue Chip consensus of economic forecasters. Although the prospects for economic expansion are good, I continue to be concerned about the prospect of much higher taxes in the future, under policies currently being considered in Congress.

Although the economy has proven to be extremely resilient in recent years, the possibility of a policy mistake undermining economic growth cannot be dismissed lightly. If we can avoid such mistakes, the prospects of economic expansion will continue to be favorable over the next several years.

So once again, Mr. Chairman, let me thank you for being here with us this morning, and we look forward to hearing from you.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 34.]

Chairman Schumer. Vice Chairperson Maloney.

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, VICE CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Vice Chair Maloney. Thank you, Chairman Schumer from the great State of New York. I welcome Chairman Bernanke and thank you for testifying today.

This hearing comes at an important time because monetary policy is at a critical juncture. With new risks in the housing markets and weak business investment, the Fed last week essentially acknowledged that economic conditions may be deteriorating more than expected.

Evidence of a slowing economy is building, and the concern is that the unemployment rate will begin to rise, if slow growth continues which argues for easing rates.

At the same time, inflation has been higher than the Fed is comfortable with over the long term which seems to have prevented the Fed from lowering interest rates. To ease or not to ease which way will the arrow go?

How the Fed will answer that question is what we will all try to divine today. I look forward to gaining some insights into how the Fed will balance the various risks to the economy.

How American families are faring should be part of the Fed's equation because the economy is weakening even before many have shared in the gains from the economic growth we have seen so far.

Income is growing the most for executives and highly-compensated individuals but ordinary working Americans are only just beginning to see their paychecks rise above inflation.

The ability of American consumers to keep spending, may be flagging with the cooling housing market and recent stock market volatility. We are facing, by all accounts, a tsunami of defaults and foreclosures in the subprime market.

In each of our districts, our constituents are encountering payment shock as their subprime loans reset to much higher rates. By some estimates, 2.2 million homeowners with subprime loans made through 2006 are at risk of losing their homes.

Rising delinquencies on subprime home loans, while devastating to the many families who have fallen prey to these vehicles, could also have broader implications for the economy. Some economists have already started to compare the subprime market meltdown to the dot-com bubble.

Chairman Bernanke, I hope you will provide some reassurance that this is not the case. In the House, we are working on comprehensive subprime lending legislation to fix this problem. One question before us today is whether the Fed will act under its Home Ownership and Equity Protection Act powers to regulate unfair and deceptive practices to extend the proposed guidelines, the joint guidelines that came out to non-bank lenders, or whether Congress should legislate to achieve that result.

Setting the right course for monetary policy is complicated by our current fiscal and international imbalances. The challenge for this Congress is to return to the fiscal discipline that has been squandered by the President and Congress over the past 6 years.

Today in the House of Representatives, we are debating a realistic budget plan that adheres to pay-go principles for controlling the deficit and bringing revenues into line with what we need to spend to defend the country and take care of the needs of our citizens.

Mr. Chairman, thank you for holding this important hearing, and I look very, very much forward to Chairman Bernanke's testimony. Thank you for being here.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 35.]

Chairman Schumer. Thank you. I see that my colleague, Senator Brownback, is not here but we'll afford him the opportunity to do an opening statement in addition to his question period.

Chairman Bernanke, the floor is yours.

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

Chairman Bernanke. Thank you, Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of

the Committee, for inviting me here this morning to present an update on the outlook for the U.S. economy.

I will begin with a discussion of real economic activity, and then turn to inflation.

Economic growth in the United States has slowed in recent quarters, reflecting, in part, the economy's transition from the rapid rate of expansion experienced over the preceding years, to a more sustainable pace of growth.

Real gross domestic product rose at an annual rate of roughly 2 percent in the second half of 2006 and appears to be expanding at a similar rate early this year.

The principal source of the slowdown in economic growth that began last spring has been the substantial correction in the housing market. Following an extended boom in housing, the demand for homes began to weaken in mid-2005.

By the middle of 2006, sales of both new and existing homes had fallen about 15 percent below their peak levels. Homebuilders responded to this fall in demand by sharply curtailing construction.

Even so, the inventory of unsold homes has risen to levels well above historical norms. Because of the decline in housing demand, the pace of house price appreciation has slowed markedly, with some markets experiencing outright price declines.

The near-term prospects for the housing market remain uncertain. Sales of new and existing homes were about flat, on balance, during the second half of last year. So far this year, sales of existing homes have held up, as have other indicators of demand, such as mortgage applications for home purchase, and mortgage rates remain relatively low.

However, sales of new homes have fallen, and continuing declines in starts have not yet led to meaningful reductions in the inventory of homes for sale.

Even if the demand for housing falls no further, weakness in residential construction is likely to remain a drag on economic growth for a time as homebuilders try to reduce their inventories of unsold homes to more normal levels.

Developments in subprime mortgage markets raise some additional questions about the housing sector. Delinquency rates on variable-interest-rate loans to subprime borrowers which account for a bit less than 10 percent of all mortgages outstanding, have climbed sharply in recent months.

The flattening of home prices has contributed to the increase in delinquencies, by making refinancing more difficult for borrowers with little home equity. In addition, a large increase in early defaults on recently-originated subprime variable-rate mortgages casts serious doubt on the adequacy of the underwriting standards for these products, especially those originated over the past year or so.

As a result of this deterioration in loan performance, investors have increased their scrutiny of the credit quality of securitized mortgages, and lenders, in turn, are evidently tightening the terms and standards applied in the subprime mortgage market.

Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families,

the implication of these developments for the housing market, as a whole, is less clear.

The ongoing tightening of lending standards, although an appropriate market response, will reduce somewhat the effective demand for housing, and foreclosed properties will add to the inventories of unsold homes.

At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency. We will continue to monitor this situation closely.

Business spending has also slowed recently. Expenditures on capital equipment declined in the fourth quarter of 2006 and early this year.

Much of the weakness in recent months has been in types of capital goods used heavily by the construction and motor vehicle industries, but we have seen some softening in the demand for other types of capital goods as well.

Although some of this pullback can be explained by the recent moderation in the growth of output, the magnitude of the slowdown has been somewhat greater than would be expected, given the normal evolution of the business cycle.

In addition, inventory levels in some industries, again, most notably in industries linked to construction and motor vehicle production, rose over the course of last year, leading some firms to cut production to better align inventories with sales.

Recent indicators suggest that the inventory adjustment process may have largely run its course in the motor vehicle sector but remaining imbalances in some other industries may continue to impose some restraint on industrial production for a time.

Despite the recent weak readings, we expect business investment in equipment and software to grow at a moderate pace this year, supported by high rates of profitability, strong business balance sheets, relatively low interest rates and credit spreads, and continued expansion of output and sales.

Investment in nonresidential structures such as office buildings, factories, and retail space, should also continue to expand, although not at the unusually rapid pace of 2006.

Thus far, the weakness in housing and in some parts of manufacturing does not appear to have spilled over to any significant extent to other sectors of the economy.

Employment has continued to expand as job losses in manufacturing and residential construction have been more than offset by gains in other sectors, notably healthcare, leisure and hospitality, and professional and technical services. And, unemployment remains low by historical standards.

The continuing increases in employment, together with some pickup in real wages, have helped sustain consumer spending which increased at a brisk pace during the second half of last year and has continued to be well-maintained so far this year.

Growth in consumer spending should continue to support the economic expansion in coming quarters. In addition, fiscal policy at

both the Federal, State and local levels should impart a small stimulus to economic activity this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad has helped to spur strong growth in U.S. real exports which rose about 9 percent last year, and a robust world economy should continue to provide opportunities for U.S. exporters this year.

Growth in U.S. real imports slowed to about 3 percent in 2006, in part reflecting a drop, in real terms, in imports of crude oil and petroleum products.

Despite the improvements in trade performance, the U.S. current account deficit remains large, averaging 6.5 percent of nominal GDP during 2006.

Overall, the economy appears likely to continue to expand at a moderate pace over coming quarters. As the inventory of new homes is worked off, the drag from residential investment should wane.

Consumer spending appears solid, and business investment seems like to post-moderate gains.

This forecast is subject to a number of risks. To the downside, the correction in the housing market could turn out to be more severe than we currently expect, perhaps exacerbated by problems in the subprime sector.

Moreover, we could see yet greater spillover from the weakness in housing to employment and consumer spending than has occurred thus far.

The possibility that the recent weakness in business investment will persist is an additional downside risk.

To the upside, consumer spending, which has proved quite resilient despite the housing downturn and increases in energy prices, might continue to grow at a brisk pace, stimulating a more rapid economic expansion than we currently anticipate.

Let me now turn to the inflation situation. Overall, consumer price inflation has come down since last year, primarily as the result of the deceleration of consumers' energy costs.

The Consumer Price Index, or CPI, increased 2.4 percent over the 12 months ending in February, down from 3.6 percent a year earlier.

Core inflation slowed modestly in the second half of last year, but recent readings have been somewhat elevated, and the level of core inflation remains uncomfortably high.

For example, core CPI inflation over the 12 months ending in February was 2.7 percent, up from 2.1 percent a year earlier. Another measure of core inflation that we monitor closely, based on the price index or personal consumption expenditures, excluding food and energy, shows a similar pattern.

Core inflation, which is a better measure of the underlying inflation trend than overall inflation, seems likely to moderate gradually over time. Despite recent increases in the price of crude oil, energy prices are below last year's peak, although I might add that in the last few days that has become less true.

If energy prices remain near current levels, greater stability in the cost of producing non-energy goods and services will reduce pressure on core inflation over time.

Of course, the prices of oil and other commodities are very difficult to predict, and they remain a source of considerable uncertainty in the inflation outlook.

Increases in rents—both market rents and owner's equivalent rent—account for a substantial part of the increase in core inflation over the past year. The acceleration in rents may have resulted, in part, from a shift in demand toward rental housing, as families found home ownership less financially attractive.

Rents should begin to decelerate as the demand for owner-occupied housing stabilizes and as the supply of rental units increases. However, the extent and timing of that expected slowing is not yet clear.

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 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 be contained.

Although core inflation seems likely to moderate gradually over time, the risks to this forecast are to the upside. In particular, 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 most clearly in the tightness of the labor market. Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in a range of 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, a result of the tight labor market conditions.

To be sure, faster growth in nominal labor compensation does not necessarily portend higher inflation. Increases in compensation may be offset by higher labor productivity or absorbed, at least for a time, 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 generally favorable despite the recent slowing in some measures, and the markup of prices over unit labor costs is high by historical standards so such an outcome is certainly possible.

Moreover, if the economy grows at a moderate pace for a time, as seems most likely, pressures on resource-utilization should ease.

However, a less benign possibility is that tight product markets might allow firms to pass some or all of their higher labor costs through to prices. In this case, increases in nominal compensation would not translate into increased purchasing power for workers but would add to inflation pressures.

Thus, the high level of resource-utilization remains an important upside risk to continued progress in reducing inflation.

In regard to monetary policy, the Federal Open Market Committee has left its target for the Federal Funds Rate unchanged at 5.25 percent since last June.

To date, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing in core inflation.

Because core inflation is above the levels most conducive to the achievement of sustainable growth and price stability, the Committee indicated in a statement following its recent meeting that its predominant policy concern remains the concern that inflation will fail to moderate as expected.

However, the uncertainties around the outlook have increased somewhat in recent weeks. Consequently, the Committee also indicated that future policy decisions will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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

[The prepared statement of Hon. Ben Bernanke appears in the Submissions for the Record on page 36.]

Chairman Schumer. Thank you, Mr. Chairman, for your, as usual, erudite testimony.

I want to focus my questions, as I mentioned, on the subprime market. Last week, there was a lot of discussion about the failure of regulators to act as problems started to unfold.

In December I wrote this letter to you with several of my colleagues on the Banking Committee that asked why your October guidance, outlining the need to underwrite loans at their fully-indexed rate in order to truly assess the borrower's ability to pay, did not pertain to subprime mortgages, especially to the increasingly popular exploding ARMs.

I'm aware that the Fed is preparing new guidance related to mortgage underwriting—including subprime loans—this summer, and that this guidance is in the comment phase.

Today I could not help but notice in your testimony—and I think this is for the first time—that you acknowledge that faulty underwriting standards—such as the ones we wrote you about in the letter—could have contributed to this subprime crisis that is devastating for hundreds of thousands of families.

So I have two questions: First, will your new guidance be enough? Considering that you don't even regulate non-bank lenders who have issued the vast majority of subprime loans in the past 2 years, should non-bank mortgage lenders be subject to Federal regulations that banks are now forced to comply with, like HMDA, HOPA, and your new nontraditional mortgage guidance?

The second question is: Why has it taken till 2007 to come up with underwriting standards for the mortgage lending industry in general, let alone the more risky subprime aspect of the lending in particular?

The writing has been on the wall for some time now that all too many mortgage lenders have been tricking borrowers into loans they could never mathematically afford.

Chairman Bernanke. Thank you, Mr. Chairman. First, the nontraditional mortgage guidance, to which you allude, does apply to subprime mortgages.

It was specifically targeted at so-called exotic mortgages, interest-only, option arms, those types of not-amortizing-types of mortgages.

We began discussion of that guidance with our colleagues in 2004. We went out for guidance after that, so this guidance has been in the air, so to speak, for some time.

And in particular, the principles that that guidance enunciated were three: First, that underwriting has to be good, has to be, indeed, consistent with the fully-indexed rate; secondly, that disclosures must be adequate; and thirdly, that risk management by the lenders must be appropriate.

The more recent subprime guidance to which you allude really closes a technical loophole, which is that the nontraditional mortgage guidance did not apply to fully-amortizing mortgages such as 2/28s and 3/27s.

Chairman Schumer. Right.

Chairman Bernanke. We are closing that loophole with this new guidance, but I would say that the basic principles of good lending that were enunciated in the nontraditional mortgage guidance, I hope, were understood to apply more broadly.

With respect to non-bank mortgage lenders, the HMDA and HOPA regulations do, in fact, apply to them in terms of the regulation, but the Federal Reserve has no authority to enforce those regulations.

Chairman Schumer. Right.

Chairman Bernanke. Therefore, it falls to the States or to other agencies to do that enforcement.

With respect to our subprime and other guidances, that also does not apply to non-bank lenders.

Chairman Schumer. Right.

Chairman Bernanke. However, we have tried to coordinate, to some extent, with the State banking supervisors in the hope that they, in many cases———

Chairman Schumer. Is your advice to us to include non-bank lenders who have issued these subprimes and give you the ability to regulate them or some other Federal agency?

Chairman Bernanke. I think—more generally, first, from the Federal Reserve's point of view, I think that where we need more clarity is on our authority to regulate non-bank subsidiaries of banks or bank holding companies.

There was some uncertainty about our authorities there, particularly with respect to consumer issues.

And I have asked our staff to do a complete review of our powers and practices with respect to those.

The broader issue of non-bank lenders is a difficult issue. I think it bears on the question of whether you want to go to a Federal predatory lending law. I think it's worth looking at that.

There are a number of questions that would have to be answered. One would be: Would it be a preemptive law or would it be a base law? And, the second question to which you allude is: Who would enforce it?

Chairman Schumer. Right.

Chairman Bernanke. Frankly, that's a very difficult question. Currently, it's the states, and I think the question arises———

Chairman Schumer. They haven't done a very good job, have they?

Chairman Bernanke. The question arises as to whether Federal requirements or funding would allow the oversight, which is uneven—in some places it's good; in some places it's not so good.

Chairman Schumer. You don't rule out of hand, expanding Federal regulation and jurisdiction to these non-bank lenders, because if you close down the bank lenders or regulate them, the non-bank lenders will just move in, and they're much worse.

They account for the worst of the loans, the worst of the excesses, and it seems to me that it makes no sense to say we're regulating the bank subprime area when it will just shift over to the non-bank. Don't you agree with that?

Chairman Bernanke. I agree with that, and I think that looking at alternative ways of enforcing the rules is worthwhile.

Chairman Schumer. Final question—and this relates more to the systemic aspect. And I was glad to hear what you said in answer to the first question. We have to do something here, and we will. As I mentioned, I'll be introducing legislation on this area very shortly.

The second is systemic. If the perfect storm of lower home values and higher mortgage rates, along with shakier paychecks and unsuitable loans, does lead to a dramatic increase in foreclosures that many are predicting, how will the dumping of empty homes on the market affect overall housing supply and housing prices in the near term? And second, many of my friends in New York working in the financial sector are warning me that they're already beginning to see the subprime default problem creep into the prime market.

To what extent do you think this is happening, and what are the chances that the prime market will be impacted as well?

Chairman Bernanke. Mr. Chairman, we're certainly watching that very carefully—we've been monitoring the markets. We're looking at not only the other portions of the mortgage market, but also other types of credit like automobile credit and so on, and so far, we don't see any significant indications that this problem has spilled over into those other markets.

We're certainly going to follow that and watch it carefully. We've also spent a lot of energy and thought in trying to determine what implications the subprime situation might have for the overall housing market. We're very uncertain, as I said in my testimony.

Our best guess, based on the size of that market and its contribution to overall demand for housing—the fact that subprime issuance, particularly some of the worst subprime issuance, seems to have come down already—is that the effects on the housing market will be moderate, and therefore, that the effects on the economy overall should be relatively small.

However, as I said, there's a risk there and we're certainly going to watch it very carefully.

Chairman Schumer. But, thus far, you see none of this spreading into the prime market?

Chairman Bernanke. We have not.

Chairman Schumer. Okay, thank you, Mr. Chairman. I'm now going to call on the Senate Ranking Member, Senator Brownback. I mentioned, while you were out, Sam, that if you want to do an opening statement in addition to your questions, feel free.

Senator Brownback. Thank you very much, Mr. Chairman. I apologize for being here late, and I will not deliver my opening statement, although I would like to if I could have a little more time on a question.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 38.]

Chairman Schumer. That's fine.

Senator Brownback. Mr. Chairman, thank you very much for being here. I appreciate your discussion and your statement.

If I could go right directly to comments by your predecessor suggesting that there are factors existing now that we're leaning towards a recession or—I don't know if he would put quite that careful of a term, knowing that he picks his terms carefully.

It got quite a stir. But you, in your testimony, don't point towards that I take it. Are there factors that you're looking at, or that he doesn't know about, that would cause the situation to lean towards a recession or—I would just like to hear your comment on that very public discussion that took place and give you a chance to comment about it, because I think it's on a lot of people's minds. It certainly is when I get questioned by the media.

Chairman Bernanke. Well, Senator, as I have indicated, we continue to expect the economy to grow at a moderate pace, so we expect continued growth. There are risks to the outlook in both directions, as I indicated, so we'll have to watch to see if those risks materialize, and if so, how serious they are.

But again, our expectation is for moderate growth. I would make a point, I think, which is important, which is there seems to be a sense that expansions die of old age; that after they reach a certain point, then they naturally begin to end.

I don't think the evidence really supports that. If we look at history, we see that the periods of expansions have varied considerably. Some have been quite long, and the evidence that expansions must ultimately come to an end, essentially of old age, does not seem to be there.

So, our basic forecast remains for moderate growth, and that's our expectation.

Senator Brownback. With all the factors that you are looking at, even though the housing market and the subprime issue is out there, you don't see that leading towards a recession at this point in time?

Chairman Bernanke. We do not, but we do note that there are risks to the central forecast.

Senator Brownback. Let me go specifically at a couple of areas that you said that there were notable expansions in. And I think these actually pose some real questions and potential problems.

You note the expansion in employment in the healthcare sector, which, as I've been looking at that, that sector of the economy—healthcare as a percentage of GDP—has been growing substantially, if not unsustainably fast.

If I'm remembering my numbers correctly, some are projecting it to be up to 20 percent of the economy within the next 10 years. Is that an area of concern that you look at, or do you look at that as saying, well, this is just a key area of growth for us as a country, and this does not represent any particular concern or issue area?

Chairman Bernanke. Senator, the point I was making in the short-term context is that our economy is now more than 80 percent service-oriented, including healthcare, but many other things as well.

And so the weakness we're seeing in housing and in certain parts of manufacturing, 100 years ago that would have been most of the economy. Today it's a relatively small part of the economy, and much of the rest of the economy is growing pretty strongly, which is the point I was making in the testimony.

Your question, though, is a good one. Our healthcare system is very strong; it's technologically very advanced, but it's not very efficient. And, it's growing; the costs of healthcare are growing rapidly, and that raises very serious questions for us, both in terms of competitiveness and in terms of, in particular, the long-term fiscal situation, because Medicare and the costs of providing healthcare for seniors is the single largest long-term concern from the point of view of the Federal budget.

So, I think it is very important that we begin to try to address the question of healthcare costs. I'm not sure this is the appropriate forum to talk about this large issue, but we can certainly do that.

But I think this is a serious question, and we do need to take measures that will keep healthcare costs from growing faster than the economy. They have been growing much faster than the economy as a whole, and as you point out, they therefore become a bigger share of total GDP. I think that, in the long run, is a concern.

Senator Brownback. One other question that I want to look at as far as the overall impact on the economy, and it's a big policy issue that we're wrestling with and going to wrestle with—that is immigration and immigration reform. You note labor market and anecdotal data about shortages in labor market area. Do you have particular concerns of what we're looking at on immigration reform or areas that we should, vis-a-vis the shortages in labor market areas that you cite in here?

Chairman Bernanke. Well, not necessarily in the context of what I've been talking about. It's generally more difficult finding qualified workers at higher skill levels. Many immigrants are lower skill levels.

Nevertheless, the lower-skilled workers are heavily integrated into various aspects of our economy, ranging from agriculture to construction to other areas as well, and I would hope that whatever decisions the Congress makes about this, attention be paid to the possibility of short-term disruptions to the existing labor force and to the existing pattern of employment.

Senator Brownback. Do you have concerns that that is happening now?

Chairman Bernanke. I haven't seen too much happening now, no.

Senator Brownback. I raise the issue because it is going to be a key debate that we're going to have.

Mr. Chairman, thank you very much for being here and addressing some of these key questions.

Chairman Schumer. Thank you. Congresswoman Maloney, Vice Chair Maloney.

Vice Chair Maloney. Thank you very much, Mr. Chairman.

Chairman Bernanke, as you know, the Federal Reserve has authority under HOPA to prevent unfair and deceptive practices, and a Fed rulemaking would apply to all lenders, not just to the Federally-regulated depository institutions.

And to me, this authority offers a simple avenue to extend to all parts of the market, the principles that were set out in the Federal guidance that you issued on March 2nd, especially the notion that lenders must assess the borrower's ability to repay the loan at the fully-indexed rate.

Do you agree that the Fed could use this authority to extend the principles of the guidance to the whole market?

Chairman Bernanke. Vice Chairman, first of all, let me just make a comment that there's been some impression that we have not used this authority, which is incorrect. We have, in fact, used it on three separate occasions to prevent loan-flipping, demand mortgages and some practices with respect to open-end versus closed-end debt, so we do use it.

Vice Chair Maloney. Well, I congratulate you for using it and for coming out with the guidance that I think is very useful and very helpful, and I applaud the regulators for coming out with this guidance.

But you do agree—you mentioned earlier that you need to have control over the non-bank subsidiaries. Couldn't we just extend HOPA to cover the non-bank subsidiaries?

Chairman Bernanke. It does cover them so you are correct that by setting rules under the HOPA unfair, deceptive acts and practices provision, the Federal Reserve could set rules for all mortgage lenders. You are correct about that.

There are a couple of questions that I would just raise for your attention.

Vice Chair Maloney. But do you plan to do that?

Chairman Bernanke. We are going to review and look at it very carefully. The concerns we have are two. The first is that this is enforceable by private right of action, that is, by lawsuit. Therefore, we have to make the rules extremely precise.

If we simply try to implement a guidance which is a general set of principles, through this rulemaking, we would be setting up lenders for the uncertainties associated with these general principles, and we would probably be killing the market, because there would be so much legal uncertainty associated with lending in this market.

So we are reviewing our powers, and we are going to try to determine whether there are steps we can take under this authority that will be useful in applying to all lenders in the economy.

The other point I would make, which I also discussed with Chairman Schumer, was that although we have the authority to pass these rules, we still have the enforcement issue. Our enforcement powers do not extend beyond the banking system.

Vice Chair Maloney. Do you think the guidance should be extended to the secondary market? Obviously, lenders would not be making these risky loans if people were not buying them. Freddie Mac has, by their own initiative, announced that they will follow

the Federal guidance now and will no longer buy these risky loans, but do you think it should be extended to the secondary market?

Chairman Bernanke. That's an interesting question, and I don't have a final answer to that, but I do think we do need to be somewhat careful. I believe that the State of Georgia did so-called assignee liability, which meant that anyone who bought the loan had the same liability as the originator of the loan.

And I believe I'm correct that that had some significant effects on the ability of lenders in Georgia to securitize those loans to ultimate investors. So, the balance is between maintaining a healthy access to capital in this market versus making sure that these rules are obeyed.

I think the best place to apply these rules would be at the level of the originator. I'm open to discussion on assignment liability, but I do think we have to go very carefully in that direction.

Vice Chair Maloney. What about the rating agencies? Were they asleep at the switch? They were rating everything as an AAA when they were risky-risky-risky subprime. And what are your comments on the rating agencies' role in this?

Chairman Bernanke. Well, ratings do sometimes lag behind reality, and that seems to have happened at least in some cases here.

Vice Chair Maloney. And I just want to ask about the markets. Do you think that there is too much liquidity in the markets with the rising debt, the high yield, the bonds, the security loans? Is there too much liquidity? And I have also been told that China is coming forward with a trillion-dollar hedge fund. What impact will that have on the markets? There seems to be a tremendous amount of liquidity and—your comments?

Chairman Bernanke. Well, "liquidity" has a number of different meanings, and I think they tend to get confused sometimes.

I think there is liquidity in the sense that outside the United States there is a lot of excess savings, and that is flowing into the United States and looking for return.

In that sense there is a lot of "money," quote/unquote, looking for opportunities. That search for opportunities, in turn, has triggered a great deal of market activity such as hedge funds and private pools of capital, which make the markets quite liquid in another sense, in the sense that there is lots and lots of trading.

So markets are liquid in that sense. But I do not think that is necessarily a problem, although I do think that people have to be aware not to get carried away as perhaps they did in the subprime lending situation.

With respect to the Chinese, what they have set up, I believe, is about a $200 billion fund to try to increase returns on their overall investments. They are doing that on a gradual basis. I think it is mostly diversification across instruments as opposed to across currencies, and I do not really see any problem with that.

I do not think that is going to generate any particular problems for our financial markets or for our economy.

Vice Chair Maloney. Thank you. My time is up. Thank you, Mr. Chairman.

Chairman Schumer. Congressman Saxton.

Representative Saxton. Mr. Chairman, thank you.

Chairman Bernanke, I would like to return to the subject of monetary policy and the state of the economy. The Federal Open Market Committee's statement of last week suggested to some in the markets that Fed monetary policy stance was becoming, quote, "more neutral."

The statement is perhaps still having an impact on markets. There still is some controversy about the exact meaning of the statement, and what the exact meaning of a move toward "neutral policy" means.

If that is in fact your understanding, could you within this context give us your definition of "neutral policy"?

Chairman Bernanke. Neutral policy would be one where there is a sense that the risks are weighted equally on both sides of the dual mandate, and therefore, policy is essentially unpredictable. It depends on events as they come forward.

In our statement we said that our view was that the inflation risk was still predominant. And so our policy is still oriented towards control of inflation, which we consider at this time to be the greater risk.

Nevertheless, as I mentioned in my testimony, the uncertainties have risen and therefore a little more flexibility might be desirable. Nevertheless, I do want to emphasize that we have not shifted away from an inflation bias.

Representative Saxton. So the bias continues to be toward inflation, but I think you just said that there is a movement toward, or in the direction of, a more neutral policy? Is that fair?

Chairman Bernanke. I would say it would be more accurate to say we are looking for a bit more flexibility, given the uncertainties that we are facing and the risks that are occurring on both sides of our outlook.

An additional point, we in general prefer not to give advance rate guidance; that is, not to tell the market we're going to do this, that and the other. Rather, it is better for the FOMC to describe our outlook and the risks we see to the outlook, and let the markets make their own determination about how to price assets.

So one aspect of this change has been to move away from forward-rate guidance, which we view as something that should be undertaken mostly under unusual circumstances.

Representative Saxton. Does the policy statement suggest that economic conditions were weaker as of that statement, which was March 21st, than at the January meeting? Or that real estate adjustments have a good way to go before they're concluded? Or that, as you just mentioned, inflation is more persistent than expected?

Chairman Bernanke. Our statement included a description both of a situation on the real side of the economy and on the inflation side, and our sense that the risks had increased on both sides—that the outlook for output was a bit weaker as we indicated in our statement—but that the inflation situation had become slightly riskier as well. And so, both sides of the mandate are facing somewhat greater risks.

Representative Saxton. And with regard to real estate adjustments, is there a concern, a continuing concern with regard to that subject?

Chairman Bernanke. We believe that the housing market does present a potential downside risk to our baseline forecast. We are watching it very carefully. Our baseline forecast is that this housing correction will work itself out, and that sometime later this year, as the inventory of unsold homes comes down, construction will stabilize, and the economy will consequently strengthen somewhat.

Representative Saxton. Certainly the Blue Chip Consensus has been revised down almost every month recently. Can you give us any idea how the forecast in February the Fed made in January might be revised as we go forward? Will it follow the Consensus?

Chairman Bernanke. Congressman, the forecast we present is a Committee product. It is the entire FOMC's collective wisdom. So we have not revisited that, and I cannot really give you new numbers at this juncture.

Our general outlook, the contour of how we expect the economy to evolve, is very much unchanged—at least it has not materially changed. In particular, we expect the economy to continue to grow at a moderate pace. We expect to see some strengthening later on as the housing market returns to something closer to equilibrium. And we expect inflation to moderate gradually. But as I discussed this morning, we do see risks to all of those forecasts.

Representative Saxton. Finally, the Fed policy statement does appear to be somewhat more straightforward than earlier was the case. In that sense we welcome this tiny step, I guess, toward more transparency.

Could you comment on any progress the Fed is making in becoming more transparent?

Chairman Bernanke. Congressman, as I think you know, we have been discussing a whole range of issues to try to improve our transparency and our accountability for monetary policy to the Congress.

Because we meet only every 6 weeks or so, it has been a slow process, and it has been a deliberative process. But we have made considerable progress. We have looked at a number of possible ways of increasing our transparency, though we have not yet come to any decisions.

I am and will be consulting with Congress on any matters that need to be brought forward, but we have not yet reached a point where I can report that we have made specific decisions on this.

Representative Saxton. Thank you very much.

Thank you, Madam Chairlady.

Vice Chair Maloney [presiding]. Thank you, sir. And I yield to Mr. Hinchey.

Representative Hinchey. Thank you, Madam Chairman.

Chairman Bernanke, it is a pleasure to be with you, and I very much appreciate your service. The work that you do is very important to our country, and I think that you do a very good job in doing it.

Recently you gave testimony before the House Budget Committee on an issue that was raised here briefly a moment ago where you focused a lot of attention on the rising cost of health care.

You said, I think correctly, that it is not the best issue to bring up at this particular moment, but it is something that is really

haunting for all of us. Because it is an issue that we are going to have to address in the context of this economy. Failure to do so is going to provide some very substantial problems, as you pointed out very clearly in that testimony before the Budget Committee.

There are other aspects of the economic circumstances that we are confronting that I am beginning to become somewhat pessimistic about.

They relate to a number of things, one of which is the fall in housing, a drop that was expected to be somewhat in the neighborhood of 100 million, and it dropped to something over 800,000, I think, last year.

So that has been one of the driving forces of this economy, and it is part of the driving force based upon debt. We have an economy here that is increasingly driven by debt. Even though the budget deficits have fallen somewhat—the deficit last year was just about $250 billion and that is less but it is a very substantial budget deficit nevertheless—and the national debt is now up over $8.8 trillion.

So we have an economy at the public level that is driven largely by debt, but that is also true with the average person across the country, spending somewhere in the neighborhood of almost 110 percent of what they earn.

Now it is pretty obvious, I think, that this is a situation that really cannot be sustained. And it cannot be sustained as we also confront other issues like the loss of jobs and the loss of meaningful jobs.

The income of households across the country is dropping. I think it has dropped by more than 4 percent, I think something in the neighborhood of 4.5 percent over the course of the last several years.

And we are exporting more jobs each year. As you pointed out in your testimony, the economy here is driven increasingly not by manufacturing but by service sector jobs. And the major service sector jobs, including the best paying service sector jobs, are being exported very dramatically more and more.

So, these are the things that I think ought to be very troubling to us as we try to confront what we should do as a Congress to keep this economy moving. The economy has been growing, but most of that growth has been reflected in corporate profits. Very little of it is being transferred to the average person across the country.

Wages have continued to decline, although the decline is less steep than it had been previously over the previous several years.

What do you think we should be doing? And how serious do you think this situation is? We have an economy that is based upon debt, one that has a Current Account Deficit of $856.7 billion, 6.5 percent of GDP, and continues to rise. And with that Current Account Deficit going up, the exportation of jobs is increasing.

How do you think we should be dealing with this?

Chairman Bernanke. The central theme of the remarks you are making has to do with savings and debt. It is true that the U.S. is a low-saving country, and that has a number of implications.

One of them, of course, is the Current Account Deficit. Because we invest more here in terms of capital goods and housing than we

save domestically, we have to borrow the difference from abroad, and that is in fact the Current Account Deficit.

We also have the concern that our country is going through a demographic transition: we are becoming an older society with more people of retirement age with fewer workers for each retiree. And so, it is important that the U.S. increase its savings to better prepare for the future.

There are essentially two ways to do that:

One is through fiscal policy, by trying to run smaller deficits or even surpluses at both the Federal and the sub-Federal levels. That is very challenging, I understand, and particularly challenging given the entitlement costs that are going to be coming down the pike, but it is certainly something to be looked at.

The other is to try to encourage more saving among the private sector. Corporations do a good bit of our savings. Retained earnings, for instance, are a good bit of the savings of the U.S. economy. But households, as you point out, do not directly save very much.

Unfortunately, we do not have a set of policies which we know are time-tested to increase saving. Just one small step that I think the Congress took that was useful was the pension reform.

The Congress made it possible for employers to offer 401K plans that have an opt-out provision rather than an opt-in. And when people are automatically put into the 401K and they have to actively seek to be taken out, that they tend to save more. So, these sorts of insights can help us improve saving.

Another thing which relates very much to the subprime lending issues that Congresswoman Maloney and others have mentioned has to do with financial literacy and training people to understand better not only mortgage terms, but also budgeting and issues like retirement planning, so that they will better appreciate the need to put aside some of their income for the future.

Vice Chair Maloney. The gentleman's time has expired.

Representative Paul. We are under the 5-minute rule.

Mr. Paul.

Representative Paul. Thank you, Madam Chairman, and welcome Chairman Bernanke.

It seems to me too often that we run into our financial problems, and then there is the wringing of the hands, and yet many have predicted that we are going to get into these problems.

For instance, in the 1990s it was not a total surprise to a lot of people that things were out of whack when it came to the NASDAQ, and yet the NASDAQ bubble collapses, and people panic, and people get hurt, and then there is an outcry.

Well, what we have to do is craft more regulations again. And there has been fraud. Of course all the penalties necessary to take care of Enron were taken care of without new regulations, and the market sort of handled the distortions that were there, but nobody asked the questions: Why was there such distortion?

The same way in the housing bubble. The same predictions have been going on for years and years, and yet everybody gets reassured, and everybody knows that we have to spread home ownership to those who do not really qualify, and yet the same bubble is being built, and nobody said: Well, where does all this credit come from?

I think we fail to ask the question of what the cause is, and then when the problem hits, then we treat the symptoms, and we say, well, what we need are more regulations. If we would only regulate the lenders we could have prevented these problems from occurring.

And I do not buy into that. I do not think it is that simple. And I think we fail too often even to look to the fundamental monetary policy, because easy credit does allow people to do things they would not ordinarily do.

When you have interest rates down to 1 percent, and then you subsidize Fannie Mae and Freddie Mac with a line of credit, and then you encourage these loans, I do not see why anybody should be surprised this should happen.

But my concern is that we do not look to the cause, which is easy credit. I mean, we have no savings rates, so this credit has to come from somewhere. It usually comes out of thin air. And we end up with these problems.

But one measurement that we used to have to sort of indicate what is going on monetarily was the M3 numbers, which I think is an important number. And there is a private source now that reports M3 numbers. And I think, most likely, they are pretty accurate compared to the old M3, and they report that M3 is growing at an over-11 percent rate, which I would think would, you know, get people's attention if it was an official report from the Federal Reserve.

So, it seems like there is almost a distraction from the real cause.

Then again, we look at our CPI, and we say, oh, the CPI is not going up so badly, we have no inflation. And yet you look at the cost of housing, the prices of houses are soaring. But they are excluded from the CPI.

It just seems like we do not have everything on the table, and that we should be more concerned about monetary policy, per se, rather than saying, well, we have problems; all we need to do here in Congress is if we just wrote more regulations we're going to solve all our problems.

But I have one specific question dealing with the recent crisis coming up and the recent changes in the stock market. And that was on the February 27th was a sudden change in the market, and ours went down over 400 points.

On days like that, does the Presidential Working Group on Financial Markets? Do you have meetings to talk about sudden changes in the marketplace like that?

Chairman Bernanke. We did not have a meeting on February 27th. It is a usual practice whenever there is some stress in financial markets for the senior staff deputies to be in touch with each other gather information to see if anything is going on.

In this particular case there was no indication, other than the computer problem at the New York Stock Exchange, of any kind of breakdown of markets or anything like that. And so, no further action was taken and no meeting of the principals occurred.

Representative Paul. So, the Working Group has not taken any precise action in the last several months, would you say? Or have you taken some action of some sort? And why is that informa-

tion not readily available to us and to the markets? Because it would have profound significance if we knew that group was interfering in the marketplace.

Chairman Bernanke. We took no action with respect to the stock market. We released, as you know, a set of principles describing how we believe that oversight of hedge funds and private pools of capital ought to be conducted—principally through a market discipline approach, as we discussed in that document.

Representative Paul. Is there any chance that we would ever get minutes of meetings for the Working Group that the Congress would know more about how the Working Group operates, and how often? I understand it's more active, and you meet more often than you used to.

Chairman Bernanke. I don't know what the information gathering is. We meet and discuss broad issues of general importance in the financial area in terms of financial regulation, financial markets.

And then if we have findings, we present them to the public in the form of the principles, for example.

Representative Paul. My time has expired. Thank you.

Chairman Schumer [presiding]. Thank you.

Senator Casey.

Senator Casey. Mr. Chairman, thank you for chairing this hearing and having us to get together to have Chairman Bernanke here, and thank you, Mr. Chairman, for your public service.

I am going to try to get in, if I can, three questions. The first one centers on the issue of workforce. We have had over many years, as far back as a decade ago, an attempt by the Federal Government to have a positive impact on workforce development in training a workforce for this country.

We know the impact it has on economic growth and the impact on competitiveness, and so I think in so many ways we could spend a hearing just on that. It is a transcendent economic issue.

I was struck in your testimony on page 6 by something that kind of jumped off the page at me. It was in the second full paragraph on page 6. I will just read one sentence. It says: "Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in a range of occupations."

It is a profound statement in and of itself, and I know it is a tremendous challenge we have as a country. I really have two questions:

What is your source or the underpinning for that statement and the challenge that it creates? If you can comment on that.

And second, what do you think this government needs to do not just in this budget year but in terms of a long-term strategy on workforce development?

Chairman Bernanke. Thank you, Senator. We have many, many contacts throughout the business community around the country, some of them through the user bank branches that are around the country, many by contacts that we have with CEOs and leaders of various corporations and various businesses.

We hear that in the labor market there is something of a divide—that low-skilled workers can be found but for people with substantial skills, whether they be nursing, or banking, or welding,

it is very difficult to find appropriately qualified people. And this is a theme we hear over and over again from businesses and from all types of temporary help agencies from all types of employers.

As I have talked about in some recent speeches, I do think that improving the level of skills and training is the critical issue for addressing, for example, the rise in income inequality; to give people the opportunities to succeed in our economy, and particularly in an economy which is becoming more and more technologically advanced.

The main theme I would leave you with is that there are many different ways to accomplish that. And while it is very important to try to improve our K-12 system, there are many other ways in which people learn. There are junior colleges, community colleges, online colleges, on-the-job training, life-long learning, early childhood education, many different ways. I think it would very helpful for Congress to continue to look at these different approaches and try to encourage good, innovative ways of increasing the skill level of our workforce. It is a critical issue.

Senator Casey. I think we agree on that priority.

Let me just ask you one follow-up with regard to that. Is there one area that you—and you have listed a number of them, whether they are nursing or welding or manufacturing skill, as well as technological skill—that you have most concern about in the labor sector or that has, in your judgment, or would have, if we do not invest or we do not have a strategy that would have the most adverse impact on our competitiveness around the world?

Chairman Bernanke. No, I think it is very broad-based. People often point to those with advanced degrees—engineers and so on—and those people are important of course. But again, in manufacturing, for example—where there has been over the years a general decline in employment—there has actually been an increase in the demand for highly skilled workers.

So that need for skills really cuts across a wide variety of sectors and levels.

Senator Casey. And just following up on what you said as well with regard to workforce. I believe you mentioned income inequality. Wage stagnation is something we have all discussed before, and it is interesting.

Chairman Schumer and his team do a great job of preparing for this hearing, and one of the things they did, and I wish I had the chart itself—it is hard to see—but it is a chart that really shows the gap between productivity when productivity has been rising or output per hour; that's been going up. Obviously, we are happy about that, and our workers deserve a lot of credit. And our economy is reflective of that.

But there is a gap, according to the chart we have used here, starting in 2001, between productivity and compensation. And that is a significant gap, and it is a real nightmare for workers.

I just wanted to have you comment on this statement. This is not mine, but I think it reflects my thinking: Most of the gains from growth—there it is [the chart], I'm sorry. This is a good team we have got here.

You can see where the gap begins starting in 2001, and I think it is pretty clear. And one thing that the commentary with the

chart said is: Real compensation of workers, their wages and benefits, tends to track productivity growth as they did in the 1990s, but starting in 2001 that has not happened.

What is your sense of that? And what do you think we need to do to close that gap? And I realize it will not happen in 1 year, but we need a strategy to do that.

Chairman Bernanke. Well, there are a lot of factors involved, but part of it is a lag that does occur. When productivity picks up, generally that shows up first in profits, and only after a period you begin to see the real wage response.

If your picture went back to the mid-1990s, you would see the same thing in the mid-1990s in the long recovery at that period. In this case, it has been the case that productivity has outstripped compensation for a while. More recently we have seen some gains in real wages.

Last year, for example, we saw some improvements in that respect. So I think there is a lot of evidence in the long run that compensation per hour and productivity per hour do line up, but there are periods when it lags. And the most recent period, as often happens during slow growth periods like 2001 and then during the initial recovery, there has been a lag.

Senator Casey. Thank you. I am out of time.

Thank you, Mr. Chairman.

Chairman Schumer. Thank you.

Senator Sununu.

Senator Sununu. Thank you.

Mr. Chairman, in general, I think members of this Committee and Members of Congress would support, very much support, sensible, reasonable, appropriate standards for credit. That benefits consumers because with good disclosure and standards for credit, consumers get access to appropriate levels of credit which help them improve their quality of life and do the things that they wish to do for their families.

And, it is good for lenders. Because lenders want to make appropriate loans in whatever sectors of our market they are lending because that is how they make money. Lenders do not make money, they lose money when they lend inappropriately and as a result see default, whether it is in housing or any other area of the economy.

So it makes sense to have good standards for credit. But it is important that we understand what effect an inappropriate dramatic tightening of credit might have on the economy and in the housing area in particular, and I would like to talk a little bit about that this morning.

It is my understanding that the average down payment on homes in America is in the 15 to 16 percent range. And that is probably divided among a lot that are in the conforming area, 20 percent down payment, and those that are nonconforming. I think about 40 percent of the mortgages outstanding fit into that nonconforming area. The average down payment there is 9 percent.

Now, if we have a significant tightening of credit, whether it is through regulation and subprime or any other area, it seems to me that the most likely result would be a movement in the industry toward that 20 percent limit, toward that 20 percent conforming down payment standard.

What effect would that have on the activity in the market and on demand?

Chairman Bernanke. Well, you raise a good point. Our sense is that outside of the subprime mortgage area—that is in prime mortgages and in other types of credit—we have not seen much effect from the subprime developments, and so we have not seen a significant tightening of credit in those areas.

There has been a tightening of credit in subprime mortgages. Certainly some of that is desirable because excessively lax underwriting was one of the problems that led to the situation we have.

We have to hope that it will not overshoot in some sense, and that credit will still be available. In particular, those people who are facing difficulties and possible foreclosure, one way to solve that problem is to refinance. So if refinancing funds are not available or are not on terms that are affordable, that is going to in some sense exacerbate the problem.

So, while the improper or inappropriate lending has ended, we would hope that the standards do not revert to such a level that reasonable, sensible lending cannot continue. And that is an issue we have to follow.

Senator Sununu. There was about $320 billion put toward down payment last year. Is it reasonable to assume that consumers are not going to step forward with more down payment money this year?

Chairman Bernanke. Well, as you pointed out, the down payments are typically higher the prime market. And the prime market does not seem to be changing very much.

Senator Sununu. I'm sorry, higher as a percentage of value. If consumers in last year's economy, in last year's market, allocated $320 billion in aggregate down payments, I just do not think it is likely that in this market they are going to suddenly step up with $380- or $400 billion in down payment. The amount available for down payment in the aggregate will probably be the same or slightly less? Is that reasonable?

Chairman Bernanke. In the prime market, I am not sure. I do not think the problem in terms of demand——

Senator Sununu. I am talking about economy-wide. I am not making a distinction between prime and subprime. I am saying: In the economy as a whole, I think there were about $2 trillion in purchases, home purchases last year, $320 billion in down payment. How will the economy as a whole react, consumers react, in allocating money toward down payment this year?

Chairman Bernanke. And I am trying to say that I think, in the prime market, people will still be able to do that and the down payments will not change very much.

The real issue for buyers in that market is the uncertainty about what is happening to house prices and to housing demand, and trying to make a decision about when is the right time to get back in the market.

In the subprime market where there have been a lot of very low down payment loans, I think those will be less available and that will prove a constraint for some people who will not be able to afford mortgages.

Senator Sununu. My point is that it is unlikely that the consumers will allocate significantly more than $320 billion for down payments in the coming year. But as we tighten standards, if we move them toward, everyone toward, a 20 percent conforming standard arbitrarily, that means that the down payment that is available will support a dramatically lower volume of purchases. And that, in turn, will drive the inventories even higher.

So, I am trying to get from you a reasonable estimate of what the magnitude of that effect might be. If you assume that the same amount of down payment will be available, and you assume a movement toward that 20 percent, then instead of seeing inventories at 6 or 7 months which is where they are today, and the inventory level is going to be between 8 and 10 months.

So now you do not have to agree with those assumptions or the likelihood, but I would like to know what you think the impact on demand or on the economic level of activity would be if housing inventories were at an 8- to 10-month inventory as opposed to a 6-month inventory.

Chairman Bernanke. If they were at that level, and I do not expect that they will be, but if they were at that level, then construction would fall even further, and it would be an additional source of contraction in the economy.

Chairman Schumer. Senator Bennett.

Senator Bennett. Thank you very much, Mr. Chairman, and Chairman Bernanke, welcome again to the Congress.

You talked in your testimony about the strength of the international economy helping the American economy, and I would like to focus on that for a bit.

Our headline writers get consumed with China, and they talk about the rate of growth in the Chinese GDP. I like to point out to them at the amount of growth in the American GDP from 2001 till now has been greater than the total Chinese GDP is. That is, our GDP has grown in that period close to $3 trillion, and their total GDP is less than 2.5. So, I focus a little less on China than on our main trading partner and investment partner which is the European Union.

There is more investment across the Atlantic than with any other partner by far. There are trillions of American dollars invested in Europe and trillions of European dollars, or euros, converted into dollars invested in America.

And one of the problems that is being identified as we talk about our relationship between the European Union or the European economic community, define it as you will, and America is that we are seeing more and more American companies moving activities into Europe by virtue of the regulatory burden in America.

The Chairman, along with the Mayor of New York City, held a press conference and talked about this—where New York is ceasing to be the dominant financial center of the world, it is shifting to London. And the two primary drivers of that shift that I found when I was in Europe talking to people about it are—not necessarily in this order, they come up in this order but they are not necessarily in this order in their impact—Sarbanes-Oxley and the Tort system in the United States, with companies saying we just cannot expose ourselves to the kinds of class action lawsuits and

other activities that are available in the United States that are not available to people in Europe.

Do you see any signs, other than the concern of New York which I share although it is a provincial concern, the world economy will not fail if London replaces New York as the primary source? But do you see any economic concerns of an impact if, indeed, more and more barriers exist in the United States to other companies in other countries investing here and building plants here and so on?

Toyota has just announced a major, major investment in Mississippi, and Senator Lott is all excited. They offered him one of their SUVs, and he said, no, that is an import. I will wait until the plant is built and I will buy the Toyota from Mississippi.

And I tried to chide Senator Alexander. I said, you are driving a Nissan. He said, yes, it is a great Tennessee product. And Senator Voinovich saw my wife's Honda Accord and approvingly said, yes, that is built in Ohio.

So, do you see in this whole circumstance American regulatory barriers showing signs of discouraging other countries for making these kinds of investments in the United States?

Chairman Bernanke. Senator, there are different issues that I think you correctly point out. Foreign direct investment in the United States is still healthy. We receive a lot of foreign direct investment, and it is good for our economy. We get jobs from that. We get technological transfers and productivity gains from that, and that is still going on.

The issue that Senator Schumer and others have raised has to do with, in particular, the competitiveness of our financial markets, our exchanges.

Senator Bennett. As we move more and more into a service economy, that becomes more and more important.

Chairman Bernanke. Yes. And it is important. To some extent, it is to be expected that New York would not dominate the world the way it had earlier in the last century as other centers grow and develop and become more sophisticated.

At the same time, it is important for us to decide and investigate whether specific rules and regulations that we have in the United States are more burdensome than necessary to achieve their regulatory objectives.

And the two that you mentioned have come up a lot. With respect to Sarbanes-Oxley, there has been, of course, considerable concern about the costs of implementing it and concerns particularly about Section 404, as you know.

I think some progress is being made on that particular issue in that the Public Company Accounting Oversight Board and the SEC together are proposing new audit standards that would be more flexible and risk-focused for smaller companies. I think that is a good step, and we ought to see whether that reduces the costs of Sarbanes-Oxley sufficiently and makes them more commensurate with the benefits of that legislation.

I agree also that the issues of securities litigation is one we need to take a look at. We do have a great deal more of that than other countries, and we should take a look at that to see whether it can be reduced somehow or at least made more commensurate with the benefits of that activity.

Chairman Schumer. Thank you.

Congressman Brady.

Representative Brady. Thank you, Chairman.

Thank you, Chairman, for being here with us again today. Two questions: One budget policy, one trade. We are in a serious discussion on Capital Hill about how to balance the budget which is good. As Republicans we should have spent more time doing that ourselves.

But there are two competing approaches, one of which is to balance the budget in 5 years with increased spending and allowing President Bush's tax cuts to expire which increases marginal tax rates, capital gains, and dividends rates. For a family of four in Texas it is an average increase of about $2700 on the family budget.

The competing proposal, Republican proposal, is to balance it in the same period of time but to not let those tax rates expire, and to begin to attempt to restrict spending at least to the point of trying to prepare ourselves for the massive expenditures when our baby boomers start to hit.

I am not trying to draw you into this debate, but from an economic standpoint, which approach is the preferred method in your view?

Chairman Bernanke. There are inevitably questions of values in that decision. Clearly, low tax regimes, if they are properly structured, will provide better incentives and tend to be more efficient and, therefore, are beneficial in that respect.

On the other hand, government spending has value as well. We talked about training and education programs for example. So I think the law that I would support would be the law of arithmetic which says that whatever you spend and whatever you take in needs to be commensurate.

So, if you propose low taxes, that is good. That has benefits for the economy. But it is important to find the spending cuts on the other side to balance those tax cuts.

If, on the other hand, you want to increase government spending programs, you need to find revenues from some source to balance it.

The tradeoff between those two things is not inconsequential. It makes a difference to the economy but the tradeoff depends ultimately on the values you attach to these different outcomes. And Congress is the elected body that embodies the values of the American People and is ultimately responsible for making that decision.

Representative Brady. In a choice between balancing the budget with lower tax rates and balancing the budget with higher tax rates which is the preferred method?

Chairman Bernanke. If you have lower tax rates you will tend to have better incentives and lower dead-weight loss which is what economists refer to as the distortions that are created by high tax rates that affect behavior.

But one might be willing to accept those distortions and losses if one thinks that the spending that is being done has sufficiently high social value. That is the kind of balance that Congress has to come to.

Representative Brady. My final question. You make the point in your testimony that trade is an important part of the U.S. economy. America is the world's largest seller of products and goods. We are also the largest buyer. And you make the note that the growth rate in our sales is actually about three times larger than the growth rate in what we are purchasing.

Since 2002, with the President's ability to trade promotional authority to go out and negotiate trade agreements, we have seen increased sales to those countries. I think the markets for those 13 nations only equal about 7 percent of the global market, yet they represent almost half of what we are selling abroad.

So while we are very open, we find other countries are often closed. These trade agreements open up these markets with new customers for us.

How important—as trade promotion authority is set to expire later this year, as the clock is running on trade agreements with Peru, and Colombia, Panama, perhaps Korea, how important, from an economic standpoint, is it that we continue to have the ability to open up those markets?

How important is it that Republicans and Democrats try to find some common ground to allow us to go out there and set those rules for us to compete?

Chairman Bernanke. There is considerable evidence that open markets and free trade promote growth and strengthen an economy. And I hope that we will continue to try to open markets and do so in a more comprehensive way.

I think it would be better if we could do it through a DOHA process instead of country-by-country. We have to address some of the implications of trade. We may have to deal with issues of helping workers who are dislocated and so on.

But I hope the United States will not turn away from trade because it has been a tremendous source of growth and prosperity for us over the last couple hundred years.

Representative Brady. Thank you.

And Chairman, I would point out we have a trade surplus of $5.5 billion with our trading partners and most of our trade deficit, overall 80 percent, is with those we do not have trade agreements with. So, it is important we address this issue.

Thank you.

Chairman Schumer. Thank you, Congressman.

They have just called the vote. My colleague, Congressman Hinchey, wishes to ask a question. Then if we have time, we will let Congresswoman Maloney ask a question, and then we will break.

Congressman Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman.

I just wanted to return to the situation of the economy and its impact on people broadly. The discussion of Toyota and Nissan reminded me of a comment made by the Chairman of General Motors many, many years ago in testimony before the Congress: What's good for General Motors is good for the Nation.

Now it seems: What's good for Toyota and good for Nissan is good for the Nation. Although it really isn't. Because, although there are jobs, the profit is being exported out of the country. And

so we are not just exporting jobs, we are exporting profits to other corporations that are coming here to bring in jobs because our ability to do it seems to be greatly impaired.

And that is an interesting question that I think this Congress has to deal with. We are ostensibly going through an economic recovery, but the fact of the matter is it is not the same kind of economic recovery we have experienced in the past.

Ever since the Second World War, every economic recovery has seen a rise in wages and salaries averaging 3.7 percent. This economy since November of 2001, the increase in wages and salaries have only been 1.7 percent. We are seeing a greater and greater concentration in the hands of the economic elite of this country and a reduction in the economic capacity of the middle class. And in fact, a shrinking of the middle class.

That is not just bad for the economy, it is bad for the Democratic Republic. You cannot have a country like ours without a strong middle class.

So my question, Mr. Chairman, is: What are we going to do? How are we going to change this thing around? I do not think we can continue to move in this same direction without having this country change completely. Not just economically but also in terms of its democratic processes as well.

Chairman Bernanke. Let us first address the issue of foreign direct investment.

Like free trade, free flows of foreign direct investment can be quite beneficial. When we invest abroad other countries invest here. In the case of Nissan, as you mentioned, it creates jobs here but not all of the profits leave because, of course, there are American shareholders of those companies as well.

So I hope that we will not throw up barriers to investment in the same way we will not throw up barriers to trade in goods and services.

Now, we do not want to poormouth America. We have enormous strengths, very flexible markets, innovative culture, lots of entrepreneurship, very deep capital markets. So we are a very strong economy.

We are the wealthiest economy in the world.

Representative Hinchey. But the benefits of that economy are not being experienced by all the people. We have seen the chart that was up here a little while ago talking about productivity growth that was very interesting.

One of the factors of productivity growth is based upon technology rather than on the fact that people are being able to produce more through working. And because it is based on technology, the profits from that productivity growth are going to fewer and fewer people.

So, if you have an economy where wages and salaries are only going up by 1.7 when they traditionally have gone up by 3.7 in recoveries, there is something wrong.

Chairman Bernanke. Congressman, I was going to say that we have these strengths, and we should recognize these strengths. But we have some things we need to work on as well.

With respect to the specific issue about the recent growth in real wages, I do think we are going to see some improvement as real wages tend to catch up with productivity.

But more broadly, as I already indicated—and I think when we discussed this a moment ago—there are two areas where we do need to improve. One is in the skills of our workforce and we need to take that very seriously.

And the other is in saving, to create more resources for capital investment and for foreign investment.

I think those are the two weaknesses that we need to address if we want to compete effectively in this open globalized economy we live in.

Chairman Schumer. I am going to call on Congresswoman Maloney for a short question with a short answer.

Vice Chair Maloney. Thank you.

Is it reasonable to expect that business investment and net exports can grow to offset the loss of housing investment and possible slowing of consumption? And, could you walk us through the kinds of likely incoming news that would increase the chances that the Fed would lower rates, and what kind of news would discourage such a move?

Chairman Bernanke. Well, as we say, given the current housing situation, we think growth is going to be moderate. It is probably going to stay moderate until the housing situation turns around and we begin to see greater construction.

At that point, if nothing else changes we will begin to see a more rapid expansion. I cannot tell you specifically what policy is going to do but we are obviously going to be paying attention to both parts of the dual mandate—sustainable employment and price stability—and using our collective judgment to make the best decisions we can to get the best outcome for the American people.

Chairman Schumer. Thank you, Mr. Chairman.

Vice Chair Maloney. Thank you.

Chairman Schumer. And thank you. I want to thank my colleagues here, and I want to thank the Chairman.

Just one little final comment in reference to some of Senator Sununu's comments. One of the problems with the mortgage market these days is: the accountability does not occur until you get way to the top.

The person who offers the mortgage gets a fee. The mortgage company, particularly if they are not a bank, gets a fee. Even the first issuer of securities gets a fee. And then it is divided up and somebody buys, as the securities are sliced up, the riskiest ones.

And that, I would just say, means that your standard practice of, well, just let the market adjust to all these things, it takes awhile because there is no immediate accountability.

It creates a lot of bumps in the road, and sometimes it is a lot less perfect than a perfect market ought to be. Hence, the need for some kind of regulation at the lower levels where there is no accountability at all.

I do not know if you agree or disagree with that, but you are shaking your head and I will let the record show—I do not know if he was just shaking his head because it is a good question or he agrees with the answer.

[Laughter.]

Chairman Bernanke. It was an excellent question, Senator.

[Laughter.]

Chairman Schumer. An excellent question. On that happy note, we will conclude. Thank you, Mr. Chairman.

[Whereupon, at 12:09 p.m., Tuesday, March 28, 2007, the hearing of the Joint Economic Committee was adjourned.]

Submissions for the Record

JOINT ECONOMIC COMMITTEE

SENATOR CHARLES E. SCHUMER

CHAIRMAN

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER, CHAIRMAN

I want to welcome Federal Reserve Chairman Ben Bernanke to this hearing of the Joint Economic Committee on "The Economic Outlook." This Committee has a broad mandate to study and make recommendations about economic policy, and we frequently seek the views of the Federal Reserve Chairman as we carry out that mandate.

Chairman Bernanke, we live in interesting times and you face a number of important challenges in setting a course for monetary policy that will achieve the multiple goals of high employment, balanced economic growth, and reasonable price stability.

Those challenges are all the more complicated by what is turning out to be an emerging crisis for homeowners all over the country—the sub-prime mortgage market fallout.

Today is the first time we will hear Chairman Bernanke say that the wave of defaults we are witnessing in the sub-prime market "casts serious doubt on the adequacy of the underwriting standards" for these loans.

Today, we will take his words as a further indication that we must respond on the Federal level. When so many mortgage brokers are able to deceive our most vulnerable families into loans that they could never afford, without anyone batting an eye—the system is broken.

I'm planning on introducing a bill that would establish a national regulatory system for all mortgage brokers, including those at non-bank companies; and establish a suitability standard for borrowers so that they will never issue a loan that the borrower cannot afford.

The wave of sub-prime foreclosures that we have seen so far is just the "tip of the iceberg"—and we all know what these foreclosures do to the families that fall victim to them. It's on the front page of our major national newspapers every day.

What is less clear—and what we hope to examine today—is how the sub-prime crisis will impede our broader economic growth.

In many ways, I believe that the layering on of the risk in the sub-prime market reflects the layering on of risk in our broader economy. From our negative personal savings rate, record-high debt levels, trade imbalances, and vulnerability to sharp currency depreciation if the rest of the world starts to foreclose on us—we must figure out how to get out of this mess. Just as families teased into unsuitable subprime loans are signing over their economic security, the nation is at risk of mortgaging away our economic future if we don't change course and start investing in our own future growth.

There are times when the direction for monetary policy is clear but this does not appear to be one of those times. It looks like the Fed has become more neutral about the future direction of monetary policy and I think that is prudent for a number of reasons.

First, the typical American family has been left behind so far in the recovery from the 2001 recession. Productivity growth has been strong but workers' earnings have not kept up with that growth. Profits have risen sharply and so have the salaries and bonuses of top management.

But middle class families have not seen their paychecks keep up with gas prices, health care premiums, and college costs, just to name a few expenses squeezing families today. It would be a cruel injustice if this recovery were to be cut short before workers' earnings began to reflect their productivity and families' real incomes more closely followed the trajectory of our economic growth.

Another reason to be open to an easing of monetary policy is the concern that the housing market adjustment is far from over. Recent housing data has offered little encouragement that the market might be stabilizing; so it is still too early to tell if the worst is over for the housing market.

I personally don't think the worst IS over for the housing market because everyday on the front page of major newspapers, I read of families all over the country who are now in a financial tailspin because they were deceived into unsuitable loans.

As the New York Times reports today, just across the river from my home state, in Newark, New Jersey, a majority of the foreclosures were in areas with concentrated minority populations and a majority of those borrowers had bad credit.

52,000 families foreclosed on their homes last year in New York State alone, so I am particularly concerned with what is happening in the sub-prime market. This is a terrible instance where a lack of oversight has led to a wild-west mentality among unscrupulous lenders and, frankly, the exploitation of large numbers of financially unsophisticated borrowers.

It is bad that entire corporations built on this faulty business plan and investors who funded those schemes will be out of business or out of money. Those failures will surely lead to some adjustment in the financial markets.

But the real tragedy here is that 2.2 million homeowners face the real possibility of losing their homes because they were misled, or just plain swindled by modern day bandits. This Committee will be very interested in your testimony, Chairman Bernanke, about the causes and consequences of the troubles in the sub-prime market and their effects on the overall economy.

Problems in the housing market are at the forefront of my concerns about the overall economic outlook but there are other issues as well that we are keenly focused on. The new Congress is beginning to take real steps to get the budget deficit under control in the wake of budget excesses of the past 6 years. But those excesses have brought us a large trade deficit, low national saving, and a mounting debt to the rest of the world.

I hope, Chairman Bernanke that you agree with me that the current trade deficit is unsustainably large and that it is critically important that we take concrete steps to bring it down. I look forward to your testimony on the economic outlook and to a discussion of how we can best meet the economic challenges we face, and finally how we can better protect millions of American families from being robbed in this lawless, wild west of exotic home loans.

Normally I encourage all of our members to make opening statements. But because we have votes expected on the floor and in order to stay within our limited time with Chairman Bernanke, I am going to ask only our Vice Chairman and the Senate and House Ranking members to make opening remarks. Other members may submit their full opening statements into the record.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

Congressman Jim Saxton
Ranking Republican Member

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, RANKING MINORITY

It is a pleasure to join in welcoming Federal Reserve Chairman Ben Bernanke before the Committee this morning.

As the Federal Reserve has noted, the U.S. economy has performed well in recent years. Economic growth has been strong, unemployment stands at 4.5 percent, and 7.6 million jobs have been created since August of 2003. Furthermore, long-term inflation pressures are under control, and long-term interest rates remain low.

According to the Federal Reserve's Monetary Policy Report submitted to Congress last month, "the economic outlook for this year and next appears favorable." This

report notes that the drag on the economy from the decline in homebuilding may lessen during 2007, real wage and job gains should continue to boost consumer spending, and financial conditions for businesses are good. In addition, U.S. exports are expected to make a positive contribution to growth.

The risks to the economy going forward include the potential impact of unsound subprime lending, continued weakness in housing, and slower growth of business investment. Nonetheless, taking these and other factors into account, the Federal Reserve Board has projected that U.S. economic growth will range between 2.5 and 3.0 percent in 2007.

The economic growth projected by the Fed in 2007 is in line with that of the Blue Chip consensus of economic forecasters. Although the prospects for economic expansion are good, I continue to be concerned about the prospect of much higher taxes in the future under policies currently being debated in Congress.

Although the economy has proven to be extremely resilient in recent years, the possibility of policy mistakes undermining economic growth cannot be dismissed lightly. If we can avoid such mistakes, the prospects for economic expansion will continue to be favorable over the next several years.

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

Thank you, Chairman Schumer. I want to welcome Chairman Bernanke and thank him for testifying here today.

This hearing comes at an important time because monetary policy is at a critical juncture. With new risks in the housing market and weak business investment, the Fed last week essentially acknowledged that economic conditions may be deteriorating more than expected.

Evidence of a slowing economy is building and the concern is that the unemployment rate will begin to rise if slow growth continues, which argues for easing rates. At the same time, inflation has been higher than the Fed is comfortable with over the longer-term, which seems to have prevented the Fed from lowering interest rates.

To ease or not to ease rates? How the Fed will answer that question is what we will all try to divine today. I look forward to gaining some insights into how the Fed will balance the various risks to the economy.

How American families are faring should be part of the Fed's equation because the economy is weakening even before many have shared in the gains from the economic growth we have seen so far. Income is growing the most for executives and highly compensated individuals but ordinary workers are only just beginning to see their paychecks rise above inflation. The ability of American consumers to keep spending may be flagging with the cooling housing market and recent stock market volatility.

We are facing, by all accounts, a tsunami of defaults and foreclosures in the primary subprime market. In each of our districts, our constituents are encountering payment shock as their subprime loans reset to much higher rates. By some estimates, 2.2 million homeowners with subprime loans made through 2006 are at risk of losing their home.

Rising delinquencies on subprime home loans, while devastating to the many families who have fallen prey to these vehicles, could also have broader implications for the economy. Some economists have already started to compare the subprime market meltdown to the dot-com bubble. Chairman Bernanke, I hope you will provide some reassurance that this is not the case.

In the House, we are working on comprehensive subprime lending legislation to fix this broken system. One question before us today is whether the Fed will act under its Home Ownership and Equity Protection Act powers to regulate unfair and deceptive practices to extend the proposed guidelines to non-bank lenders or whether Congress should legislate to achieve that result.

Setting the right course for monetary policy is complicated by our current fiscal and international imbalances. The challenge for this Congress is to return to the fiscal discipline that has been squandered by the President and Congress over the past 6 years. Today in the House, we are debating a realistic budget plan that adheres to pay-go principles for controlling the deficit and bringing revenues into line with what we need to spend to defend the country and take care of the needs of our citizens.

Mr. Chairman, thank you for holding this important hearing and I look forward to our discussion about the economic outlook.

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

Chairman Schumer, Representative Saxton, and other members of the Committee, thank you for inviting me here this morning to present an update on the outlook for the U.S. economy. I will begin with a discussion of real economic activity and then turn to inflation.

Economic growth in the United States has slowed in recent quarters, reflecting in part the economy's transition from the rapid rate of expansion experienced over the preceding years to a more sustainable pace of growth. Real gross domestic product (GDP) rose at an annual rate of roughly 2 percent in the second half of 2006 and appears to be expanding at a similar rate early this year.

The principal source of the slowdown in economic growth that began last spring has been the substantial correction in the housing market. Following an extended boom in housing, the demand for homes began to weaken in mid-2005. By the middle of 2006, sales of both new and existing homes had fallen about 15 percent below their peak levels. Homebuilders responded to the fall in demand by sharply curtailing construction. Even so, the inventory of unsold homes has risen to levels well above recent historical norms. Because of the decline in housing demand, the pace of house-price appreciation has slowed markedly, with some markets experiencing outright price declines.

The near-term prospects for the housing market remain uncertain. Sales of new and existing homes were about flat, on balance, during the second half of last year. So far this year, sales of existing homes have held up, as have other indicators of demand such as mortgage applications for home purchase, and mortgage rates remain relatively low. However, sales of new homes have fallen, and continuing declines in starts have not yet led to meaningful reductions in the inventory of homes for sale. Even if the demand for housing falls no further, weakness in residential construction is likely to remain a drag on economic growth for a time as homebuilders try to reduce their inventories of unsold homes to more normal levels.

Developments in subprime mortgage markets raise some additional questions about the housing sector. Delinquency rates on variable-interest-rate loans to subprime borrowers, which account for a bit less than 10 percent of all mortgages outstanding, have climbed sharply in recent months. The flattening in home prices has contributed to the increase in delinquencies by making refinancing more difficult for borrowers with little home equity. In addition, a large increase in early defaults on recently originated subprime variable-rate mortgages casts serious doubt on the adequacy of the underwriting standards for these products, especially those originated over the past year or so. As a result of this deterioration in loan performance, investors have increased their scrutiny of the credit quality of securitized mortgages, and lenders in turn are evidently tightening the terms and standards applied in the subprime mortgage market.

Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families, the implications of these developments for the housing market as a whole are less clear. The ongoing tightening of lending standards, although an appropriate market response, will reduce somewhat the effective demand for housing, and foreclosed properties will add to the inventories of unsold homes. At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency. We will continue to monitor this situation closely.

Business spending has also slowed recently. Expenditures on capital equipment declined in the fourth quarter of 2006 and early this year. Much of the weakness in recent months has been in types of capital goods used heavily by the construction and motor vehicle industries but we have seen some softening in the demand for other types of capital goods as well. Although some of this pullback can be explained by the recent moderation in the growth of output, the magnitude of the slowdown has been somewhat greater than would be expected given the normal evolution of the business cycle. In addition, inventory levels in some industries—again, most notably in industries linked to construction and motor vehicle production—rose over the course of last year, leading some firms to cut production to better align inventories with sales. Recent indicators suggest that the inventory adjustment process may have largely run its course in the motor vehicle sector but remaining imbalances in some other industries may continue to impose some restraint on industrial production for a time.

Despite the recent weak readings, we expect business investment in equipment and software to grow at a moderate pace this year, supported by high rates of profit-

ability, strong business balance sheets, relatively low interest rates and credit spreads, and continued expansion of output and sales. Investment in nonresidential structures (such as office buildings, factories, and retail space) should also continue to expand, although not at the unusually rapid pace of 2006.

Thus far, the weakness in housing and in some parts of manufacturing does not appear to have spilled over to any significant extent to other sectors of the economy. Employment has continued to expand as job losses in manufacturing and residential construction have been more than offset by gains in other sectors, notably health care, leisure and hospitality, and professional and technical services, and unemployment remains low by historical standards. The continuing increases in employment, together with some pickup in real wages, have helped sustain consumer spending, which increased at a brisk pace during the second half of last year and has continued to be well maintained so far this year. Growth in consumer spending should continue to support the economic expansion in coming quarters. In addition, fiscal policy at both the Federal and the state and local levels should impart a small stimulus to economic activity this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad has helped to spur strong growth in U.S. real exports, which rose about 9 percent last year, and a robust world economy should continue to provide opportunities for U.S. exporters this year. Growth in U.S. real imports slowed to about 3 percent in 2006, in part reflecting a drop in real terms in imports of crude oil and petroleum products. Despite the improvements in trade performance, the U.S. current account deficit remains large, averaging 6½ percent of nominal GDP during 2006.

Overall, the economy appears likely to continue to expand at a moderate pace over coming quarters. As the inventory of unsold new homes is worked off, the drag from residential investment should wane. Consumer spending appears solid, and business investment seems likely to post moderate gains.

This forecast is subject to a number of risks. To the downside, the correction in the housing market could turn out to be more severe than we currently expect, perhaps exacerbated by problems in the subprime sector. Moreover, we could yet see greater spillover from the weakness in housing to employment and consumer spending than has occurred thus far. The possibility that the recent weakness in business investment will persist is an additional downside risk. To the upside, consumer spending—which has proved quite resilient despite the housing downturn and increases in energy prices—might continue to grow at a brisk pace, stimulating a more-rapid economic expansion than we currently anticipate.

Let me now turn to the inflation situation. Overall consumer price inflation has come down since last year, primarily as a result of the deceleration of consumers' energy costs. The consumer price index (CPI) increased 2.4 percent over the twelve months ending in February, down from 3.6 percent a year earlier.

Core inflation slowed modestly in the second half of last year but recent readings have been somewhat elevated and the level of core inflation remains uncomfortably high. For example, core CPI inflation over the twelve months ending in February was 2.7 percent, up from 2.1 percent a year earlier. Another measure of core inflation that we monitor closely, based on the price index for personal consumption expenditures excluding food and energy, shows a similar pattern.

Core inflation, which is a better measure of the underlying inflation trend than overall inflation, seems likely to moderate gradually over time. Despite recent increases in the price of crude oil, energy prices are below last year's peak. If energy prices remain near current levels, greater stability in the costs of producing nonenergy goods and services will reduce pressure on core inflation over time. Of course, the prices of oil and other commodities are very difficult to predict, and they remain a source of considerable uncertainty in the inflation outlook.

Increases in rents—both market rent and owner's equivalent rent—account for a substantial part of the increase in core inflation over the past year. The acceleration in rents may have resulted in part from a shift in demand toward rental housing as families found homeownership less financially attractive. Rents should begin to decelerate as the demand for owner-occupied housing stabilizes and the supply of rental units increases. However, the extent and timing of that expected slowing is not yet clear.

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 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 be contained.

Although core inflation seems likely to moderate gradually over time, the risks to this forecast are to the upside. In particular, 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 most clearly in the tightness of the labor market. Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in a range of 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.

To be sure, faster growth in nominal labor compensation does not necessarily portend higher inflation. Increases in compensation may be offset by higher labor productivity or absorbed—at least for a time—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 generally favorable, despite the recent slowing in some measures, and the markup of prices over unit labor costs is high by historical standards, so such an outcome is certainly possible. Moreover, if the economy grows at a moderate pace for a time, as seems most likely, pressures on resource utilization should ease.

However, a less benign possibility is that tight product markets might allow firms to pass some or all of their higher labor costs through to prices. In this case, increases in nominal compensation would not translate into increased purchasing power for workers but would add to inflation pressures. Thus, the high level of resource utilization remains an important upside risk to continued progress in reducing inflation.

In regard to monetary policy, the Federal Open Market Committee has left its target for the Federal funds rate unchanged, at 5¼ percent, since last June. To date, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing in core inflation. Because core inflation is above the levels most conducive to the achievement of sustainable growth and price stability, the Committee indicated in the statement following its recent meeting that its predominant policy concern remains the risk that inflation will fail to moderate as expected. However, the uncertainties around the outlook have increased somewhat in recent weeks. Consequently, the Committee also indicated that future policy decisions will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Thank you Chairman Schumer for scheduling today's hearing. And thank you Chairman Bernanke for taking the time to share your views on the outlook for the American economy with us this morning.

The U.S. economy seems to be in a transition from the rapid rate of expansion we have experienced over the past several years to a more sustainable average pace of growth.

The main source of the recent moderation has been a substantial cooling in the housing market, which has led to a noticeable slowdown in the pace of residential construction. However, the slowdown in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other parts of the economy. The exception, of course, lies in the subprime mortgage market where delinquency rates and defaults have increased and a number of large lenders have closed shop. It remains to be seen whether or to what extent difficulties in the subprime mortgage market spill over to more general credit availability, and we look forward to your comments on that issue.

Consumer spending, which accounts for the vast majority of our Nation's gross domestic product, has continued to expand at a solid rate, supported by continued healthy gains in incomes and employment. On average, about 162,000 new payroll jobs have been added each month over the past 6 months, and the unemployment rate, at 4.5 percent in February, remains very low by historical standards. In fact, Chairman Bernanke, in testimony that you delivered before Congress in February,

you referred to "tightness" in the labor market and identified anecdotal reports suggesting that businesses are having difficulty recruiting well-qualified workers in certain occupations. To the extent that the "tight" labor market makes it easier for Americans who want jobs to get jobs, I am delighted by labor market tightness.

In addition to healthy household finances, outside of subprime mortgages with variable interest rates, the business sector also seems to be in sound financial condition. And, outside the United States, economic growth of our major trading partners has continued to rise. Strong demand from abroad has helped generate a strong expansion in U.S. real exports, which grew about 9 percent last year. However, despite improvements in our trade performance, the U.S. current account deficit remains large and grew to nearly 6.5 percent of our Nation's gross domestic product last year.

Inflation, inflation expectations, and long-term interest rates remain low by historical standards. It will be interesting to hear your thoughts on the outlook for inflation and interest rates as we move forward.

There are, of course, uncertainties associated with the outlook for the U.S. economy. Probably the biggest uncertainty today involves what will be the ultimate outcomes of the housing market correction and the fallout in subprime mortgage lending.

In terms of the long-term outlook for the economy, I would say that we know one thing with certainty: we know that we will soon observe the retirement of the baby boomers and we know that promises made under our Social Security and Medicare systems are unsustainable. With that certainty, Congress must act now to reform our entitlement programs and avoid a fiscal train wreck. Failure to do so will threaten the health of our economy.

While our focus today is on a macroeconomic overview of the state of the economy, I believe that there are some powerful social and cultural trends that play a significant role in determining a family's economic well being. Unfortunately, these factors are often overlooked in our discussions. This is particularly the case when we look at the widening income inequality that has been occurring for decades. From the evidence I have reviewed, it appears that factors such as family structure and education level have a significant impact on where households find themselves on the income scale.

When you look at the makeup and educational levels in households at the top and bottom 20 percent of the income distribution, the numbers are striking in terms of married versus single parent families. In the top 20 percent almost 90 percent of households are married. In the bottom 20 percent, only 25 percent of households are married. If marriage rates continue to decline and if the size of the education premium continues to rise, the existing income gap will likely widen further. I believe that we have to be aggressive in implementing policies that serve to strengthen the traditional family if we are going to reverse this trend.

I have made it a priority to work toward reducing disincentives toward marriage that are built into our tax code and our government programs. Stable families, low taxes, a growing economy, and education are what will promote economic opportunity and success.

I look forward to your testimony and the question and answer session to follow.

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