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THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

NOVEMBER 8, 2007

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JOINT ECONOMIC COMMITTEE

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THURSDAY, NOVEMBER 8, 2007

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

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

Senators present. Bennett, Bingaman, Brownback, Casey, Klobuchar, Schumer, and Sununu.

Representatives present. Brady, Cummings, Doggett, English, Hinchey, Maloney, Paul, Sanchez, and Saxton.

Staff present: Christina Baumgardner, Ted Boll, Heather Boushey, Chris Frenze, Stephanie Dreyer, Nan Gibson, Colleen Healy, Marc Jarsulic, Aaron Kabaker, Israel Klein, Tyler Kurtz, Michael Laskawy, Zachary Luck, Kimberly Magee, Robert O'Quinn, Jeff Schlagenhauf, Robert Weingart, Adam Wilson, Jeff Wrase, and Adam Yoffie.

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

Senator 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. We're always pleased when the Federal Reserve Chairman comes to share his views on the state of our economy.

Chairman Bernanke, when you came before this Committee last March, one of the major topics discussed, was the potential for fallout from the subprime lending crisis. It's something this Committee has been very concerned with for quite some time, and I think you'd be the first to admit that the subprime mess has not been contained, but, instead, has proved to be a contagion that has spread in dangerous ways throughout not just the housing market, but our economy, and even into the global financial system.

The seizing up of credit markets this summer, was the clearest indication of the unanticipated, potentially disastrous risks that out-of-control subprime lending poses to the financial markets.

There is now a lack of confidence in creditworthiness throughout the markets, and, at the core, there is a lack of confidence in the subprime market. Until we correct that, we will not solve our broader problems.

I want to applaud you and the Federal Reserve Board for your aggressive, and, I believe, appropriate response to this summer's liquidity crisis. It's vital that we maintain the health of our financial markets and ensure that they function smoothly.

You deserve credit for your prompt actions. However, while we did weather that summer storm, I am worried that there may be a bigger storm on the horizon.

Quite frankly, I think we are at a moment of economic crisis, stemming from four key areas: Falling housing prices, lack of confidence in creditworthiness, the weak dollar, and high oil prices.

Each of these problems, alone, would be enough of a threat to our economic well being, but taken together, they are essentially the four horsemen of economic crisis.

First, as we have warned, and as you acknowledge in your testimony, we face a wave of foreclosures in the next years, that threaten millions of American homeowners and the neighbors.

The housing boom has busted, and we see trillions of dollars in lost home values across the Nation.

Second, the credit markets remain in crisis. It's just simply a lack of confidence. The dollar has dropped dramatically against most of the major currencies of the world, and it seems to hit lows not seen in decades, nearly every day.

Finally, oil prices keep reaching near record highs, driving up energy costs in all sectors of the economy.

Even our bedrock assumptions are being put into doubt. As housing prices decline, there are real fears that we won't be able to depend on consumers, the engine of our economy over the past few years, to keep spending.

We now hear that foreign investors may no longer be confident in the dollar as the global currency of choice.

I'm not surprised to hear experts such as your predecessor, Alan Greenspan, warn about the threat of recession. I've begun to worry about it, too.

In particular, as I watch bank after bank write down bad investments tied to baroque financial instruments that even sophisticated investors don't understand, I fear for the stability and ultimate confidence in our financial system.

I've talked about the Wild West of subprime mortgage brokers, and I'm beginning to wonder if we have a Wild West of unregulated financial instruments, of SIVs and mis-rated CDOs and other complicated investments, whose values are not marked-to-market, or even marked-to-model, but, to quote one Wall Street strategist, are marked-to-make believe.

To quote you, Mr. Chairman, the markets want to know how much these damn things are worth, and I want to know what all of us—the Federal Reserve, the Congress, and this Administration can do, if anything, to assuage those fears.

I'm very concerned, Mr. Chairman, that none of the regulators are acting quickly or boldly enough to deal with the risks we're facing. A laissez faire, hands-off attitude, might be appropriate, if we had one of these crises, but confronting all of these problems at once, should be a call to action, because the danger we face is so much greater.

I know that Secretary Paulson has organized a "super conduit" to deal with the liquidity crunch faced by SIVs and the threat they pose to broader financial markets.

To be direct, I'm worried that this may just be a shell game, an attempt to move bad investments around, and keep them from landing back on the books.

I'd be curious to hear your opinion today, Mr. Chairman, about the Secretary's plan, as well as your view about the risks these complex and opaque pools of capital now present to our financial system, and how you intend to deal with them.

If you don't feel you have the tools at your disposal to address these problems, then I hope you'll share your views on what we in Congress ought to do.

I am glad to see that much of your statement is given over to the importance of helping distressed subprime borrowers. You mention some of the efforts my colleagues and I have made—and I won't spend more time on that right now, but I will say that it would really be nice if the Administration would join us in our attempts to protect families from the fallout of the subprime lending disaster.

The policy responses from the Administration have not come close to matching the magnitude of the crisis. There is a lack of confidence that anyone is in charge.

Mr. Chairman if you feel that, in your position, you cannot speak publicly about the changes that are needed, I urge you to speak privately to members of the Administration, use your position to jawbone them into action.

Your predecessor was not shy about putting his prestige and credibility to work behind the scenes. I encourage you to do the same.

One of the great legacies of the American economy, has been its ability to make everyone better off. Throughout most of our history, when our economic pie has gotten bigger, everyone has shared and the Nation has prospered and everyone got along.

But over the 7 years of this Administration, that has not been the case. Even in the recovery of the past few years, the benefits have gone mainly to those at the top.

Now, as we face an economic slowdown, or worse, I'm very worried that it's those Americans who haven't shared in our recent growth, who will bear the brunt of economic decline, and the policies of this Administration, will only further exacerbate their difficulties.

I don't pretend that there are easy solutions to troubling challenges facing our economy. The oil crisis, the falling dollar, they took years in the making and will not be solved with the snap of a finger, but we cannot shy away from those challenges.

We cannot, for another day or month, avoid these problems any longer because the chickens seem to be coming home to roost.

We need your voice, either publicly or privately, to help move us in that direction. I look forward to your testimony on the economic outlook, and to an interesting discussion of how we best meet these and other economic challenges we face.

Senator Schumer. Normally, I encourage all of our Members to make opening statements, but because we only have a limited time with Chair Bernanke, I'm going to ask your Vice Chairman and the Senate and House Ranking Members to make opening statements. Other Members may submit their full opening statements for the record.

Now, I turn to the Committee's Ranking Republican, my colleague on the House side, Mr. Saxton.

[The prepared statement of the Senator Schumer appears in the Submissions for the Record on page 40.]

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

Representative Saxton. Mr. Chairman, thank you very much. Chairman Bernanke, I'm pleased to join in welcoming you again here to testify before the Joint Economic Committee.

I appreciate your testimony in the past and look forward to your views on the economic outlook today. .

According to the standard measures of performance, such as economic growth and the unemployment rate, the U.S. economy, on the one hand, seems to be doing quite well.

Real economic growth was 3.9 percent in the third quarter, while the unemployment rate remains relatively low at 4.7 percent in October.

Exports and consumer spending continue to advance, reflecting the resilience of the U.S. economy. The recent pace of economic growth is all the more remarkable, given the challenges facing the economy.

Residential real estate investment declined at a 20–percent rate in the third quarter, continuing a longer trend. Housing prices are falling in many areas of the country, and housing inventory levels are on the rise.

Oil prices, as we all know, are nearing $100 a barrel, and the dollar is falling. In recent months, it has also become clear that a number of large financial institutions have invested in mortgage securities of dubious quality.

Huge writedowns of assets by Citigroup and Merrill Lynch, are recent validations of the serious concerns about the value of mortgage-backed securities. Uncertainty about the extent of bad investments related to the subprime and other mortgages has spread, resulting in sharp declines in the valuation of bank stocks.

The financial markets have become very volatile, as we have seen, particularly in the last several days. Even though recent economic growth appears to be strong, the combination of the decline in homebuilding, falling housing prices, spiking oil prices, and financial turmoil risks to the continuation of healthy economic growth.

The Fed has acted to reduce the strains on the financial sector, to head off a slowdown in the economy. According to leadership consensus and Federal Reserve forecasts, the economy will continue to expand through 2008.

Thank you, Mr. Chairman. I look forward to the testimony.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 43.]

Senator Schumer. Vice Chair Maloney.

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

Representative Maloney. Thank you very much, Mr. Chairman, for holding the hearing, and welcome to Chairman Bernanke. We are all eager to hear your remarks on the economic outlook and what that may mean for monetary policy during these troubling times.

Tremendous uncertainty remains about how the subprime fallout and the housing slowdown will infect the broader economy. Calling it a subprime crisis is no longer adequate, as the breadth and depth of this escalating credit crisis roils our major financial institutions, almost daily.

The seeming inability of our most sophisticated and respected institutions to measure their exposure to these assets, and more importantly, to manage the risks associated with them, poses a serious threat to our financial markets.

The chairman of General Motors' recent admission, yesterday, that he could not tell with any accuracy what the Company's exposure is to subprime losses at GMAC is both stunning and frightening. Investors did not understand what they were buying when they held CDOs and SIVs.

Now we're seeing billions of dollars in losses on these investments. Risk is coming home to roost with a vengeance. We have yet to see the full impact of these losses, on the economy or on the labor market.

In the near term, forecasters expect the economy to slow, as high energy prices and falling home values squeeze consumers, all of which points to a gathering storm that could drag down the economy, taking American jobs with it.

The Federal Reserve has worked to prevent the economy from derailing and has eased the credit crunch by lowering its key interest rates, but at their last meeting, the Fed signalled a wait-and-see approach for further action.

With crude oil edging toward $100 a barrel and the dollar sinking like a stone, inflation is certainly a concern for the Fed. The dollar fell sharply again yesterday, as the Chinese government signalled a shift away from the purchases of dollars in favor of Euros.

I think we would all like to hear more from Chairman Bernanke about any contingency plans the Fed has, should economic forces move toward a free-fall of the dollar. Our tremendous fiscal imbalances, including our record $9-trillion debt, further complicate the Fed's job of setting the right course for monetary policy, but for the moment, core inflation has remained unchecked, and there is little evidence that the labor market poses any real inflationary risks.

Wages have barely kept pace with rising prices, and they have lagged far behind productivity.

I hope the Chairman will agree, that how American families are faring, should not take a back seat to fighting inflation.

By all accounts, we haven't felt the worst of the housing market slump.

Millions of Americans are worried that they can't afford to keep their homes, let alone to heat them this winter.

Congress is working very hard to keep people in their homes, and to prevent another crisis like this one from happening again.

In the House of Representatives, we have passed reform legislation to shore up the FHA and the GSEs.

Just this week, we passed sweeping mortgage and anti-predatory lending legislation through the Financial Services Committee, which will head to the floor next week.

These are important first steps. There is a great deal more to do to help restore the American dream of many hardworking families.

Mr. Chairman, we look forward to gaining some insights into how the Fed will balance various risks to the economy with monetary policy. Again, we welcome you to the Committee.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 44.]

Senator Schumer. Thank you, Vice Chair Maloney.

Ranking Member Brownback.

OPENING STATEMENT OF HON. SAM BROWNBACK, A U.S. SENATOR FROM KANSAS

Senator Brownback. Thank you, Mr. Chairman. Mr. Chairman we're pleased to have you here.

The American economy has demonstrated, I believe, amazing resilience in the face of a variety of challenges. Witness 24 consecutive quarters of positive, real economic growth—24 consecutive quarters; 50 consecutive months of payroll employment growth. That's the longest on record.

And there has been significant expansion in our exports, yet my perception, and, I think, that of my colleagues up here, is that our economy is at a crossroads. That's why I think we're all so interested in your testimony here today and why the markets are so interested in your testimony.

We have had a nice long run, but it looks as if there are some really troubling signs out there. We've all talked about oil prices; we've all talked about the subprime market. I know you're going to address those.

One thing that certainly seems clear to me, on our part as legislators, is that the idea of raising taxes at this point in time would be a terrible idea and a terrible thing for the economy. If we were either to raise them purposefully, or to allow them to be raised because we didn't vote to extend the tax cuts that have been put in place, that would be the exact wrong signal, the exact wrong thing to do in an economy that is at a crossroads.

So, from our stance of fiscal policy and what we can do for economic growth on our side, I would certainly hope we would set aside all sorts of ideas about raising taxes, and say no, we're going cut taxes and we're going to keep them low to try to keep the economy going.

On your side of it, I look forward to your comments and what your thoughts are on what we should do with subprime mortgages, also on the impact of high oil prices on consumer spending.

I do hope the Fed is considering a further cut in rates to help the economy, to help the American consumer, who accounts for 70 percent of the economy.

Going into the important Christmas buying season, it seems to me now is the time—and I know you're weighing this—but I would certainly put my two cents worth in, that rate cuts at this point in time, when the consumer is seeing so much direct pressure on their pocketbook—those gas prices get up to $3 a gallon—it seems to hit some sort of psychological point in the consumer's mind.

They have less to spend, and that's a reality for them. I'm going to spend less in other areas. That reverberates further on through the economy.

So, a rate cut could be something very valuable, a signal to send into this economy—to the economy and to the consumer.

Much is at stake on our part and on your part. We look forward to your thoughts and wisdom that you can share with us on what we need to do to navigate through these troubled waters. I'm delighted you're here, delighted that you're in that job and I'm not.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 46.]

Senator Schumer. Mr. Chairman, proceed.

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

Chairman Bernanke. Thank you, Chairman Schumer, Vice Chair Maloney, Representative Saxton and other Members of the Committee. Thank you for inviting me here this morning to present an update on the economic situation and outlook.

Since I last appeared before this Committee in March, the U.S. economy has performed reasonably well. On preliminary estimates, real gross domestic product grew at an average pace of nearly 4 percent over the second and third quarters, despite the ongoing correction in the housing market.

Core inflation has improved modestly, although recent increases in energy prices, will likely lead overall inflation to rise for a time.

However, the economic outlook has been importantly affected by recent developments in financial markets, which have come under significant pressure over the past few months. The financial turmoil was triggered by investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates.

The continuing increase in the rate of serious delinquencies in such mortgages, reflects, in part, a decline in underwriting standards in recent years, as well as a softening of house prices.

Delinquencies on these mortgages are likely to rise further in coming quarters, as a sizable number of recent vintage subprime loans experience their first interest rate resets. I will have more to say about this problem and its implications for homeowners, later in my testimony.

At one time, most mortgages were originated and held by depository institutions. Today, however, mortgages are commonly bundled together into mortgage-backed securities or structured credit products, rated by credit-rating agencies, and then sold to investors.

As mortgage losses have mounted, investors have questioned the reliability of credit ratings, especially those of structured products.

Because many investors had not developed the capacity to perform independent evaluations of these often complex instruments, the loss of confidence in the credit ratings, together with uncertainty about developments in the housing market, led to a sharp decline in the demand for these products. Since July, few securities backed by subprime mortgages have been issued.

Although the problems with subprime mortgages initiated the financial turmoil, credit concerns quickly spilled over into a number of other areas. Importantly, the secondary market for securities backed by prime, jumbo mortgages, also contracted, and the issuance of such securities has declined significantly.

Prime jumbo loans are still being made to prospective home purchasers, but they are at higher spreads and have more restrictive terms.

Concerns about mortgage-backed securities and structured credit products, even those unrelated to mortgages, also greatly reduced investor appetite for asset-backed commercial paper, although that market has improved somewhat recently.

In the area of business credit, investors shied away from financing leveraged buyouts and from purchasing speculative-grade corporate bonds, and some larger banks, concerned about potentially large and difficult-to-predict draws on their liquidity and balance sheet capacity, became less willing to provide funding to their customers and to each other.

To be sure, the recent developments may well lead to a healthier financial system in the medium to long term. Increased investor scrutiny of structured credit products is likely to lead, ultimately, to greater transparency in these products and to better differentiate among assets of varying quality.

Investors have also become more cautious and are demanding greater compensation for bearing risk. In the short term, however, the events do imply a greater measure of financial restraint on economic growth, as credit becomes more expensive and difficult to obtain.

At the height of the recent financial turmoil, the Federal Reserve took a number of steps to help markets return to more orderly functioning. The Fed increased liquidity in short-term money markets in early August through larger-than-normal open market operations, and on August 17, the Federal Reserve Board cut the discount rate, the rate at which it lends directly to banks, 50 basis points, or ½ percentage point, and, subsequently, took several additional measures.

These efforts to provide liquidity, appear to have been helpful, on the whole, but the functioning of a number of important markets remained impaired.

The turmoil in financial markets, significantly affected the Federal Reserve's outlook for the broader economy. Indeed, in a statement issued simultaneously with the Board's August 17 announcement of the cut in the discount rate, the Federal Open Market Committee noted that the downside risk to economic growth had increased appreciably.

The Committee took further action at its next scheduled meeting on September 18th, when it cut its target for the Federal Funds Rate by 50 basis points.

This action was intended as a counterbalance to the tightening of credit conditions and to address, in a preemptive fashion, some of the risks that financial developments pose to the broader economy.

The Committee met most recently on October 30 and 31. The data reviewed at that meeting, suggested that growth in the third quarter had been solid at a 3.9 percent rate, according to the initial estimate by the Bureau of Economic Analysis.

Residential construction declined sharply during the quarter, as expected, subtracting about 1 percentage point from overall growth. However, the GDP report provided scant evidence of spillovers from housing to other components of final demand.

Strong growth in consumer spending was supported by gains in employment and income, and businesses increased their capital spending at a solid pace.

A strong global economy stimulated foreign demand for U.S.-produced goods and services, as foreign trade contributed nearly 1 percentage point to the growth of real output last quarter.

Looking forward, however, the Committee did not see the recent growth performance as likely to be sustained in the near term. Financial conditions had improved somewhat after the September FOMC action, but the market for nonconforming mortgages remained significantly impaired and survey information suggested that banks had tightened terms and standards for a range of credit products over recent months.

In part because of the reduced availability of mortgage credit, the contraction in housing-related activity seemed likely to intensify. Indicators of overall consumer sentiment suggested that household spending would grow more slowly, a reading consistent with the expected effects of higher energy prices, tighter credit, and continuing weakness in housing.

Most businesses appear to enjoy relative good access to credit, but heightened uncertainty about economic prospects could lead business spending to decelerate, as well.

Overall, the Committee expected that the growth of economic activity would slow noticeably in the fourth quarter, from its third quarter rate.

Growth was seen as remaining sluggish through the first part of next year, then strengthening as the effects of tighter credit and the housing correction began to wane.

The Committee also saw downside risks to this projection. One such risk was that financial market conditions would fail to improve, or even worsen, causing credit conditions to become even more restrictive than expected.

Another risk was that in light of the problems in mortgage markets and the large inventories of unsold homes, house prices might weaken more than expected, which could further reduce consumers' willingness to spend and increase investors' concerns about mortgage credit.

The Committee projected overall core inflation to be in a range consistent with price stability next year.

Supporting this view were modest improvements in core inflation over the course of the year, inflation expectations that appeared reasonably well anchored, and futures quotes suggesting that investors saw food and energy prices coming off their recent peaks next year.

But the inflation outlook was also seen as subject to important upside risks. In particular, prices of crude oil and other commodities had increased sharply in recent weeks and the foreign exchange value of the dollar, had weakened.

These factors were likely to increase overall inflation in the short run and should inflation expectations become umoored, have the potential to boost inflation in the longer run, as well.

Weighing its projections for growth and inflation, as well as the risk to those projections, the FOMC, on October 31, reduced its target for the Federal Funds Rate an additional 25 basis points to 4.5 percent.

In the Committee's judgment, the cumulative easing of policy over the past 2 months, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets, and promote moderate growth over time.

Nonetheless, the Committee recognized that risk remained to both of its statutory objectives of maximum employment and price stability. All told, it was the judgment of the FOMC that after its action of October 31, the stance of monetary policy roughly balanced the upside risk to inflation and the downside risk to growth.

In the days since the October FOMC meeting, the few data releases that have become available have continued to suggest that overall economic activity, the overall economy, remain resilient in recent months; however, financial market volatility and strains have persisted.

Incoming information on the performance of mortgage-related assets, has intensified investors' concerns about credit market developments and the implications of the downturn in the housing market for economic growth.

In addition, further sharp increases in crude oil prices have put renewed upward pressure on inflation, and it may impose further restraint on economic activity.

The FOMC will continue to carefully assess the implications for the outlook of the incoming economic data and financial market developments and will act as needed to foster price stability and sustainable economic growth.

I would like to say a few words about actions being taken to help homeowners who have fallen behind on their mortgage payments, or seem likely to do so.

As I mentioned, delinquencies will probably rise further for borrowers who have a subprime mortgage with an adjustable interest rate, as many of these mortgages will soon see their rates reset at significantly higher levels.

Indeed on average, from now until the end of next year, nearly 450,000 subprime mortgages per quarter are scheduled to undergo their first interest rate reset. Relative to past years, avoiding the payment shock of an interest reset by refinancing the mortgage will be much more difficult, as home prices have flattened out or declined, thereby reducing homeowners' equity, and lending terms have tightened.

Should the rate of foreclosure rise proportionately, communities, as well as individual borrowers, would be hurt because concentrations of foreclosures tend to reduce property values in surrounding areas.

A sharp increase in foreclosed properties for sale could also weaken the already struggling housing market, and thus potentially, the broader economy.

Home losses through foreclosure can be reduced if financial institutions work with borrowers who are having difficulty meeting their mortgage payment obligations. In recent months, the Federal Reserve and other banking agencies have issued statements calling on mortgage lenders and mortgage servicers to pursue prudent loan workouts.

Our contacts with the mortgage industry suggest that servicers have recently stepped up their efforts to work with borrowers facing financial difficulties or an imminent rate reset.

Some servicers have been proactive about contacting borrowers who have missed payments or face resets, as experiences shows that addressing the problem early increases the odds of a successful outcome.

Foreclosure cannot always be avoided, but in many cases, loss mitigation techniques that preserve home ownership are less costly than foreclosure.

To help keep borrowers in their homes, servicers have been offering assistance through repayment plans, temporary forbearance, and loan modifications.

Comprehensive data on the success of these efforts to avert foreclosures are not available, but my sense is that there is scope for services to further increase their loss mitigation efforts.

The development of standardized approaches to workouts and the sharing of best practices can help increase the scale of the effort, even if ultimately, workouts must be undertaken loan-by-loan.

Although workouts are to be encouraged, regulators must be alert to ensure that they are done in ways that protect consumers' interests and do not disguise lenders' losses or impair safety and soundness.

The Federal Reserve has been participating in efforts by community groups to homeowners avoid foreclosure. For example, Governor Kroszner of the Federal Reserve Board serves as a director of NeighborWorks America, a nonprofit organization that has been helping thousands of borrowers facing current or potential distress to obtain assistance from their lenders, their servicers, or trusted counselors through a hotline.

The Federal Reserve Board staff has been working with consumer and community affairs groups through the Federal Reserve System, to help identify localities that are most at risk of high foreclosures, with the intent to help local groups better focus their outreach efforts to borrowers.

Other contributions include foreclosure prevention programs such as the Home Ownership Preservation Initiative which the Federal Reserve Bank of Chicago helped to initiate, and efforts by Reserve Banks to convene workshops for stakeholders, to develop community-based solutions to mortgage delinquencies in their areas.

The Federal Reserve System is also engaged in research and analysis that should involve policy responses to these issues.

The Congress is also focused on reducing homeowners' risks of foreclosure. One statutory change that could help is the modernization of programs administered by the Federal Housing Administration.

The FHA has considerable experience helping low- and moderate-income households obtain home financing, but it has lost market share in recent years, partly because borrowers have moved toward nontraditional products with more flexible and quicker underwriting and processing, and partly because of a cap on the maximum loan value that can be insured.

In modernizing the FHA, the Congress might encourage joint efforts with the private sector that expedite the refinancing of subprime loans held by creditworthy borrowers facing resets.

It might also consider granting the Agency the flexibility to design products that improve affordability through such features as variable maturities or shared appreciation.

Also, the FHA could provide more refinancing options for riskier households, if it could tailor the premiums it charges for mortgage insurance to the risk profile of the borrower.

As I have discussed in earlier testimony, the Federal Reserve is taking steps to avoid subprime lending problems from recurring, while preserving responsible subprime lending. In coordination with other Federal supervisory agencies and the Conference of State Banking Supervisors, we have issued principles-based underwriting guidelines on subprime mortgages to help ensure that borrowers obtain loans that they can afford to repay and have the opportunity to refinance, without prepayment penalty for a reasonable period before the first interest rate reset.

In addition, together with the Office of Thrift Supervision, the Federal Trade Commission, the CSBS, and the American Association of Residential Mortgage Regulators, we have launched a pilot program aimed at strengthening reviews of consumer protection compliance at selected non-depository lenders with significant subprime mortgage operations.

Finally, using the authority granted to us by the Congress under the Home Ownership and Equity Protection Act, we are on schedule to propose rules by the end of this year to address unfair or deceptive mortgage lending practices. These rules would apply to subprime loans offered by any mortgage lender.

We are looking closely at practices such as prepayment penalties, failure to escrow for taxes and insurance, stated income and low-documentation lending, and failure to give adequate consideration to a borrower's ability to repay.

Using our authority under the Truth in Lending Act, or TILA, we expect that we will soon propose rules to curtail abuses in mortgage advertising and to ensure that consumers receive mortgage disclosures at a time when the information is likely to be the most useful to them.

We are also engaged in a rigorous broader review of the TILA rules for mortgage loans which will make use of extensive consumer testing of disclosures. Thank you. I'd be pleased to answer your questions.

[The prepared statement of Chairman Bernanke appears in the Submissions for the Record on page 49.]

Senator Schumer. Thank you, Mr. Chairman. We very much appreciate your comprehensive testimony.

You noted in your statement, that you thought there would be slow growth in the next few quarters, but not a recession. You also noted that there are downsides that one would have to take into account, and they would be, again, what I call the four horsemen of our economic problems: Lower housing prices, higher oil prices, dropping dollar, and lack of confidence in the credit markets.

So, let me ask you a question: Is a recession out of the question? What is the likelihood that we might go into a recession? If I could make it simple, on a scale of 1 to 10, 10 being most likely, how likely is a recession?

Chairman Bernanke. Mr. Chairman, as you noted, our forecast is for moderate, but positive growth going forward through the next few quarters. Economists are extremely bad at predicting turning points, and we don't pretend to be any better.

We have not calculated a probability of recession, and I wouldn't want to offer that today. Again, our assessment is for slower growth, but positive growth going into next year. We think that by the spring or early next year, that as these credit problems resolve and as we hope the housing market begins to find a bottom, that the broader resiliency of the economy, which we are seeing in other areas outside of housing will take control and will help the economy recover to a more reasonable growth pace.

Senator Schumer. Thank you. Next, yesterday, there was mention by a Chinese official—and some gave it more credence than others—that the Chinese might start investing more of their assets, even switching over some of their assets to those in stronger currencies than the dollar.

How worried are you about that? How likely is it to occur? How much credibility do you give this statement that was made yesterday?

Chairman Bernanke. There is no official Government statement in this regard, and I'm not particularly concerned about any major change in the holdings of China or any other country.

There is, on the margin, sovereign wealth funds and portions of reserve accumulations that are being devoted to higher returns which means spreading across instruments, as well as across currencies.

But, again, I don't see any significant change in the broad holdings of dollars around the world. dollars remain the dominant reserve asset, and I expect that to continue to be the case.

We would like to add, though, that the strength of the dollar, in the medium term, will ultimately depend not on those portfolio choices, so much as on the strength of the U.S. economy, our trade situation, and on the openness of our financial markets to foreign capital. I'm optimistic on those fronts, and I do believe that that will lead to a sound dollar in the medium term.

Senator Schumer. Wouldn't it be in the interest of some of these foreign countries, in the longer term, not in the immediate term, if the dollar continues to show the weakness that it has shown so far, to diversify?

Chairman Bernanke. Well, if they're pegging their exchange rate to the dollar, then there's a certain need, but to hold dollars, of course. But I think, more broadly, that the financial markets in the United States are still the deepest, the most liquid, and offer the most range of investment opportunities; and in that respect, you often see, for example, trade between third countries, still being invoiced in dollars, because it remains a standard of value around the world, and I expect that to continue.

Senator Schumer. One of the engines of our economic growth, the main engine, has been consumer spending. It's been estimated that a significantly high percentage of that consumer spending was fueled by refinancings of homes which gave the consumer more money to spend for other things.

The decline in housing prices, both because refinancings would decline and because people felt they had less in terms of assets, present a problem for consumer spending. How much do you expect the decline in housing prices to affect consumer spending? And again, if home prices decline further than you expect, would that create a real danger for our economy?

Chairman Bernanke. Certainly, as homeowners see their wealth declining in terms of their house value, that will affect their thinking about long-term spending opportunities and affect their spending.

We do not take an alarmist view of this, however. There are some who feel that consumers react extremely strongly, for example, to changes in home equity line availability.

Our sense is that the relationship between home wealth and consumer spending is governed primarily by what's called the wealth effect, which suggests that for each dollar that a house value falls, there's a net effect on consumer spending of somewhere between 4 and 9 cents, something like that.

That may be an effect that's maybe spread over a period of time, so there will be an effect, but we see it as relatively moderate. But as you point out correctly, there are a number of factors at play right now, including high oil prices, for example, that would be negatives for consumer spending.

On the other hand, to the extent the labor market has remained reasonably strong and employment income has continued to grow, that is a positive to help sustain consumers.

Senator Schumer. One final question: Federal Reserve Governor Kroszner recently suggested that mortgage investors and servicers modify subprime mortgages en masse rather than on a case by case basis because it's just so hard. There are so few people on the ground. These are complicated instruments these days.

What is your view of doing that? I know the Federal Reserve has said you were going to issue some guidance to lenders on these standardized loan modifications. Could you comment on how seriously the Fed would take Governor Kroszner's idea and what you're doing about it?

Chairman Bernanke. We take it seriously. I mentioned in my testimony the need to scale up these efforts as resets become eminent. We are looking, for example, we are already talking with servicers who are developing either computer programs or templates or procedures that allow them, at least as a first cut, to categorize mortgages in terms of how they are to be treated.

That, on the one hand, will help them scale up their efforts. We believe that is beginning to happen. We encourage that to happen. In addition, by providing a systematic approach to addressing these mortgages they actually protect themselves against claims by investors or others who feel that they are arbitrarily changing or modifying the loans.

We do support scaling up these efforts. And the best way to do that is to create some more systematic approaches to doing so.

Senator Schumer. Thank you.

Congressman Saxton.

Representative Saxton. Thank you, Mr. Chairman.

Let me ask: I sat here this morning observing the information flow back and forth. We talked about a number of issues, some of which are positive and some of which are not so positive.

For example, on the positive side, it is good news that core inflation—the numbers that we look at to study core inflation—lead us to think that inflation, at least core inflation, seems to be pretty much in check.

On the other hand, we have talked about construction, particularly housing construction, being in not such good shape.

You just mentioned that the house price decline has a wealth effect which has implications going forward. The financial condition of large banks has been discussed here at some length this morning, and that is cause for some concern relative to economic growth.

And of course, the potential effect of hundred-dollar-a-barrel oil has implications going forward as well.

I noted from the FOMC statement last week, it suggested at least to some that some in the markets said the Fed monetary policy stance was becoming, quote, "more neutral."

Given that core inflation seems to be in check, and given that there are concerns going forward with the economy, could you give us your view of what perhaps "more neutral monetary policy" means?

Chairman Bernanke. Yes, Congressman.

As we said in our statement, we feel that the risks in terms of what could go wrong in both directions have become more balanced since we have taken 75 basis points of cuts in the last two meetings to try to offset the tightening of credit that we see.

On the inflation side, it is true that there are some positives. Core inflation has been lower. We believe that inflation expectations remain reasonably stabilized.

That being said, Congresswoman Maloney mentioned oil prices and the declining dollar which may have some effects on import prices. Those are effects we cannot ignore.

Should inflation expectations begin to move up and inflation begin to rise, it would be very costly for us to have to bring that back down. And so that is a concern we have, and we need to pay attention to inflation. It is very important that we do so.

On the output side, again, we do expect some slowing relating to a variety of factors including tightening credit conditions and the slowing in the housing market. But as you mentioned yourself, the broader economy outside of housing has been remarkably resilient over the last couple of years.

We had 4 percent growth in the third quarter even with the percentage point subtracted for housing, and the numbers we have seen in the last week or two have not really changed the view that, so far at least, the spillovers from housing to the broader economy have been limited.

Having said all that, there are a lot of uncertainties. The financial market turmoil creates a good deal of uncertainty on how that is going to evolve. The housing market creates uncertainty. The dollar and oil prices are sources of uncertainty.

So our view is that we have a mandate to fulfill. That mandate is to ensure price stability and maximum employment, and we will be very dependent on the data. We will be observing what data comes in. We will be looking at conditions of the financial markets, and we will be trying to continuously update our views on how the economy is likely to evolve and respond as we see those risks change in one direction or another.

We certainly want to be able to respond as needed to meet our mandate.

Representative Saxton. Thank you. On the housing spillover, I have been curious about this because I have been watching the same, or many of the same numbers that you have.

You would think that with construction being down, other sectors of the economy would be directly affected: major appliances, hardware of various kinds, the lumber industry obviously, and other sectors of the economy that provide products that are used in the home construction business, as well as other related sectors of the economy.

Do you have any idea why it is that the spillover effect does not seem to be more evident?

Chairman Bernanke. Congressman, we do see the spillover in the areas that you mentioned. For example, the Detroit auto makers are showing declines in their sales of pickup trucks because of the declines in construction activity.

And certainly companies making appliances and home furnishings and so on have seen activities decline, and in general manufacturing activity has slowed and looks at this point to be growing very, very slowly. That in part reflects the relationship between manufacturing and housing, which is only partly offset by exports.

But in general I think there are two factors that have kept the economy growing. One is that the labor market has remained reasonably strong, and with reasonably good availability of jobs and income growth consumers have money to spend.

The second factor which is going to support the economy going forward is that the global economy is also very strong, and demand for U.S. production and exports has helped buoy our economy.

For the first time in this last year, in a year-and-a-half or so, for the first time in many years the trade sector has been a positive contribution to the U.S. growth as opposed to a negative contribution. And I think going forward we will see additional strength coming from foreign trade.

Representative Saxton. Thank you, Mr. Chairman.

Senator Schumer. Vice Chair Maloney.

Representative Maloney. Thank you very much for your testimony today. I am really stunned by the lack of understanding by investors in major sophisticated institutions in SIVs and CDOs. They seem not to have understood the risk.

We are seeing major losses at major institutions. My question is: Does the Fed—I certainly hope the Fed has a better understanding, or sense of what is in these CDOs and SIVs than the investors.

Chairman Bernanke. The problems emerged some time ago when the subprime losses began to appear. Some of these mortgage-backed securities and other types of instruments that had mortgages, even though they were technically rated AAA began to show losses.

Suddenly the confidence was lost, and investors became unwilling to buy these instruments. In retrospect, it is surprising and disappointing that, as you say, sophisticated investors essentially looked at the credit rating and that is all they did. They did not do due diligence. They did not investigate what was in the CDOs, for example, in any detail.

Representative Maloney. Has the Fed investigated?

Chairman Bernanke. The Fed of course is working with the other regulators: the SEC, the Accounting Board, and so on, to make sure that these off-balance-sheet instruments and the bank balance sheets themselves are being written down appropriately so they reflect the actual values.

We are working with the banks and the ones who sponsor these off-balance-sheet instruments to make sure they are getting true valuations.

It is a little bit of a moving target, because as time passes, we see ratings downgrades, for example, and some of the assets have to be re-valued again.

But it is very much in the interest of the banks to disclose as much as possible and to write down their losses. We, along with the other regulators, are paying close attention to that marking process.

Representative Maloney. It seems that the CDOs are so opaque in their risk and composition that trade in them only works in a rising market.

I have seen your actions in this area and I wonder why hasn't the Fed been more insistent on a major improvement in transparency as a condition of the Government's willingness to participate in basically propping up these markets.

As you know, when Government came in and worked with long-term capital markets in 1998, we demanded risk management. Best practices came out of it. Treasury demanded basic improvement in the bailout in Mexico.

Why isn't the Fed coming out with specific, really best practices or goals to force the transparency in this area that everyone seems to not understand basically what they're buying or the value?

Chairman Bernanke. First, Congresswoman, we are not bailing out anybody. We did not put a penny of our money or Federal money into the banks, or into the CDOs. What we are doing is exercising our responsibility to make sure that the banks disclose the information, and that they value these things properly.

It is not our practice in the broad financial world to protect investors, particularly sophisticated investors who should be able to make their own evaluations, from buying individual instruments.

Our responsibility is to make sure that the banks are safe and sound, and they are appropriately valuing their balance sheets and their exposures to these off-balance-sheet instruments are appropriately measured and accounted for, particularly with respect to capital. That is what we are focused on.

We have been focused on it for some time. As we move forward into Basel II and other changes we are making, it is certainly going to be something we are looking at very closely.

Representative Maloney. Last week former Secretary Rubin said that a weak dollar is bad for the U.S. economy. Do you agree with him that a strong dollar increases Americans' standard of living and keeps inflation low?

Or do you think, as some economists argue, that we can devalue our way to prosperity, allow the dollar to weaken to boost exports, help close the trade deficit, and create better jobs?

Chairman Bernanke. Again, the Secretary of the Treasury is the spokesperson for official policy. We are looking at the dollar primarily as it affects the U.S. economy.

Representative Maloney. Let me say this a different way. Do you think that the dollar, the decline of the dollar, will lead to inflation and higher long-term interest rates?

Chairman Bernanke. The decline of the dollar has the potential to raise import prices and contribute to inflation. Therefore, we are very attentive to that risk.

In all but the shortest of terms, the Federal Reserve's policy determines how much inflation there is, and we are going to make sure that the inflationary impact that may come from the weakening dollar is not passed into broader prices and becomes part of the underlying inflation rate.

Representative Maloney. Thank you. My time is up.

Senator Schumer. Senator Brownback.

Senator Brownback. Thank you, Mr. Chairman.

Mr. Bernanke, on page 6 of your testimony you indicated you were going to continue to talk about the need to foster price stability and sustainable economic growth.

I want to make sure I am clear with you on this. Do you consider either of these as the greater threat at this point in time? Or that these are roughly kind of equal threats, price stability, or inflation and economic growth?

Chairman Bernanke. We assess the risk to those objectives as being roughly balanced at this time. There are risks on both sides of the mandate.

As we go forward, however, we are not dogmatic. As we go forward we are going to follow the data. We are going to see what happens in the financial markets, and we are going to try to make judgments over time as we get the information.

Senator Brownback. Even as oil prices go to $100 a barrel, $3 at the gas pump? You look at those as particularly equal?

I look at gas prices and that is directly out of the consumers' pocketbooks. That is a direct hit. Then as we are going into the Christmas season, I am having to pay a lot more at the pump. I think you really begin to affect the mentality when you get to that $3-a-gallon gas or above, as it is in many places around the country.

Chairman Bernanke. Senator, you are absolutely right. This is a big burden for the U.S. economy. Although we have been pretty resilient so far in dealing with higher oil prices, I would point out that while it has its effects on consumer spending it is also obviously an inflation risk both because of oil prices and gasoline prices are part of the consumer's basket and therefore part of inflation, and even more concerning would be if those gas prices were to feed through into other costs and lead to a broader rise in prices.

So we have to be very vigilant to make sure that higher oil prices do not translate into broader inflation in the economy.

Senator Brownback. Not as the Fed Chairman, but as an economist, raising taxes at this point in time, not dealing with the Alternative Minimum Tax problem that is grabbing more people, or allowing a raising of taxes on dividends or capital, what sort of impact would that have on the economy at this point in time?

Chairman Bernanke. Senator, I am not going to comment on specific individual proposals. I do think that a net gain, a net increase in taxes that was substantial would probably not be advisable because of its effect on aggregate demand.

But it is a complex issue, each of these tax areas that you are mentioning, to talk about the pros and the cons. We can pursue that if you like, but I prefer not to take a position on one side or the other of these individual tax proposals.

Senator Brownback. Still, as an overall item in the economy at this point in time where you have an economy that is concerning, to raise taxes now would not be advisable for its impact on the long-term economic growth in the economy.

Chairman Bernanke. A large increase in net taxes would tend to be a drag on consumer spending and on the economy through a number of different channels, I should say. That would be an issue, I think, if that were to be the case, given what we expect to be a slower growth economy for the next couple of quarters.

Senator Brownback. I want to look at the impact of China on the U.S. economy. You must be watching that very closely. Their purchasing, or their use of dollar denominations, inflationary impact coming from consumer products coming out of China into the U.S. economy, or the concern we have of consumer products coming from China, what are the lead factors you are watching in the Chinese economy as far as its impact in the United States?

Chairman Bernanke. The main thing we would like to see in China is a rebalancing of the economy away from this very strong dependence on exports which contributes to global imbalances and to the U.S. external deficit toward a more domestically driven economy.

So, particularly, in China this is a rather remarkable statistic. But the average national savings rate in China is close to 50 percent, as poor a country as it is. Which means that in order—even though they have very high capital investment—in order to sustain growth they have to export. They have a current account surplus now on the order of 9 to 10 percent of GDP.

They need to re-orient their growth toward domestic needs. They do need to do that by strengthening consumer spending and by reducing the emphasis on exports.

I gave a speech some time ago talking about some of the ways they could do that, by strengthening the social safety net so people did not have to save so much in anticipation of being sick or retiring.

In addition, as we have talked often—and Senator Schumer has often emphasized—they need to increase the flexibility of their exchange rate in order to allow for the natural process of demand to shift away from a totally export-oriented economy and more toward a balanced domestically oriented economy.

Senator Brownback. Thank you, Mr. Chairman.

Senator Schumer. Senator Bingaman.

Senator Bingaman. Thank you very much, Mr. Chairman, for being here.

Let me ask about the secondary market for mortgages. My impression is that the ability of an individual to borrow from a bank ultimately depends upon the ability of that bank to turn around and sell that mortgage into a secondary market of some kind.

That seems to me to be the place where the system is breaking down or has broken down; and over the next 6 months or so, that's the place where the greatest danger lies.

If banks are not able to sell into a secondary market, credit continues to get restricted and limited. Would you have any thoughts as to how to fix that problem?

Chairman Bernanke. I agree with you that one of the largest factors that leads us to think the economy is going to slow somewhat, is precisely that issue. Mortgage availability has declined significantly. That's affecting demand for housing and the housing sector and seeping over to the broader economy.

Some of this is probably inevitable, in the sense that we've seen a significant tightening of lending standards in the subprime area, which is understandable given the problems in that area. But we're also seeing, for example, problems of banks securitizing prime jumbo mortgage loans, that is, mortgage loans that are greater than $417,000.

That doesn't mean those loans aren't being made. Many banks are making them and keeping them on their balance sheets, and there is some securitization going on that's limited.

The result is that those mortgages are still available, but at somewhat tighter terms and higher prices than otherwise.

I think, over time, that market is going to improve. I'm not sure what an immediate fix would be. There's been some discussion of raising the conforming loan limit on GSEs.

If we do that, I think it ought to be a very temporary measure and be done in a way that assures us that doing so doesn't risk the underlying safety and soundness of those institutions.

Senator Bingaman. Would you think a temporary increase of that $417,000 limit would make some sense?

Chairman Bernanke. One suggestion I would have—again, it's very important that we not override the regulators' view that the safety and soundness of these institutions must be protected.

So, one possibility would be if the Federal Government were willing to act as guarantor. For example, suppose the GSEs were to pay their usual mortgage insurance credit fee to the Federal Government which then acted as guarantor, so to take away the credit risk from the GSEs.

They could then process these jumbo loans and sell them in the secondary market, and that would, I think, be of some assistance to the mortgage market.

From the Federal Government's point of view, that would be taking on some credit risk which you may or may not be willing to do. I think that if you did that, it would be a good idea to make the GSEs ultimately responsible for any excess losses, or some part of excess losses relative to the premiums that are paid, and leave it to the regulator to determine when the safety and soundness was adequate that the GSEs could make that repayment.

So I think there might be some mechanisms that involve Federal interaction, but I think it's extremely important, as we look at these options, that we don't take actions that will endanger the safety and soundness of the underlying institutions.

Senator Bingaman. Just to follow up on that suggestion that you made there about the Federal Government taking on this risk, would we have to legislate to do that?

Chairman Bernanke. Yes.

Senator Bingaman. Is the legislation that is pending in the House—have you reviewed that as to whether that accomplishes what you're suggesting?

Chairman Bernanke. I'm not aware that it does. The legislation in the House, is mostly about dealing with those who are in trouble, borrowers already in trouble, and, prospectively, the rules for avoiding future abuses.

There is not, to my knowledge—perhaps Senator Schumer can correct me—there has not been, to my knowledge, a lot of effort devoted toward the secondary market.

Senator Bingaman. Thank you.

Senator Schumer. Senator Sununu.

Senator Sununu. Thank you, Mr. Chairman. I think I'll begin my questioning with an issue related to the one Senator Bingaman was talking about, but it is, frankly, a little bit more negative in its perspective.

Yesterday, the Dow dropped 360 points, and a number of analysts in the financial press blamed a lot of that drop on the New York Attorney General and his press release that alleged, in his words, quote, "systemic fraud," and, quote, "a pattern of collusion in the mortgage industry."

The Attorney General made those allegations with specific reference to transactions between Fannie Mae, Freddie Mac, and Washington Mutual for which he issued subpoenas. My question to you, is, in this environment where we see big problems with credit in the mortgage industry, is this kind of a press release really helpful to solving the problems in front of us.

Chairman Bernanke. Senator, I don't want to intervene in the Attorney General's decisions about what cases to pursue, and I would add that the Federal Reserve has, obviously, no regulatory authority over any of those institutions.

I think what's upsetting the stock market is that it's primarily financial stocks that have been falling, and the concern is that financial firms have not, in the view of the stock market, perhaps completely written down the losses that they've suffered.

Senator Sununu. I will be happy to address transparency, and I'm not asking you to comment on whether or not someone is guilty or not guilty, but I'm trying to identify whether or not this will help us address the problems that exist in the industry.

Chairman Bernanke. I don't want to intervene in the Attorney General's decisions.

Senator Sununu. If you don't want to comment on it, that's fine. Obviously, again, I want to understand what is helpful and what isn't.

You mentioned transparency in the marking-to-market. This is something else that I'd like to talk about, and apparently, you'd like to talk about it more than my first question, so I'll be happy to move there.

The Treasury announced a super SIV, a large, enhanced liquidity vehicle to try to deal with liquidity issues in structured investment vehicles. There are 30 of them, mostly held by very large institutions.

You point out that transparency is essential. The process of price discovery is essential to working through these problems.

What, in your opinion, is the purpose of this enhanced liquidity vehicle, and what will its impact on price discovery be?

There is a Federal official quoted in the Wall Street Journal, that said that this proposal, quote, "has the potential to contribute, rather than to impair these markets in the process of price discovery."

I would maintain that it's just as true to say this vehicle has the potential to impair, rather than to contribute to the markets in the process of price discovery. What's the purpose of the vehicle and what impact do you think it will have on price discovery?

Chairman Bernanke. Senator, it all depends on the execution, as I'm sure you would agree. My understanding of the idea behind it is that a consortium of banks, together with investors—major investors—would oversee the process of purchasing high-quality assets from these unwinding SIVs and create a new vehicle which would then be financed by commercial paper purchased by, for example, large mutual funds.

My understanding of the process is that because investors, as well as a number of banks would be involved, essentially as gatekeepers in bringing assets into this new vehicle, that the valuations—there will be an incentive, particularly on the part of the investors, but also on the part of banks who didn't have direct disclosures.

There would be an incentive to create accurate market pricing if that is the way it works. Again, it depends on the execution, but if that's the way it works, it would remove some overhang from the market; it would create a stable financing source for those assets, and it ought not to be inconsistent with the price discovery process.

Senator Sununu. I would only observe the operative phrase you used regarding participation of investment firms that don't have exposure in these areas. If you look at the list of firms that were most excited about participating, they all have significant exposure in these investment areas.

When you were here last, which was 7 months ago, I explained if you looked at the aggregate down payment available in our economy from consumers on homes and looked at changes in credit underwriting standards, it was very likely that this year, home inventories, inventories of unsold homes, would increase from the level back in March of—approximately 6 months, to 8 to 10 months. I asked you, what do you think the impact on demand or the economic level of activity would be, if housing inventories were at 8 to 10 months, as opposed to today's 6 months?

And you responded, if they were at that level—and I do not expect that they will be, construction will fall further. I'm sure we'll never have the opportunity to say at any other time, that I was right and you were wrong, and granted, maybe it was just a lucky guess, but I think we've looked at changes in credit and we've looked at what was available for down payment. It's highly likely that inventories would go at least to those levels.

I think, without going into detailed explanation, that there's a very good chance, over the next 12 months, that inventories will go to at least 12 months and probably to 14 months. What would be the impact on the economy and, in specific terms, of an increase in housing inventories to 14 months, and what is the best estimate or the best forecast of those at the Fed looking at the housing industry today?

Chairman Bernanke. Senator, you were right and I was wrong.

Senator Sununu. I didn't ask you to say that by any means.

Chairman Bernanke. Inventories have risen, and they've produced a great deal of downward pressure on construction. And to get to where you're describing would require further declines in demand, slower responses by homebuilders, and it would suggest even a greater disequilibrium and a longer period of workout that would subtract directly from economic growth, and increase the hazard of spillovers into other parts of the economy. That's a concern.

Again, our anticipation—and it depends very much on both the homebuilders' response and the buyers' response—is that those inventories are not going to go much further from here, but in 6 months, you can tell me, you know, that I was wrong again.

Senator Sununu. I will not look forward to that.

Chairman Bernanke. We believe that this process, although we're now under a million single-family homes, from a peak of 1.7 million—we've really greatly reduced the rate of home construction, so, in some sense, we think there's a minimum because there is a certain amount of family formation and so on that's going to support a certain amount of building.

So we don't expect it to get to the point you suggest, but perhaps you're a better forecaster.

Senator Schumer. Congressman Cummings.

Representative Cummings. Thank you very much, Mr. Chairman. Mr. Chairman, thank you for meeting with us.

Many Members of Congress are now holding forums in their districts, as I will be doing very shortly to help people who are coming to our doors, literally with tears in their eyes, trying to figure out how they're going to manage a foreclosure that's right around the corner. Unfortunately, they have been harmed by what they thought was going to be a dream, now turning into a nightmare.

You know, as I sat here and I listened to you, it seems like you have painted a very rosy picture of the foreclosure situation, but if you came and walked through my district, Mr. Chairman, I think people would be surprised that you seem so calm.

Let me ask you a broad question on how we make economic decisions. Why did anyone think that the housing market would not suffer tremendous losses, particularly given the extent of subprime lending extending to those with poor credit, and also given the obvious risks associated with the increases, which could certainly be expected due to adjustable-rate mortgages and certain nontraditional loan packages?

Given the extent of the declines that have occurred, do you think that our markets are adequately regulated?

Chairman Bernanke. Congressman, first, I don't know how you got the impression that I was unconcerned about foreclosures.

Representative Cummings. I didn't say you were not concerned. I just said you seem to be pretty calm about it, and I guess what I'm trying to make sure of is that there's a connection. I note so often that what happens is that when we make a decision in the suites, we forget about the people who actually have to go through this, but I will not forget those indivuduals, especially as a Member that lives in the inner city of Baltimore.

I look at my constituents who are losing their homes, who are seeing their values go down. Baltimore appreciated, I think, something like 1200 foreclosures in January, now 7,000 just recently, in a month. I mean, things—they're becoming alarming, and I guess I'm just trying to figure out exactly how. You talked a little bit earlier about efforts on the part of the companies to fix mortgages in order to help people get fixed rates.

I just want to know, I want from you every single thing that you can possibly do to help us help our constituents.

I was just telling Representative Hinchey on the way over, when a person loses their home, it's not just their loss; it's the family's loss and their dream. The dream that they thought they had captured suddenly disappears out of their hands. Children look at them and they say, well, gee, I don't know whether I'm going to try to buy a house. That's the problem.

Many of them, I'm sure, will go a lifetime and never be able to buy a house. Again, we're talking about this economy that we want to keep strong, but what we're failing to examine, are the people who are literally being taken out of the market due to a foreclosure.

Chairman Bernanke. Congressman, I spent about half my testimony talking about this problem. It's a very serious problem. I think it hurts people; I think it hurts communities.

I discussed a number of the actions that companies are taking, and I would urge, first of all, that people in trouble get in contact very early with their servicer or their lender because the earlier you get in touch, the better chance there is to work something out.

I urge the lenders and the servicers to expand their efforts to try to restructure mortgages and help people stay in their homes. I think it's very important.

I talked about the Federal Reserve's efforts to try to work with community groups to try to assist that process, and I also talked about regulatory actions that we're taking to try to ensure that it doesn't happen again.

So, it is a very important problem, and we spend a lot of time— we've been meeting with people. I met a few days ago with Reverend Jesse Jackson to talk about some of these issues.

We have been spending a lot of time on this issue, and we think it's a very, very important issue for which we're going to do everything we can.

Representative Cummings. Those companies that are participating are pretty much voluntary?

Chairman Bernanke. We have to try to give them guidance, to show them how best to approach this problem. We think it's in their interest. It's in nobody's interest if a creditworthy borrower loses their home. It's not in anybody's interests.

We want to try to make sure that they have the flexibility and the leeway needed to restructure loans for people who should be in the home, have the credit to be in the home.

Representative Cummings. A little earlier, you said that the patchwork nature of enforcement authority and subprime lending poses a special challenge. Can you discuss what should be done to improve enforcement of provisions intended to protect consumers in the subprime markets?

Chairman Bernanke. Enforcement is an issue. We are working, as I mentioned, on a set of regulations that would apply to all lenders, so that would be a new set of rules that would apply to all lenders, including those outside of the Federal safety net.

The question is enforcement. The States are typically in charge of overseeing the non-federally regulated lenders. Some of them are very, very good at doing that, but we think there's probably more that we can do at the Federal Reserve to work with them, to coordinate with them.

We have right now going on, a pilot program where we are working with other agencies and with the States to try to compare our approaches to supervision and oversight for mortgage lenders, to see what we can learn from each other, and to try to increase our coordination with them, to try to make them as effective as possible, and try to get as close a relationship with them as possible.

Representative Cummings. Thank you, Mr. Chairman.

Senator Schumer. Congressman Paul.

Representative Paul. Thank you, Mr. Chairman. The best way I could describe the problems that we face here in this country, as well as the problem the Federal Reserve faces, is that we are, indeed, between a rock and a hard place.

We have a serious problem that we don't talk about much, how we got here. We talk about how we're going to patch it up.

The bubble has been burst. We saw what happened after the NASDAQ bubble burst. We don't ask how it was created, and now we have a housing bubble that's deflating and spreading. Nobody says, where does it come from?

What is the advice that you generally get? That is, inflate the currency. They don't say inflate the currency; they don't say debase the currency; they don't say devalue the currency; they don't say cheat the people who are safe; they say, lower the interest rates, but they never ask you—and I don't hear you say too often—the only way I can lower interest rates is, I have to create more money. I have to lower the discount rate; I have to make it generous; I have to increase reserves; I have to lower the interest rate, fix the interest rate, the overnight rate.

The only way you can do this is by increasing the money supply. I see this as the problem that we don't want to talk about.

Currently, of course, we can't follow the money supply with M3, but we can follow one of your statistics, the MZM, the rating caps available, and we see that inflation is alive and well.

That money supply figure is going up at about 20 percent, annualized. This just means the dollar gets weaker. Everybody says, well, that's great, the dollar is weaker and we're going to have exports. And that is a fallacy. It may be for a month or 2, but it just invites inflation.

Unless we get down to the bottom of it and define what inflation is, and not look only at prices—this was taught by the free market economists all through the 20th century. They said, beware, they will increase the money supply, but they will make you concentrate on prices, and we'll give you CPIs and PPIs and they'll fudge those figures, and they'll talk about wage and price controls to solve our problems.

And we ignore the fundamental flaw which is, not only have we had a subprime market in housing, but the whole economic system is subprime, and we have artificially low interest rates.

It was not under your tenure in office. It has been going on for 10 years or longer. Now we are bearing the fruits of that policy of 1 percent interest rates, overnight rates, and that is not a distortion? Instead of looking at the prices, the consumer prices which nobody in this country really believes, we need to talk about the distortion, the malinvestment, the misdirection, the bad information that has been gotten from artificially low interest rates.

In many ways some people refer to you as a price fixer, you know, because you fix interest rates. The market is powerful, and usually overwhelms and does come into play, but when the Fed fixes an interest rate at 1 percent, that is price fixing.

At the end of your testimony you suggested that we should address this housing crisis and we should have rules that would address deceptive lending practices.

I just think that is not the answer at all. The real deception is when we distort the value of money when we create money out of thin air. We have no savings. Yet there is so-called "capital." There is money available, but it comes from what you have to do when the pressure is put on you.

So I think we have to get back to the very fundamentals of where this problem comes from. The bubbles occur when we have this malinvestment and the creation of new money.

So my question boils down to this: How in the world can we expect to solve the problems of inflation—that is, the increase in the supply of money—with more inflation?

Chairman Bernanke. Congressman, first as a small technical point on the growth in money, money growth has been pretty moderate over the last 2 years.

The decrease in MZM is probably related to the financial turmoil. People have been taking their savings out of risky assets and putting them into the bank, and that makes the money data show faster growth.

I am not sure that is indicative of a policy necessarily. What we tried to do is follow the mandate that Congress gave us. The mandate that Congress gave us is to look at employment and inflation as measured by domestic price growth, as I talked about today, and I think you would agree we do see risks to inflation and we are taking those into account and want to make sure that prices remain as stable as possible in the United States.

Representative Paul. How can you do this and pursue this policy you have without further weakening the dollar? There is a dollar crisis out there, and people's money is being stolen. People who have saved are being robbed.

If you have devaluation of the dollar by 10 percent, people are being robbed of 10 percent. But how can you pursue this policy without addressing the subject that somebody is losing their wealth because of a weaker dollar? And it is going to lead to higher interest rates and a weaker economy.

Chairman Bernanke. If somebody has their wealth in dollars and they are going to buy consumer goods in dollars who is a typical American, then the decline in the dollar, the only effect it has on their buying power is it makes imported goods more expensive.

Representative Paul. But not if you're retired and elderly and you have CDs; their cost of living is going up no matter what your CPI says. Their cost of living is going up. They are hurting. That is why the people in this country are very upset.

Thank you.

Representative Hinchey [presiding]. We have a certain level of anxiety up here, Mr. Chairman, because there are votes pending shortly in both Houses. I am going to go briefly, and then we will try to keep it as fast as possible.

First of all, let me express my appreciation to you for all the good work you do, and of course for being here with us today.

The Federal Reserve has a dual mandate from the Congress. One is to hold down inflation and make sure it doesn't impede upon the economy, and the other is to promote economic growth and to maintain and sustain strong employment figures—good jobs for people as much as possible.

It seems to me that right now you are facing a very complex set of conflicting circumstances on both ends. It is going to be a real challenge to deal with this not just from your point of view, but from our point of view.

I think in a variety of ways obviously we are all limited in what we can do, and I think that the mandate of the Federal Reserve is specific.

I think that you have done just about all you can do. There will probably be some pressure to lower interest rates again, but the fact is, if those interest rates continue to go down, then the inflation issue is going to continue to be jacked up.

We are right now facing an inflationary situation which is increasing. Estimates are that it could go up as high as 2 percent over the course of the next year, maybe even higher than that.

And in that context, I think we have to realize that in that core inflation we are not including the two most inflationary aspects of this economy: the cost of energy, particularly oil, and the price of food, both of which are rising dramatically. If that continues, then the pressure on inflation obviously is going to be much, much higher.

We are also confronting a situation of a declining economy. This economy is not doing well. The example of the mortgage foreclosures on 2 million people—and it may be a lot more than that as time goes on—is really not the cause of the problem we are facing, but just a factor of it. It is a factor of the weakness of this economy.

The question we are facing is: How are we going to deal with this?

You have got a dollar which is now depressed to record lows. There is every indication that that is likely to continue unless something is done to try to address it. The major problem with the dollar being driven to record lows, the major factor of that is the deep debt that this economy is in both, from the Federal point of view and from people's personal points of view.

Federal debt now is up above $9 trillion. It has risen by more than $4 trillion over the course of this Administration. And all across the country people are spending nearly 10 percent more, month by month by month, more than what they are making.

So the increase in personal debt is going up rapidly. Obviously, that cannot be sustained. And that is in fact what is sustaining whatever growth we are experiencing in this economy.

Then people talk about the job rate is good. But as a matter of fact, the job rate is not good. One of the things that is not being considered, in the context of the unemployment rate, is the number of people who have dropped out of the economy altogether, dropped out of the job market. They are not seeking jobs. The unemployment rate is not 4.7 if you bring those people in. It brings it up well above 5 percent and maybe as high as 5.5 percent.

All of these factors are crunching in on us. It reminds me of a period that we faced a couple of decades ago which was phrased "stagflation" when you had increasing inflation and a downturn in the economy, which is essentially what we are confronting today.

We have low job growth rate in America today over the course of the last 6 years, the lowest job growth that we have seen since the Depression. I think that we deeply depend upon you to give us some advice.

What is Congress going to do to try to deal with this economy when we look at the Federal Reserve struggling with it and we see that there is a limitation on what you can do with regard to interest rates, which is your primary factor in trying to drive the economy?

Chairman Bernanke. You are certainly correct that there is a delicate balance on both sides of the mandate, which is difficult to assess.

I think the area where the Congress has the most influence is fiscal policy, obviously, and making wise decisions about spending that will promote growth, that will support and structure education and those sorts of things. That is as important as is having a rational, sensible tax policy.

I would like to be more specific than that, but I think that is really the area where Congress can be most effective.

In addition, I suggested today that there might be steps Congress could take to try to ameliorate the disclosure issue you mentioned. The Federal Housing Administration is one potential vehicle, but there may be others.

I do think there are things that can be done. I guess I should also say that while we do expect slower growth, fortunately, we do not see anything approaching a period of the 1970s. We think growth will be more moderate, and inflation has some risks to it, but we do think that the performance should be much better than that, period.

Representative Hinchey. I hope your optimism on that has some validity. I would hate to see it go in the opposite direction. We are teetering right now in a very, very difficult set of circumstances.

I am very pleased to hear you talk about how this Congress should be focusing more and more attention and resources on things like education and health care and building up the basic infrastructure.

We are now spending $2 billion a month in Iraq on a war which was justified under completely falsified premises. So this Congress—you are right, Mr. Chairman—has got to refocus its attention and begin to deal with the basic aspects of this economy and deal with the situation in the Middle East much more constructively than we have.

Because I think what you have done with the interest rate situation has sustained things for a longer period of time than it would have, but I think that that time is just about on the edge of running out.

I am really concerned about what is going to happen now over the course of the next few years.

Thank you very much.

Representative Maloney [presiding]. Mr. Bennett.

Senator Bennett. Thank you very much, Madam Chair.

First, just a personal observation. When I first came to the Senate 15 years ago and attended these meetings, the drum beat that I heard over and over again was: We are not making enough credit available to the poor.

We were coming out of the savings and loan crisis. And in response to that crisis, financial institutions were bringing down the basis on which they would make loans in order to keep themselves from the bankruptcies that occurred with the savings and loan crisis.

The argument from Congress was: You were far too restrictive in your requirements as to who can get money, and you should loosen up; you should make credit available to the poor; you are failing your social responsibility for not making credit available to the poor.

Now I find it interesting that we find that the new cry is: You have made too much credit available to the poor. It is your responsibility, you financial institutions.

I do not in any way condone those financial institutions that have played fast and loose with the rules. They are the ones that are paying the biggest price with this meltdown, and they should.

But we should remember that in the circumstance, many people have acquired homes that would not otherwise have homes, and the better off they will be. Many of those borrowers who were getting hurt falsified their income statements. Others were speculators who were flipping properties and had not intention of living in them.

They were participating in the bubble and betting on tulip time, betting that some greater fool would come buy the house at a higher price than they paid, and they lost their bet, and they deserve what they got.

The fundamental question, picking up a little bit on what Senator Sununu was saying, we have heard forecasts as to how long it will take for this to work itself out, and it will work itself out.

Markets make better decisions than governments do. And the market will punish; the market will reward, and the market will ultimately stabilize.

I remember forecasts that it would work itself out in about 6 to 8 months. Give me your forecast now. That clearly is not right, and I do not know whether you made it, or whether I made it, or whatever; and that does not matter. Look into your crystal ball. Is it going to take a year? Is it going to be the end of 2008 before the market has sorted this all out?

Do you think that is too pessimistic, or too optimistic? What is your sense?

Chairman Bernanke. Senator, first the reason that many forecasters, including the Federal Reserve, have understated the amount of time it would take for this to resolve has been because we have continued to get bad news on subprime lending and the implications of that for housing demand.

We saw that in the spring. We have seen it now more recently. And these things have led us to extend the period of adjustment.

From our perspective, what we are asking ourselves is: When will housing construction stabilize, even at a low level, so that it no longer subtracts from growth percentage point as it has been?

That does not mean that it is going to be recovered to where it was or anything like that. At the risk of being proved wrong again and having a new credit crunch and other factors delaying it even further, our current calculation is that things will begin to flatten out in the second quarter of next year. So it is still I guess 6 months, but that is of course very provisional.

One of the things we look at very carefully, as the data come, in are what is happening to permits and starts and mortgage applications and the like. We continue to adjust our forecasts according to that.

Senator Bennett. You are more optimistic than some of the other economists I have talked to. That is helpful.

Let me switch topics entirely now that we have you here with your background and address a question that I think is long term—

very serious for the American economy. The short-term label on it is called "Sovereign Wealth Funds."

As we see countries by virtue of the oil prices become very, very wealthy, we think of the Middle East countries, but we also have to include Russia in this category. We see a change in the underlying economic structure. Instead of wealth being held in the hands of shareholders who have an agenda to increase the wealth, we see wealth held in the hands of governments who have political agendas as to how they will use the wealth.

If I may draw a comparison to two competing examples: ExxonMobil when it makes money off of oil, uses that money to try to find more oil; Hugo Chavez, when he makes money off that oil, uses it to try to destabilize South America and become the next Fidel Castro.

We are seeing foreign governments making purchases that have political implications. This is not the Japanese buying Rockefeller Center. I remember everybody being all upset in the 1980s: The Japanese have bought Rockefeller Center. And I said, yes, and what are they going to do about it.

Are they going to jackhammer it up and take it to Tokyo? They are stuck with it. It is in New York. And as it turned out, they sustained a fairly significant loss on the value of Rockefeller Center after they bought it.

But in today's world, you can buy a company. You can dominate an industry that is worldwide. Then, inject into that the geopolitical agenda rather than an investor's agenda and that could make your job significantly more difficult.

I am sure you had some thoughts on this down at the Fed. I would appreciate it if you would share some of those with us.

Chairman Bernanke. Certainly, Senator, this is a topic of discussion at the G7 recent meetings, Sovereign Wealth Funds. There are quite a variety of them. Norway has one, for example. But of course, many of them are based on oil revenues or foreign exchange currency revenues.

The view of the G7—collectively we asked the IMF and other institutions to work with us on this—that Sovereign Wealth Funds need to have a code of conduct that describes how they go about investing in other countries.

The code of conduct includes transparency, so we know what they are doing; governance, so we know how they are controlled and to what purpose; and importantly, to the issue you are referring to, that their investments be economically oriented and economically motivated in order to make a profit or a return, as opposed to gaining control of an important company or industry.

So I believe it is very important that Sovereign Wealth Funds follow that type of behavior. In return for that, I think we need to keep our markets open. And when they are investing as good investors and good citizens, that we should allow them access to Rockefeller Center, if that happens to be what they want to buy next.

But it is an important issue because they are now larger than hedge funds collectively, and the way they conduct their investments will be very important as we go forward.

But again, I understand your issue. The reform of CFIUS that recently took place tries to address the national security aspects of this. So I think the combination of the code of conduct by the Sovereign Wealth Funds, national security protections along the lines of CFIUS, but open financial and capital markets of the United States that will attract foreign investment I think are the elements that will allow this to work.

Senator Bennett. Thank you. My time is up. I will just make this one quick comment:

Of the oil companies that dominate the world now, those that are owned by shareholders like ExxonMobil represent a small percentage. The dominant oil companies are Gazprom, Pemex, and companies of that kind. And as we beat up on American oil companies as if they really control the market, we should understand that the market is being controlled by foreign governments.

Senator Casey [presiding]. Congresswoman Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. To some extent I would like to associate myself with the remarks of Congressman Paul earlier about some of the things that have been going on structurally. I think that is really where the problem is.

I represent Orange County, which is headquarters to probably all of the major builders, even in the United States. We export construction of new homes, in particular, from Orange County.

I am also the home of four mortgage originators: Ameriquest, 21st Century, and so many others. And I represent Anaheim and Santa Ana, California, which 1 out of every 3 homes up for sale right now in those two cities, or 33 percent, are from foreclosure. This is really, really hitting home.

By the way, I was just out to purchase a home in the last 10 days. I have an 800+ credit score. I have no debt, basically. I have a lot of assets. And I went to the one institution where I carry a small loan with them, a home loan, and they quoted me a price of 100 basis points over what is quoted in what we are talking about as far as rates in the paper, in the newspapers.

If there is a credit crunch on for somebody like me, there is really a credit crunch on for people trying to work out of their homes and trying to save their credit, or trying to save their home.

I think it is a very, very big problem for us. And of course Bill Gross, a big Republican and CEO of PIMCO, on Monday, basically told us that he thought he would foresee this for another 2 or 3 years. We are really not anywhere close to the bad part of this.

As well as some of the homebuilders, the new builders who told me, "I was selling product at a million dollars, new product at a million dollars. And today, Loretta, you can go down and the same product I am selling for $700,000 5 miles out of your District in Orange County near the Coast," not one of those places where you are out in the middle of nowhere. They are really having problems.

So I think we have really got a problem on our hands. But this generates, I think, from really bad policy, fiscal policy coming out of Washington, DC, in particular over the last 6 years. I really have to say that.

And Mr. Chairman, you are at the Federal Reserve, but you were the advisor to the President on this. I think we have some real problems here, structural problems.

I think the decline of the dollar is only beginning. And I would ask you, I have lots of questions, but I don't have time because we have a vote on the floor, but I would ask you that in your private meetings you get this Administration to understand they need to invest in their people's health. They need to invest in their people's education. We need to invest in transportation, in communication, and things that make our people more productive. And we need to stop wasting our money.

Mr. Hinchey said $2 billion a month in Iraq. It is $3 billion a week of operating expenses in Iraq. That is not even going to my defense contractors for future systems weapons in California. No. That is operating, and it does not come back to the United States.

Please, in your private meetings, you have a different role now, but in your private meetings, we need to get this Administration to understand we cannot continue to spend and not invest in our people and in our country.

That is what I would like to tell you this morning.

Senator Casey. In the interest of getting everyone to vote, the House is now having a vote, I would ask that we take a brief recess. I know the Senate has one vote. I think I can get back here rather quickly, as can other Members.

Mr. Chairman, I know you have other engagements. You are able to stay here until 12:20? That is my understanding.

We will take a brief recess and resume.

[Recess.]

Representative Maloney [presiding]. I apologize for having these votes and running back and forth.

Mr. Brady.

Representative Brady. Thank you, Madam Chairwoman.

Mr. Chairman, thank you for being here. So far about $50 billion of losses have been identified in the subprime loans at this point. Some estimates say the final amount may be equal to the savings and loan default with a total of about $150 billion.

Is that in the ballpark of what you estimate to be eventually declared?

Chairman Bernanke. Yes, that is in the ballpark. Although I would emphasize that there is no reason to think that would all be in financial institutions. It would be spread around to a lot of investors of different types.

Representative Brady. Do you see that impact working through our economy until the second quarter of next year?

Chairman Bernanke. It is not the financial losses, per se, but rather the weakness in the housing market that will keep construction on the downtrend probably through at least early next year.

Representative Brady. Do you see there being a maturing market for these mortgage assets that are basically illiquid at this point? I know Secretary Paulson is working to work with the master liquidity enhancement conduit. Does the Fed see a way to accelerate the mature market where we will see the true value of assets that are being held?

Chairman Bernanke. First I should say the markets are working hard to achieve that. The commercial paper market, for example, has stabilized and a lot of the bad paper, or weaker conduits, have unraveled and the stronger of the conduits are now stabilizing and are being funded.

With respect to Federal Reserve's role, we along with other bank regulators—the SEC and so on—whose job it is essentially to look at it from the perspective of the banks and the other financial institutions to make sure that they both have their own balance sheets, and through the conduits in which they have interests, or which they sponsor are appropriately marking down assets according to the best available prices or measures of value.

Representative Brady. How long do you think it will be before we see the true value of those assets? Do you expect that to be occurring within the next quarter? Obviously they have appreciated significantly.

Chairman Bernanke. Again, speaking from the point of view of financial institutions, I think they are being aggressive in marking down their assets. Based on what they can see, they have in most cases disclosed the losses that they have.

The possibility remains that assets, individual assets, will continue to be marked down as they get downgraded for example, which requires rethinking.

I do believe financial institutions are being aggressive, and it is certainly very much in their interests to get that information out as fast as possible.

Representative Brady. Like a Master Liquidity Enhancement Conduit (MLEC), I am trying to understand the creation of it. Do you think that accelerates the true value of these assets, or delays them a bit?

Chairman Bernanke. As I discussed earlier, I think it depends on the execution. If it does involve the oversight of investors and a range of financial institutions, then ideally the assets go into the MLEC at a fair value at a market value.

So if it works properly, I think it would speed up the recognition of values in part because it would remove some of the risks of fire sales and a rapid drawing down of assets in some of these vehicles and allow the market to stabilize and begin to make a better long-term valuation of what is in these assets.

Representative Brady. A final thought on the subprime. I know that you have given it both thought and action. I, like most Members of this body, am a big believer in home ownership for all the many benefits of it.

It seems to me Congress's policy is encouraging regulation and tax incentives. We have encouraged home loans and business loans to borrowers who do not have a strong credit history, all with the worthy goal of increasing lending to those constituencies.

But given the weakness that this crisis has revealed from income verification to lax underwriting, to suspect credit ratings, to what extent have congressional policies such as the Community Reinvestment Act—or truthfully any other policy—to what extent have Congressional policies played a role in the subprime crisis?

Chairman Bernanke. That would be very difficult for me to judge. I think what I would like to say is that lending to people without long, well-established credit histories can be both profitable and socially beneficial, and we have seen that.

We have seen responsible subprime lending, and we have seen subprime credit extended in other areas as well. We have also seen at least the reduction of red lining and those similar issues that were a problem in the past.

I think, again, it depends on execution. Banks can lend to underserved populations, but the rules of credit worthiness and underwriting still obviously apply. We have learned that lesson in the last couple of years.

Representative Brady. I asked that only because when we have taken the approach of sort of going after the market on this, and there is substantial merit to that, but I just wonder if it is time for Congress to reassess our policies. Is it time to require a down payment?

Do we have more substantial asset tests when you take out a variable rate mortgage? Because there you are, not only open to the economy, but you risk the interest rate fluctuations as well.

Is it time for Congress to take a look at back to basics, as to how we can both encourage home ownership but lessen the risk of bad loans?

Chairman Bernanke. Two comments. One goes back to the CRA issue. A lot of the subprime lending was done by nonbank lenders who have no CRA obligations. In that case, obviously there was no CRA effect.

As far as underwriting is concerned, you cannot really legislate good underwriting. But you can require, for example, that lenders take appropriate account of ability to repay and so on. That is in some of the bills that are there, but it is also something we are looking at in the Federal Reserve in our regulatory process that we expect to have next month to release some rules.

Representative Brady. Thank you. Will there be any recommendation for Congress, Mr. Chairman?

Chairman Bernanke. No, just a rules change.

Representative Brady. Thank you, Mr. Chairman.

Senator Schumer [presiding]. Senator Casey.

Senator Casey. Thank you, Mr. Chairman.

I appreciate the opportunity to participate in this hearing. Chairman Bernanke, we appreciate your patience with us voting and having a brief recess.

I just have two areas to cover. One of course is on the subprime crisis. And I have a second area to cover. I wanted to first of all highlight some of your testimony.

On page 6 of your testimony, in the section that deals with subprime borrowers, you say at the end of that first full paragraph and I quote:

> Should the rate of foreclosure rise proportionately, communities as well as individual borrowers would be hurt because concentrations of foreclosures tend to reduce property values in surrounding areas. A sharp increase in foreclosed properties for sale could weaken the already struggling housing market and thus potentially the broader economy.

Unquote.

Which is what your testimony was. I thought that was a good summation of what this crisis means for individual families and their communities, but also a larger impact on the economy.

I just wanted to direct your attention to two charts. The first is a map developed by this Committee: "Projected Economic Costs of the Subprime Mortgage Crisis State by State."

[The chart referenced above appears in the Submissions for the Record on page 58.]

I note that Pennsylvania is around $2.5 billion. Other States are higher than that. The overall numbers—for those who cannot see it—for the third quarter of 2007 to the third quarter of 2009, loss of home value, loss in neighboring property value, loss in property tax value,the overall number based upon this research can be summarized this way: Seventy-one billion dollars in housing wealth directly destroyed because of the foreclosures reducing the value of the home. Thirty-two billion dollars in housing wealth indirectly destroyed. We know these numbers. I thought this was a graphic presentation of what it means State by State and nationally, and you know that as well, Mr. Chairman.

I do note in your testimony, and I was grateful that you highlighted a lot of the strategies that are being employed now, on pages 7, 8, and 9, loan workouts, loss mitigation techniques, repayment plans, temporary forbearance, loan applications, work with community groups.

I note that Senator Schumer, Senator Brown, and I have worked on legislation. But in addition to that, we pushed to have $100 million—we actually wanted $300 million in the budget, but we came out with $100 million—to help fund these community groups that are trusted by home owners and people within that community, but also have some certifiable expertise.

So you highlight a lot of the strategies that banks and financial institutions are employing, the work the Fed has done, the work the Congress could do, especially with the Federal Housing Administration, and I say all that just as a preliminary backdrop to the question:

If someone in Pennsylvania or any other State is watching your testimony today, even though you have covered this broadly and specifically, I would ask you just to restate what you can tell them that you are trying to do, the Fed is trying to do, to deal with the immediate impact. A lot of what we talked about here will prevent this from happening again, we hope. We are working on that. But what can you tell them now that the Fed is doing in the immediate or near term to help those who have already been the victims of not just the crisis, but the impact of the reset on their bottom line families?

Chairman Bernanke. If I were speaking to someone in that situation, the first thing I would say to them is, "Get in touch with your lender."

Experience shows that the earlier you get in touch, the more quickly and more likely it is that you can resolve the issue. Indeed, the banks tell us that one of their big problems is that nobody will respond to their calls, and they find it very difficult.

So I would give that piece of advice to your constituents.

With respect to what the Fed is doing, obviously our first responsibility is to try to maintain a healthy economy, which will help reduce the costs that you allude to. But in addition, as I have discussed in my testimony, we are quite active.

As you know, we have Reserve Banks around the country, in the different regions of the country, and we have been quite active in working with those community groups that you mentioned, trying to help them identify strategies, help them identify communities where the problems are most severe and where their efforts should be concentrated trying to help with their training.

We have convened groups at the Fed and other places—I've spoken myself to many, many different people—about the barriers to refinancing, for example, the accounting and other barriers.

The Fed was one of the first to bring forward this issue of FAS–140 which is an accounting provision that can impede refinancing. So in all these dimensions, we are doing what we can as a central bank to assist in resolving this problem.

Your characterization—I read the JEC report and it properly characterizes this as a very, very important problem that has implications not just for individuals, but for the broader economy as well.

Senator Casey. Do you see any further interventions that the Fed is planning or at least contemplated or seriously considered?

Chairman Bernanke. We hope that our actions to stabilize financial markets and the economy, will help the credit crunch situation we see now.

We still have to see that improve over time. It will be very nice to see the secondary markets for prime jumbo loans, for example, jump up again. We get to see more activity.

One of the problems right now is that creditworthy borrowers who would like to refinance out of the subprime ARM are finding it very difficult to do so, because of tightened credit terms.

Credit terms should be tight and underwriting should be good, but to the extent that there's an artificial reduction in supply of credit associated with the financial market situation, we hope that our policies would lead, over time, to a more normal, better functioning financial system.

Senator Casey. I have one more question. I want to turn to a second chart. The staff of this Committee makes great charts, and I want to make sure we use them.

[The chart referenced above appears in the Submissions for the Record on page 59.]

This one is very simple, but profound in its impact. The gap—and anyone who can differentiate between red and blue on this chart, can see it—the gap between productivity, which has been rising, as we see, since the late 1990s, compensation per hour rising, but not nearly as significantly.

That gap between the blue, the higher line, the blue line, and the red line, I think, is an academic way of expressing profound frustration and anxiety that a lot of families feel. They feel that they are working harder than ever before and the data supports that, the productivity and output numbers support that, but their bottom line is not growing.

And on top of the wage stagnation or failure to grow, they have higher healthcare costs, even though they've leveled off; higher costs in tuition and stories about an increase in fuel for the average family, paying maybe 11 percent more this year that I saw in a report yesterday.

I ask you—and this is a tough question to answer briefly, but I'd ask you to choose one of two options, because I know you have some limitations on what you can say, but in the context of what either Congress can and should be doing to reduce that gap between productivity and wage growth, or if you cannot make such a recommendation, or don't feel comfortable with doing that, just a general philosophical statement about what can we do as a society and as a government, to try to bring those two lines together, to have higher wage growth in the context of higher output.

Chairman Bernanke. I was asked a little earlier about what Congress could do to address these problems. You pointed to some of the issues that are hurting middle class living standards.

One, of course, is energy. That has been a big problem throughout this period. Certainly, I know that Congress is working on energy policies and trying to find ways to provide alternative sources of energy that would be more economical in the long run.

You mentioned healthcare, where the costs continue to rise. That's part of our inflation issue, and we measure those costs in our inflation index.

Certainly, there are numerous reforms that can be undertaken. It is far too much to try to address in 15 seconds, to address that very important problem. I've spoken on a number of occasions, and this doesn't directly address your issue, but certainly there's a lot of concern about the rise in inequality in our society, and part of that, at least, is the result of the increasing return to high education and skills that we see in our modern technological, mobilized economy.

And although it's a medium- to long-term solution, I do think that education and training and skill creation is critical for creating a broad base for prosperity in this country.

Senator Casey. Thank you very much, Mr. Chairman.

Senator Schumer. We want to thank you. I know you have to leave at 12:20 p.m., but I just have a quick, quick question here.

In your testimony, you suggested that GSEs might be allowed to securitize jumbo loans with the Federal Government acting as guarantor. I think that's a very good idea.

In fact, legislatively, it is something that I would try to introduce and get passed. Do you have any idea of how high that ought to go? For all loans, even two- or three-million-dollar loans?

Chairman Bernanke. That's up to Congress, but, certainly——

Senator Schumer. What would be your thought?

Chairman Bernanke [continuing]. A million dollars.

Senator Schumer. Thank you, Mr. Chairman, for your patience. We had a series of votes. We very much appreciate your being here.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

Submissions for the Record

JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER
CHAIRMAN

JOINT ECONOMIC COMMITTEE HEARING: "THE ECONOMIC OUTLOOK"

Federal Reserve Chairman Ben Bernanke Testifies

Opening Statement
Sen. Charles E. Schumer, Chairman
November 8, 2007

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're always pleased when the Federal Reserve Chairman comes to share his views on that state of our economy.

Chairman Bernanke, when you came before this Committee last March, one of the major topics we discussed was the potential fallout from the subprime lending crisis. It's something this committee has been very concerned with for quite some time. And I think you'd be the first to admit that, contrary to what you said at the time, the subprime mess has not been "contained", but instead has proved to be contagion that has spread in dangerous ways throughout not just the housing market , but our economy, and the global financial system.

The seizing up of the credit markets this summer was the first, and clearest indication of the unanticipated, and potentially disastrous, risks that out-of-control subprime lending poses to the financial markets. There is now a lack of confidence in creditworthiness throughout the market, and at the core of is a lack of confidence in the subprime mortgage market. Until we correct that, we will not solve our broader problems.

I do want to applaud you and the Federal Reserve Board for your aggressive, and I believe appropriate, response to this summer's liquidity crisis. It is vital that we maintain the health of our financial markets, and to ensure that they function smoothly, and you deserve credit for your prompt actions

However, while we did weather that summer storm, **I'm very concerned that there may be a bigger storm on the horizon.** Quite frankly, I think we are at a moment of economic crisis stemming from four key areas: falling housing prices, lack of confidence in creditworthiness, the weak dollar and high oil prices. Each of these problems alone would be enough of a threat to our economic well-being. **But taken together, they are essentially the four horsemen of economic crisis.**

First, as we have warned, and as you acknowledge in your testimony, we face a wave of foreclosures in the next years that threaten millions of American homeowners and their neighbors. The housing boom has busted, and we may see trillions of dollars in lost home values across the nation. Second, the credit markets remain in crisis. Third, the dollar has dropped dramatically against most of the other major currencies of the world, and seems to hit lows not seen in decades nearly every day. And finally, oil prices keep reaching near record highs, driving up energy costs in all sectors of the economy.

Even our bedrock assumptions are being put into doubt. As housing prices decline, there are real fears that we won't be able to depend on consumers, the engine of our economy over the past few years, to keep spending. And now we hear that foreign investors may no longer be confident in the dollar as the global currency of choice. I'm not surprised to hear experts, such as your predecessor Alan Greenspan, warn about the threat of recession. I've begun to worry about worse.

In particular, as I watch bank after bank write down bad investments tied to baroque financial instruments that even sophisticated investors don't understand, I fear for the stability of our financial system. I've talked about the wild wild west of subprime mortgage brokers. I'm beginning to wonder whether we have a wild wild west of unregulated financial instruments, of SIVs, and mis-rated CDOs, and other complicated investments whose values are not marked to market, or even marked to model, but to quote one Wall Street strategist, are "marked-to-make-believe." **To quote you, Mr. Chairman, the markets too want to know how much these damn things are worth, and I want to know what all of us – the Federal Reserve, Congress, and this administration - can do to help assuage their fears.**

I'm very concerned, Mr. Chairman, that none of the regulators, including the Federal Reserve, are acting quickly or boldy enough to deal with the risks we're facing. A laissez faire hands off attitude might be appropriate if we had any one of these crises alone. But, confronting all of these problems at once should be a call to action because the danger we face is so much greater.

I know that Secretary Paulson has organized a "super conduit" to try to deal with the liquidity crunch faced by SIVs, and the threat they pose to the broader financial markets. To be direct, I'm worried that this just a shell game, an attempt to move bad investments around and keep them from landing back on the books. I'll be curious to hear your opinion today, Mr. Chairman, about the secretary's plan, as well as your views about the risks these complex and opaque pools of capital now present to our financial system, and how you intend to deal with this crisis. If you feel that you don't have the tools at your disposal to address these problems, then I hope you'll share with us your views on what we in Congress ought to do.

I am glad to see that so much of your statement is given over to the importance of helping distressed subprime borrowers. You mention some of the efforts my colleagues and I have made, and I won't spend more time on that right now. But I will say that it would be nice if the Administration would join us in our attempts to protect American families from the fallout of the subprime lending disaster. The policy responses from the administration have not come close to matching the magnitude of the crisis. There is a lack of confidence that anyone is in charge. Mr. Chairman, if you feel that in your position you cannot speak publicly about the changes that are needed, then I urge you to speak privately to members of the administration. Use your position to jawbone them into action. Your predecessor was not shy about putting his prestige and credibility to work behind the scenes, and I encourage you to do the same.

One of the great legacies of the American economy has been its ability to make everyone better off. Throughout most of our history, when our economic pie has gotten bigger, everyone has shared. But over the seven years of the Bush administration, that has not been the case. Even in the recovery of the last few years, the benefits have gone mainly to those at the top. Now, as we face an economic slowdown or worse, I am very worried that it is those Americans who haven't shared in our recent growth who will bear the brunt of economic decline, and that the policies of this administration will only further exacerbate their difficulties.

I do not pretend that there are easy solutions to troubling challenges facing our economy. But we cannot shy away from these challenges. I look forward to your testimony on the economic outlook and to an interesting discussion of how we can best meet these and the other economic challenges we face.

Normally I encourage all of our members to make opening statements. But because we only have a 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.

Now I turn the floor over to the committee's ranking Republican, my colleague on the House side, Congressman Saxton.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

Congressman Jim Saxton
Ranking Republican Member

PRESS RELEASE

For Immediate Release
November 8, 2007

Press Release #110-29
Contact: Christopher Frenze
Republican Staff Director
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STATEMENT OF CONGRESSMAN JIM SAXTON RANKING MEMBER

THE ECONOMIC OUTLOOK

WASHINGTON, D.C. – Chairman Bernanke, I am pleased to join in welcoming you once again to the Joint Economic Committee and appreciate your testimony on the economic outlook.

According to standard measures of performance such as economic growth and the unemployment rate, the U.S. economy appears to be doing well. Real economic growth was 3.9 percent in the third quarter, while the unemployment rate remained at a relatively low 4.7 percent rate in October. Exports and consumer spending continued to advance, reflecting the resilience of the U.S. economy.

The recent pace of economic growth is all the more remarkable given the challenges facing the economy. Residential investment declined at a 20 percent rate in the third quarter, continuing a longer trend. Housing prices are falling in many areas of the country, as housing inventory levels rise. Oil prices are nearing $100 per barrel, and the dollar is falling.

In recent months, it has also become clear that a number of large financial institutions have invested in mortgage securities of dubious quality. Huge write-downs of assets by Citigroup and Merrill Lynch are recent validations of the serious concerns about the value of mortgage-backed securities. Uncertainty about the extent of bad investments related to subprime and other mortgages has spread, resulting in sharp declines in the valuation of bank stocks. Financial markets have become very volatile.

Even though recent economic growth appears to be strong, the combination of a decline of home building, falling housing prices, spiking oil prices, and financial turmoil risks the continuation of healthy economic growth. The Fed has acted to reduce the strains on the financial sector and to head off a slowdown in the economy. According to the Blue Chip consensus and Federal Reserve forecasts, the economy will continue to expand through 2008.

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JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER, CHAIRMAN
REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

Statement of Carolyn Maloney, Vice Chair
Joint Economic Committee Hearing
November 8, 2007

Good morning. I would like to thank Chairman Schumer for holding this hearing to examine the economic outlook. I want to welcome Chairman Bernanke and thank him for testifying today.

We are all eager to hear the Chairman's remarks about the important factors shaping the Fed's views on the economic outlook and what they may mean for monetary policy during these tumultuous times.

Tremendous uncertainty remains about how the subprime fallout and the housing slowdown will infect the broader economy. Calling it a subprime crisis is no longer adequate as the breadth and depth of this escalating credit crisis roils our major banks and financial institutions almost daily.

The seeming inability of our most sophisticated and respected institutions to measure their exposure to these assets, and more importantly to manage the risks associated with them poses a serious threat to our financial markets. The chairman of General Motors' recent admission that he couldn't tell with any accuracy what the company's exposure is to subprime losses at GMAC is both stunning and frightening.

Investors did not understand what they were buying when they held collateral debt obligations, CDOs, or structured investment vehicles, SIVs, and now we are seeing billions of dollars in losses on these investments. Risk is coming home to roost with a vengeance.

I hope we will hear from Chairman Bernanke about what we should do to increase transparency for these complex investment products to assure smoothly functioning markets. We have yet to see the full impact of these losses on the economy or the labor market. In the near term, forecasters expect the economy to slow as high energy prices and falling home values squeeze consumers. All of which points to a gathering storm that could drag down the economy, taking thousands of American jobs with it.

The Federal Reserve has worked to prevent the economy from derailing and has eased the credit crunch by lowering its key interest rate, but at your last meeting the Fed signaled a wait-and-see approach to further actions.

With crude oil edging toward $100 a barrel and the dollar sinking like a stone, inflation is certainly a concern for the Fed. The dollar fell sharply again yesterday as the Chinese government signaled a shift away from purchases of dollars in favor of Euros. I think we'd all like to hear more from Chairman Bernanke about any contingency plans the Fed has, should economic forces move toward a significant fall.

Our tremendous fiscal imbalances, including our record $9 trillion debt, is further complicating the Fed's job of setting the right course for monetary policy.

But for the moment, core inflation remains in check and there is little evidence that the labor market poses any real inflationary risk. Wages have barely kept pace with rising prices and they have lagged far behind productivity, leaving no serious concern about igniting inflation. I hope the Chairman will agree that how American families are faring should not take a back seat to fighting inflation.

By all accounts, we haven't felt the worst of the housing market slump. Millions of Americans are worried that they can't afford to keep their homes, let alone to heat them this winter.

Congress is working to keep people in their homes and prevent another crisis like this from happening again. In the House of Representatives, we have passed legislation to shore up the Federal Housing Authority and the GSEs. And this week we passed sweeping mortgage reform and anti-predatory lending legislation in the Financial Services Committee that will now head to the House floor.

These are important first steps, but there is more to do to help restore the American Dream for hard working families.

Mr. Chairman, thank you for holding this hearing and I look forward to gaining some insights into how the Fed will balance the various risks to the economy when setting monetary policy.

JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

SENATOR SAM BROWNBACK, SENIOR REPUBLICAN SENATOR

Opening Statement of Senator Sam Brownback
"The Economic Outlook"
Hearing of the Joint Economic Committee
November 8, 2007

Mr. Chairman, thank you for scheduling today's hearing to give us the opportunity to hear from Federal Reserve Chairman Bernanke on the state of the economy. Since we are all interested in what Chairman Bernanke has to say and want to have time left for questions, I will keep my opening remarks brief.

The American economy has demonstrated amazing resilience in the face of a variety of challenges. We have witnessed 24 consecutive quarters of positive real economic growth, 50 consecutive months of payroll employment growth (the longest on record), and significant expansion in our exports.

My perception, however, is that our economy is at a bit of a crossroads. In the short term, the severe slump in all aspects of the housing market, the subprime mortgage fallout, and the escalating price of energy seem to pose threats to our continued economic expansion.

One thing seems clear to me. In the face of mounting pressure on the economy, the idea of raising taxes seems exactly the wrong prescription. Failing to fix or, better yet, repeal the Alternative Minimum Tax will hurt families and hurt economic growth. Allowing capital gains and dividend tax relief to expire without even a vote or imposing higher rates of taxation on carried interest will only hamper the efficient movement of capital within the economy. In my view, the efficient movement of capital is a critical issue at any time, but especially now. Such action can only serve to hurt investment and exacerbate liquidity issues that may exist in markets.

Without asking you to wade into the fiscal policy debate, I would be interested, among other things, in your thoughts about the impact that higher tax rates, particularly on forms of capital income, would have on investment, liquidity, and the efficient movement of capital. Thank you for taking the time to join us this morning.

PREPARED STATEMENT OF REPRESENTATIVE ELIJAH E. CUMMINGS

Welcome Federal Reserve Chairman Ben Bernanke to this important hearing on the U.S. Economic Outlook. As you know, this Committee has a broad mandate that includes the duty to make recommendations about economic policy that affects each and every American. It is with great anticipation that I welcome your testimony and look forward to hearing your views about the state of our economy and how to prevent what tentatively looks like a forthcoming recession.

As you know, Mr. Chairman, you testified in our last hearing on the U.S. economy in March of 2007 that you foresaw an upward swing in the U.S. market and you believed that the potential fall out from subprime lending—or rather "predatory" lending—could be "contained" instead of spilling over to other industries, such as the financial services and construction industries, amongst others.

However, despite your high hopes, the exact opposite has happened. The housing and mortgage crisis has only worsened—with housing prices falling nationally for the first time since the Great Depression. Making matters worse, the American people continue to suffer under a market where loosing ones home has become the nightmare of 1 out of 5 homeowners with subprime loans, costing 2.2 million families their homes.

The stark reality is that we as Members of Congress see the results in the devastating experiences of our constituents. Anyone who walks through my district will see family after hard-working family losing their homes because they were victimized by predatory subprime lenders. In fact, Maryland is currently ranked 22nd nationally in home foreclosures—compared to last year's ranking of 40th adding to this crisis the city of Baltimore has experienced a loss of $1.8 billion over the past 2 years in reduced property value.

The effects of the subprime lending crisis are rippling throughout the economy, reflected in everything from the accelerating slump in housing markets across the country to the summer's global financial crises driven almost entirely by fears about the collapsing subprime mortgage market. While continuing to jeopardize the overall economy, the subprime crisis also continues to drive tens of thousands of families out of their homes, constricting the flow of credit to millions of Americans and directly and indirectly affecting our financial services sector.

Investors in the financial sector have suffered from extreme losses that appear to only be worsening. Morgan Stanley recently declared a $3.7 billion loss on subprime mortgage-linked investments resulting in an expected $2.5 billion hit to its overall net income. Even financial stocks have declined due in part to the effect of the subprime lending crisis.

Although I applaud the Federal Reserve for their efforts to alleviate the negative effects of the subprime crisis by issuing guidelines to be followed by lenders and participating in programs like NeighborWorks America, a nonprofit organization that helps thousands of borrowers who are facing current or potential distress in obtaining assistance from their lenders, more needs to be done.

Therefore, I have a difficult time buying the picture of potential economic growth being painted when I see people who may have lost their only chance in a lifetime at home ownership.

All the while, Mr. Chairman, this Administration and President have continued to spend U.S. taxpayer dollars unwisely. As you are aware, on Monday, October 22, 2007, President Bush requested an additional $46 billion for U.S. military operations in Iraq and Afghanistan. This is on top of the original $150.5 billion requested at the beginning of Fiscal Year 2008, bringing the total amount requested to $196.4 billion—more than 10 times the original $50 to $60 billion cost estimated by the White House in 2002. Meanwhile, the Administration is satisfied with continuing our military operations in Iraq—functioning on borrowed time and largely borrowed money, costing an astounding 70 percent of an estimated 2.4 trillion in taxpayer dollars over the course of the next decade according to the Congressional Budgetary Office. The result is a limited budget to advance our priorities at home—like aiding the increasingly unstable real estate market, advancing U.S. trade and safeguarding a continued decline in the value of the U.S. dollar.

In fact, Mr. Chairman the dollar has declined 6 percent against the Euro since August. However, the Euro is not the only currency rising against a falling U.S. dollar: the Australian dollar, the Japanese Yen, and the Canadian dollar are following the same trend. Even in an address by the President of France, Nicolas Sarkozy in a joint session to Members of Congress and the Senate made a striking warning that "the dollar cannot remain solely the problem of others" and that if "we are not careful, monetary disarray could indeed morph into economic war, and we would all—all of us—be its victims." And sadly—it appears that President Sarkozy's warning has increasingly becoming our reality. Countries that hold large amounts of U.S.

dollars are already changing their currency reserves in favor of the Euro: Russia, Switzerland, the United Arab Emirates and Venezuela are just few examples.

It is time that we focus on individuals—and on those who are being left behind in our economy. According to data recently released by the Internal Revenue Service, Americans' average income in 2005 was less than in 2000, the fifth consecutive year in which this was the case—and the first period since World War II during which incomes have not grown. We also see that income and wealth are becoming increasingly concentrated in the hands of a very few. Thus, those making more than $1 million received just under 50 percent of all the income gain that occurred in 2005. We need to focus on ensuring that we do not leave increasing numbers of our fellow citizens behind as we work to move ahead.

Chairman Bernanke, I appreciate you appearing before us today. I look forward to your testimony and learning what steps we can take to improve our dire economic situation.

PREPARED STATEMENT OF REPRESENTATIVE RON PAUL

Our economy finds itself in a precarious state. Oil prices are rising, gold is nearing all-time highs, and the dollar is nearing all-time lows. The root of this crisis, as with past financial and economic crises, results from Federal Government intervention into the economy, not to anything endemic to the market, nor to the actions of market participants.

The collapse of the housing market has served as a catalyst for the economy's latest bust. For years the Federal Government has made it one of its prime aims to encourage homeownership among people who otherwise would not be able to afford homes. Various Federal mortgage programs through the FHA, Fannie Mae, and Freddie Mac have distorted the normal workings of the housing market.

The implicit government backing of Fannie Mae and Freddie Mac provides investors an incentive to provide funds to Fannie and Freddie that otherwise would have been put to use in other, more productive sectors of the economy. It was this flood of investor capital that helped to fuel the housing bubble.

Legislation such as the Zero Downpayment Act and the misnamed American Dream Downpayment Act made it possible for people who could not afford down payments on houses to receive assistance from the Federal Government, or even to pay no down payment at all, courtesy of the taxpayers. The requirement of a down payment has always helped to ascertain the ability of a buyer to pay off a mortgage. It requires the buyer to show hard work and thrift, the ability to delay present consumption in order to make a larger acquisition in the future.

When this requirement is minimized or eliminated, you introduce a new class of homebuyers, people who are unable to budget and save for the purchase of a home, or who should wait for a few years until they have saved enough to purchase a home. Federal policies have encouraged investors, lenders, and brokers to cater to these people, so it is no surprise that market actors came up with ever more sophisticated means of bringing these people into the real estate market.

Finally, the Federal Reserve's loose monetary policy and lowering of interest rates were a major spur to the housing boom. Low interest rates influence marginal buyers, those who are sitting on the fence, and encourage them to take on a mortgage that they otherwise would not. Even when interest rates are raised, no one expects them to stay high for long, as there is always pressure from politicians and investors to keep rates low, as no one wants the cheap credit to end.

Thinking that interest rates will cycle from low to higher, back to low, lenders begin to offer adjustable rate mortgages, 2/28's, 3/27's, and other sophisticated mortgages that may trap many unsavvy buyers. Buyers go short, lenders go long, and many people have been burned as a result.

It is time that the Federal Government get out of the housing business. Through our interventionist legislation we have caused the boom and bust, and any attempts at reform that fail to address the causes of our current problem will only sow the seeds for the next bubble.

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

Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of the Committee, thank you for inviting me here this morning to present an update on the economic situation and outlook.

DEVELOPMENTS IN FINANCIAL MARKETS

Since I last appeared before this Committee in March, the U.S. economy has performed reasonably well. On preliminary estimates, real gross domestic product (GDP) grew at an average pace of nearly 4 percent over the second and third quarters despite the ongoing correction in the housing market. Core inflation has improved modestly, although recent increases in energy prices will likely lead overall inflation to rise for a time.

However, the economic outlook has been importantly affected by recent developments in financial markets, which have come under significant pressure in the past few months. The financial turmoil was triggered by investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates. The continuing increase in the rate of serious delinquencies for such mortgages reflects in part a decline in underwriting standards in recent years as well as softening house prices. Delinquencies on these mortgages are likely to rise further in coming quarters as a sizable number of recent-vintage subprime loans experience their first interest rate resets. I will have more to say about this problem and its implications for homeowners later in my testimony.

At one time, most mortgages were originated and held by depository institutions. Today, however, mortgages are commonly bundled together into mortgage-backed securities or structured credit products, rated by credit-rating agencies, and then sold to investors. As mortgage losses have mounted, investors have questioned the reliability of credit ratings, especially those of structured products. Because many investors had not developed the capacity to perform independent evaluations of these often-complex instruments, the loss of confidence in the credit ratings, together with uncertainty about developments in the housing market, led to a sharp decline in demand for these products. Since July, few securities backed by subprime mortgages have been issued.

Although the problems with subprime mortgages initiated the financial turmoil, credit concerns quickly spilled over into a number of other areas. Importantly, the secondary market for securities backed by prime jumbo mortgages also contracted, and the issuance of such securities has declined significantly. Prime jumbo loans are still being made to prospective home purchasers, but they are at higher spreads and have more-restrictive terms. Concerns about mortgage-backed securities and structured credit products (even those unrelated to mortgages) also greatly reduced investor appetite for asset-backed commercial paper, although that market has improved somewhat recently. In the area of business credit, investors shied away from financing leveraged buyouts and from purchasing speculative-grade corporate bonds. And some larger banks, concerned about potentially large and difficult-to-predict draws on their liquidity and balance sheet capacity, became less willing to provide funding to their customers or to each other.

To be sure, the recent developments may well lead to a healthier financial system in the medium to long term: Increased investor scrutiny of structured credit products is likely to lead ultimately to greater transparency in these products and to better differentiation among assets of varying quality. Investors have also become more cautious and are demanding greater compensation for bearing risk. In the short term, however, these events do imply a greater measure of financial restraint on economic growth as credit becomes more expensive and difficult to obtain.

FEDERAL RESERVE POLICY ACTIONS

At the height of the recent financial turmoil, the Federal Reserve took a number of steps to help markets return to more orderly functioning. The Fed increased liquidity in short-term money markets in early August through larger-than-normal open market operations. And on August 17, the Federal Reserve Board cut the discount rate—the rate at which it lends directly to banks—50 basis points, or ½ percentage point, and subsequently took several additional measures. These efforts to provide liquidity appear to have been helpful on the whole, but the functioning of a number of important markets remained impaired.

The turmoil in financial markets significantly affected the Federal Reserve's outlook for the broader economy. Indeed, in a statement issued simultaneously with the

Board's August 17 announcement of the cut in the discount rate, the Federal Open Market Committee (FOMC) noted that the downside risks to economic growth had increased appreciably.

The Committee took further action at its next scheduled meeting, on September 18, when it cut its target for the Federal funds rate 50 basis points. This action was intended as a counterbalance to the tightening of credit conditions and to address in a preemptive fashion some of the risks that financial developments posed to the broader economy.

The Committee met most recently on October 30–31. The data reviewed at that meeting suggested that growth in the third quarter had been solid—at a 3.9 percent rate, according to the initial estimate by the Bureau of Economic Analysis. Residential construction declined sharply during the quarter, as expected, subtracting about 1 percentage point from overall growth. However, the GDP report provided scant evidence of spillovers from housing to other components of final demand: Strong growth in consumer spending was supported by gains in employment and income, and businesses increased their capital spending at a solid pace. A strong global economy stimulated foreign demand for U.S.-produced goods and services, as foreign trade contributed nearly 1 percentage point to the growth of real output last quarter.

Looking forward, however, the Committee did not see the recent growth performance as likely to be sustained in the near term. Financial conditions had improved somewhat after the September FOMC action, but the market for nonconforming mortgages remained significantly impaired, and survey information suggested that banks had tightened terms and standards for a range of credit products over recent months. In part because of the reduced availability of mortgage credit, the contraction in housing-related activity seemed likely to intensify. Indicators of overall consumer sentiment suggested that household spending would grow more slowly, a reading consistent with the expected effects of higher energy prices, tighter credit, and continuing weakness in housing. Most businesses appeared to enjoy relatively good access to credit, but heightened uncertainty about economic prospects could lead business spending to decelerate as well. Overall, the Committee expected that the growth of economic activity would slow noticeably in the fourth quarter from its third-quarter rate. Growth was seen as remaining sluggish during the first part of next year, then strengthening as the effects of tighter credit and the housing correction began to wane.

The Committee also saw downside risks to this projection: One such risk was that financial market conditions would fail to improve or even worsen, causing credit conditions to become even more restrictive than expected. Another risk was that, in light of the problems in mortgage markets and the large inventories of unsold homes, house prices might weaken more than expected, which could further reduce consumers' willingness to spend and increase investors' concerns about mortgage credit.

The Committee projected overall and core inflation to be in a range consistent with price stability next year. Supporting this view were modest improvements in core inflation over the course of the year, inflation expectations that appeared reasonably well anchored, and futures quotes suggesting that investors saw food and energy prices coming off their recent peaks next year. But the inflation outlook was also seen as subject to important upside risks. In particular, prices of crude oil and other commodities had increased sharply in recent weeks, and the foreign exchange value of the dollar had weakened. These factors were likely to increase overall inflation in the short run and, should inflation expectations become unmoored, had the potential to boost inflation in the longer run as well.

Weighing its projections for growth and inflation, as well as the risks to those projections, the FOMC on October 31 reduced its target for the Federal funds rate an additional 25 basis points, to 4½ percent. In the Committee's judgment, the cumulative easing of policy over the past 2 months should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time. Nonetheless, the Committee recognized that risks remained to both of its statutory objectives of maximum employment and price stability. All told, it was the judgment of the FOMC that, after its action on October 31, the stance of monetary policy roughly balanced the upside risks to inflation and the downside risks to growth.

In the days since the October FOMC meeting, the few data releases that have become available have continued to suggest that the overall economy remained resilient in recent months. However, financial market volatility and strains have persisted. Incoming information on the performance of mortgage-related assets has intensified investors' concerns about credit market developments and the implications of the downturn in the housing market for economic growth. In addition, further sharp increases in crude oil prices have put renewed upward pressure on inflation and may impose further restraint on economic activity. The FOMC will continue to carefully assess the implications for the outlook of the incoming economic data and financial market developments and will act as needed to foster price stability and sustainable economic growth.

HELPING DISTRESSED SUBPRIME BORROWERS

I would like to say a few words about actions being taken to help homeowners who have fallen behind on their mortgage payments or seem likely to do so. As I mentioned, delinquencies will probably rise further for borrowers who have a subprime mortgage with an adjustable interest rate, as many of these mortgages will soon see their rates reset at significantly higher levels. Indeed, on average from now until the end of next year, nearly 450,000 subprime mortgages per quarter are scheduled to undergo their first interest rate reset. Relative to past years, avoiding the payment shock of an interest rate reset by refinancing the mortgage will be much more difficult, as home prices have flattened out or declined, thereby reducing homeowners' equity, and lending terms have tightened. Should the rate of foreclosure rise proportionately, communities as well as individual borrowers would be hurt because concentrations of foreclosures tend to reduce property values in surrounding areas. A sharp increase in foreclosed properties for sale could also weaken the already struggling housing market and thus, potentially, the broader economy.

Home losses through foreclosure can be reduced if financial institutions work with borrowers who are having difficulty meeting their mortgage payment obligations. In recent months, the Federal Reserve and other banking agencies have issued statements calling on mortgage lenders and mortgage servicers to pursue prudent loan workouts.[1] Our contacts with the mortgage industry suggest that servicers recently have stepped up their efforts to work with borrowers facing financial difficulties or an imminent rate reset. Some servicers have been proactive about contacting borrowers who have missed payments or face resets, as experience shows that addressing the problem early increases the odds of a successful outcome. Foreclosure cannot always be avoided, but in many cases loss-mitigation techniques that preserve homeownership are less costly than foreclosure. To help keep borrowers in their homes, servicers have been offering assistance with repayment plans, temporary forbearance, and loan modifications. Comprehensive data on the success of these efforts to avert foreclosures are not available, but my sense is that there is scope for servicers to further increase their loss-mitigation efforts. The development of standardized approaches to workouts and the sharing of best practices can help increase the scale of the effort, even if, ultimately, workouts must be undertaken loan by loan. Although workouts are to be encouraged, regulators must be alert to ensure that they are done in ways that protect consumers' interests and do not disguise lenders' losses or impair safety and soundness.

The Federal Reserve has been participating in efforts by community groups to help homeowners avoid foreclosure. For example, Governor Kroszner of the Federal Reserve Board serves as a director of NeighborWorks America, a nonprofit organization that has been helping thousands of borrowers facing current or potential distress to obtain assistance from their lenders, their servicers, or trusted counselors through a hotline. The Federal Reserve Board's staff has been working with consumer and community affairs groups throughout the Federal Reserve System to help identify localities that are most at risk of high foreclosures, with the intent to help local groups better focus their outreach efforts to borrowers. Other contributions include foreclosure prevention programs, such as the Home Ownership Preservation Initiative, which the Federal Reserve Bank of Chicago helped to initiate, and efforts by Reserve Banks to convene workshops for stakeholders to develop community-based solutions to mortgage delinquencies in their areas. The Federal Reserve System is also engaged in research and analysis that should help inform policy responses to these issues.

The Congress is also focused on reducing homeowners' risk of foreclosure. One statutory change that could help is the modernization of programs administered by the Federal Housing Administration (FHA). The FHA has considerable experience helping low- and moderate-income households obtain home financing, but it has lost market share in recent years, partly because borrowers have moved toward nontraditional products with more-flexible and quicker underwriting and processing and

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[1] Board of Governors of the Federal Reserve System (2007), "Working with Mortgage Borrowers," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07–6 (April 17); and "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Supervision and Regulation Letter SR 07–16 (September 5).

partly because of a cap on the maximum loan value that can be insured. In modernizing the FHA, the Congress might encourage joint efforts with the private sector that expedite the refinancing of subprime loans held by creditworthy borrowers facing resets. It might also consider granting the agency the flexibility to design products that improve affordability through such features as variable maturities or shared appreciation. Also, the FHA could provide more refinancing options for riskier households if it could tailor the premiums it charges for mortgage insurance to the risk profile of the borrower.

As I have discussed in earlier testimony, the Federal Reserve is taking steps to avoid subprime lending problems from recurring while preserving responsible subprime lending. In coordination with other Federal supervisory agencies and the Conference of State Banking Supervisors (CSBS), we have issued principles-based underwriting guidance on subprime mortgages to help ensure that borrowers obtain loans that they can afford to repay and have the opportunity to refinance without prepayment penalty for a reasonable period before the first interest rate reset. In addition, together with the Office of Thrift Supervision, the Federal Trade Commission, the CSBS, and the American Association of Residential Mortgage Regulators, we have launched a pilot program aimed at strengthening reviews of consumer protection compliance at selected nondepository lenders with significant subprime mortgage operations.

Finally, using the authority granted us by the Congress under the Home Ownership and Equity Protection Act, we are on schedule to propose rules by the end of this year to address unfair or deceptive mortgage lending practices. These rules would apply to subprime loans offered by any mortgage lender. We are looking closely at practices such as prepayment penalties, failure to escrow for taxes and insurance, stated-income and low-documentation lending, and failure to give adequate consideration to a borrower's ability to repay. Using our authority under the Truth in Lending Act (TILA), we expect that we will soon propose rules to curtail abuses in mortgage advertising and to ensure that consumers receive mortgage disclosures at a time when the information is likely to be the most useful to them. We are also engaged in a rigorous, broader review of the TILA rules for mortgage loans, which will make use of extensive consumer testing of disclosures.

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

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Congress of the United States
House of Representatives
Washington, DC 20515

COMMITTEE ON HOMELAND SECURITY
Subcommittees:
Chairwoman Border, Maritime and Global Counterterrorism
Emergency Communications, Preparedness and Response

COMMITTEE ON ARMED SERVICES
Subcommittees:
Oversight and Investigations
Military Personnel
Readiness

November 9, 2007

The Honorable Ben S. Bernanke
Chairman of the Board of Governors
Federal Reserve System
Twentieth and Constitution Ave NW
Washington, DC 20551

Dear Chairman Bernanke:

I first want to again thank you for appearing before the Joint Economic Committee to discuss the Federal Reserve's economic outlook for the nation. I also want to reiterate my comments that you are in an important position to council the Administration on the importance of investing in our national infrastructure, education, and health.

Due to the time limitations and the breaks necessary for the Members of the House of Representatives and the Senate to vote, I was unable to deliver my questions before the full committee. I would greatly appreciate your responses to the following questions:

1. Mr. Chairman, in your testimony you discussed specific Federal Reserve policy actions due to the recent financial turmoil. You mention increasing liquidity in short-term money markets through larger-than-normal open market operations, cutting the discount rate by 50 basis points, and several additional measures. What were the additional measures taken?

2. You mentioned that you hope that policy responses to the credit crisis will not lead to an artificial tightening of credit. However, how concerned are you about artificially low interest rates?

3. Mr. Chairman, you declared that the Fed had not calculated the chances of the economy moving in a recession. If you had to, what would you say the odds are? We all know that the economy is going to slow at the housing situation will continue for two years or more. What probable event or events could take the economy over the edge into a recession?

4. With the markets reacting with so much volatility when only one, albeit large, sector of the economy takes a downturn, it appears that you are exhibiting a confidence in the overall economy that is not entirely justified. How long do you envision the housing sector to remain in recession? In your calculations, what percentage of the overall economy is made up by the housing sector?

Thank you for your attention to these questions. I look forward to receiving your response.

Sincerely,

Loretta Sanchez

Loretta Sanchez
Member of Congress

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

November 26, 2007

The Honorable Loretta Sanchez
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am responding to your letter of November 9, 2007, in which you posed several questions that followed up on my recent testimony before the Joint Economic Committee. Your questions and my responses are enclosed. I have also forwarded a copy of my response to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

RESPONSE FROM CHAIRMAIN BEN BERNANKE TO WRITTEN QUESTIONS SUBMITTED BY CONGRESSWOMAN LORETTA SANCHEZ

Q.1. Mr. Chairman, in your testimony you discussed specific Federal Reserve policy actions due to the recent financial turmoil. You mention increasing liquidity through larger-than-normal open market operations, cutting the discount rate by 50 basis points, and several additional measures. What were the additional measures taken?

A.1. The chronology below shows the principal monetary policy actions and other measures in financial markets that the Federal Reserve has taken over the past several months.

August 10: Federal Reserve issued a statement reaffirming its commitment to provide liquidity to facilitate financial market functioning and added $38 billion in reserves through three open-market operations largely collateralized by agency-issued or agency-guaranteed mortgage-backed securities.

August 17: The Federal Open Market Committee (FOMC) issued a statement observing that the downside risks to growth have increased appreciably; the Federal Reserve Board approved a 50 basis point reduction in the primary credit rate and announced that term financing will be provided for up to 30 days renewable by the borrower.

August 20: The Federal Reserve announced that it will redeem $5 billion in Treasury bill holdings from its System's Open Market Account (SOMA) portfolio.

August 21: The Federal Reserve reduced the minimum fee rate for the SOMA Securities Lending Program.

August 23: The Federal Reserve clarified the eligibility and haircuts for collateral that can be used to back discount window loans.

August 20 to October 23: The Federal Reserve approved the requests of several large commercial banks for exemptions from Section 23A of the Federal Reserve Act in order to enable the banks to lend to their securities affiliates to fund loans to customers that hold substantial mortgage-related assets. The exemptions are available for the duration of the period that the special discount window term lending arrangements announced on August 17 remains available.

September 18: FOMC reduced the target Federal funds rate by 50 basis points to 4.75 percent. The Board approved a further 50 basis point reduction in the primary credit rate.

October 31: The FOMC lowered the Federal funds rate by 25 basis points to 4.5 percent. The Board approved a further 25 basis point reduction in the primary credit rate.

Q.2. You mentioned that you hope that policy responses to the credit crisis will not lead to an artificial tightening of credit. However, how concerned are you about artificially low interest rates?

A.2. The Federal Reserve recognizes that costs and risks can arise both from a stance of monetary policy that is too tight and one that is too easy. Interest rates that are too high given anticipated economic and financial conditions can lead to subpar expansion in output and employment; interest rates that are too low can add to inflationary pressures. The objective of the Federal Reserve in conducting monetary policy is to foster achievement of our statutory dual mandate of maximum employment and stable prices.

Q.3. Mr. Chairman, you declared that the Fed had not calculated the chances of the economy moving in a recession. If you had to, what would you say the odds are? We all know that the economy is going to slow as the housing situation will continue for 2 years or more. What probable event or events could take the economy over the edge into a recession?

A.3. Over the years, economists and statisticians have made a number of formal efforts to predict recessions, and, hence, to assign odds to the likelihood of a recession occurring over a given time period. Unfortunately, these efforts have fared poorly. In part, the difficulty arises from the fact that all recessions are different. Although all recessions are characterized by declines in economic activity across a broad set of indicators, each individual recession seems to stem from different causes. Because economic conditions are different prior to and during each recession, it is difficult to find reliable indicators that help predict the next recession. Moreover, the structure of the economy continually evolves, which adds to the challenge of predicting recessions. In particular, changes in technology, domestic and international market structures, demographics, and economic policy over time result in shifts in the relationships between economic indicators and economic outcomes.

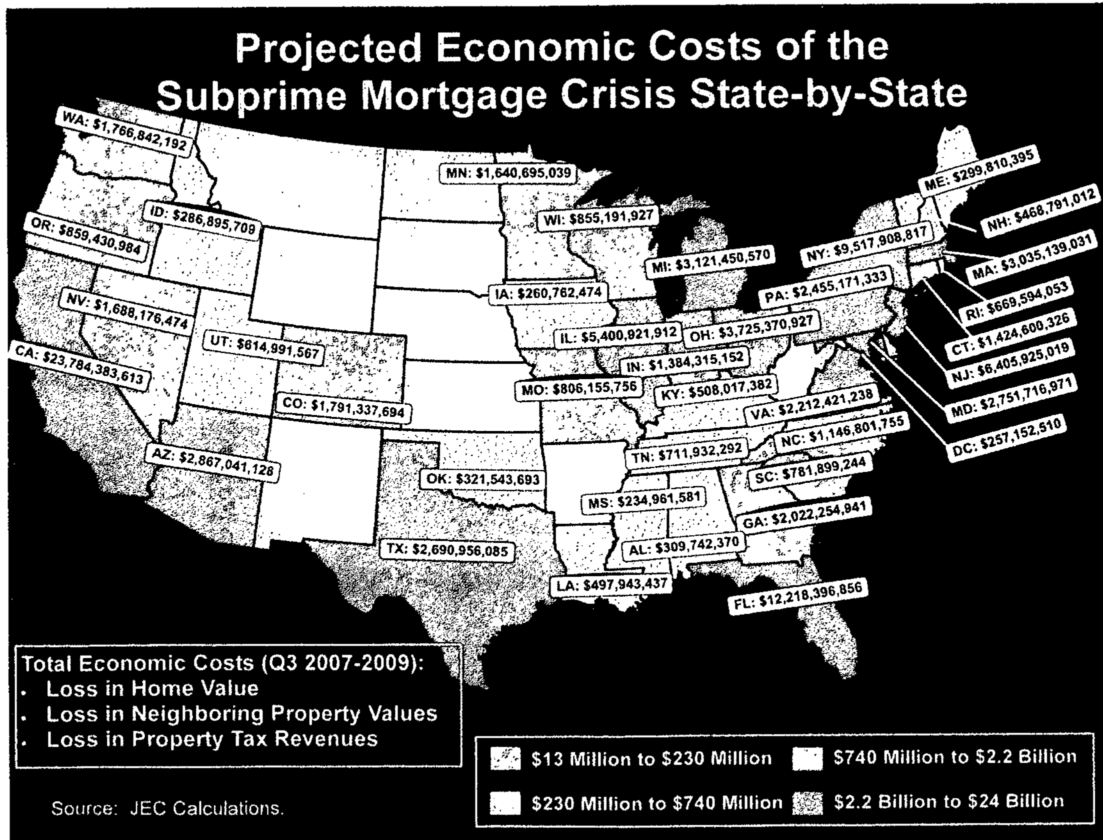
Even though one cannot predict with reasonable confidence the probability of a recession occurring over, say, the next twelve months, it is possible to identify some of the possible events that could pose downside risks to the performance of the economy. In that regard, I would point to the potential for a more severe contraction in the housing sector as an important risk. In addition, it is possible that financial market conditions could deteriorate significantly or that current tighter credit conditions could exert unexpectedly large restraint on household and business spending. Nevertheless, it is important to keep in mind that during recent decades, the U.S. economy had proved quite resilient to episodes of economic and financial distress. Accordingly, although a good deal of uncertainty surrounds the economic outlook, the pace of economic expansion seems likely slow in the near term and then should return to a moderate rate over the course of the next year.

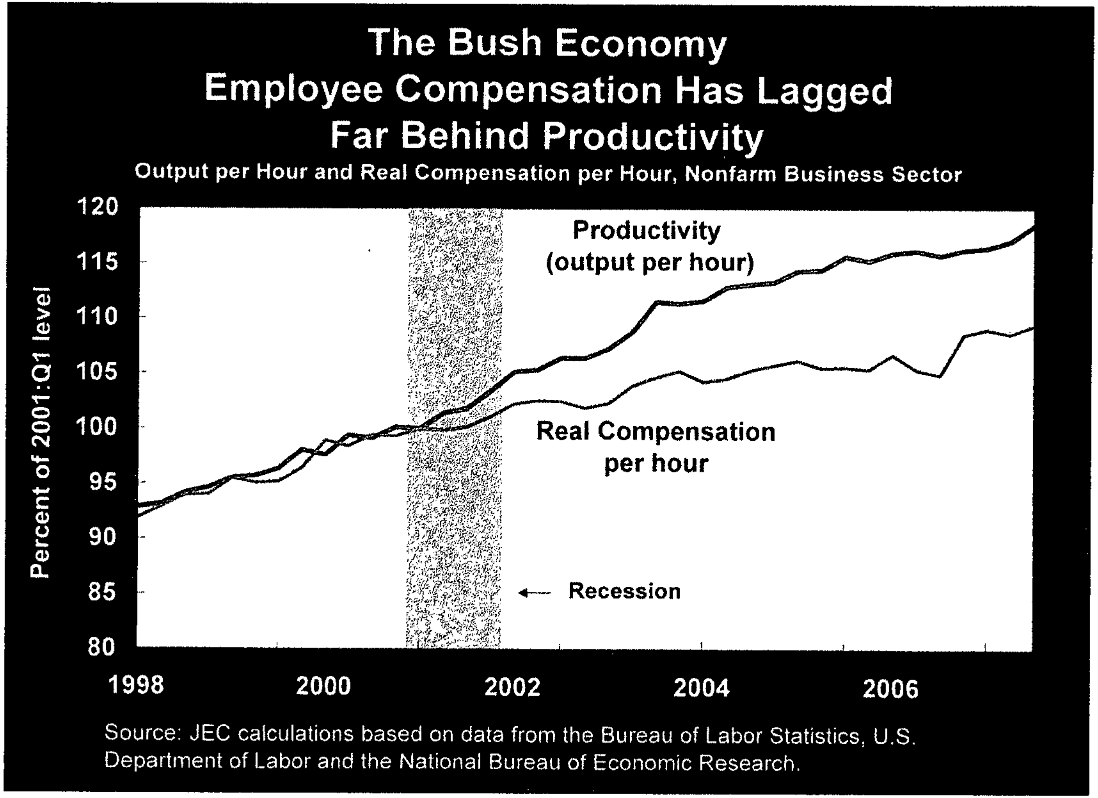
Q.4. With the markets reacting with so much volatility when only one, albeit large, sector of the economy takes a downturn, it appears that you are exhibiting a confidence in the overall economy that is not entirely justified. How long do you envision the housing sector to remain in recession? In your calculations, what percentage of the overall economy is made up by the housing sector?

A.4. Conditions in the housing sector are likely to be weak into 2008. This assessment reflects a number of factors. On the demand side, tightened terms and reduced availability of sub-prime and jumbo mortgages has impaired the ability of some prospective buyers to obtain financing. In addition, some prospective purchasers apparently are reluctant to buy when they think that house prices will be weak or falling for a while. On the supply side, the inventory of unsold homes is quite high relative to sales. The overhang is likely to weigh heavily on construction activity as well as the prices of both newly built and existing homes.

Moreover, as I mentioned in my prepared statement, on average from now until the end of next year, nearly 450,000 subprime mortgages per quarter are scheduled to undergo their first interest rate reset. Relative to past years, avoiding the payment shock of an interest rate reset by refinancing the mortgage will be much more difficult, as home prices have flattened out or declined, thereby reducing homeowners' equity, and lending terms have tightened. Should the rate of foreclosure rise proportionately, communities as well as individual borrowers would be hurt because concentrations of foreclosures tend to reduce property values in surrounding areas. A sharp increase in foreclosed properties for sale could also weaken the already struggling housing market and thus, potentially, the broader economy.

Finally, the housing sector typically is more cyclical than many other parts of the economy; its share of overall activity tends fluctuate a fair amount over time. Over the past quarter century, the nominal value of spending for residential investment has varied between $3\frac{1}{4}$ and $6\frac{1}{4}$ percent of GDP, with an average of $4\frac{1}{2}$ percent.


Projected Economic Costs of the
Subprime Mortgage Crisis State-by-State
WA: $1,766,842,192
OR: $859,430,984
ID: $286,895,709
NV: $1,688,176,474
CA: $23,784,383,613
UT: $614,991,567
AZ: $2,867,041,128
CO: $1,791,337,694
MN: $1,640,695,039
WI: $855,191,927
IA: $260,762,474
MI: $3,121,450,570
IL: $5,400,921,912
IN: $1,384,315,152
OH: $3,725,370,927
MO: $806,155,756
KY: $508,017,382
OK: $321,543,693
TX: $2,690,956,085
TN: $711,932,292
MS: $234,961,581
AL: $309,742,370
LA: $497,943,437
GA: $2,022,254,941
FL: $12,218,396,856
SC: $781,899,244
NC: $1,146,801,755
VA: $2,212,421,238
PA: $2,455,171,333
NY: $9,517,908,817
ME: $299,810,395
NH: $468,791,012
MA: $3,035,139,031
RI: $669,594,053
CT: $1,424,600,326
NJ: $6,405,925,019
MD: $2,751,716,971
DC: $257,152,510
Total Economic Costs (Q3 2007-2009):
. Loss in Home Value
. Loss in Neighboring Property Values
. Loss in Property Tax Revenues
Source: JEC Calculations.
$13 Million to $230 Million
$740 Million to $2.2 Billion
$230 Million to $740 Million
$2.2 Billion to $24 Billion


The Bush Economy
Employee Compensation Has Lagged
Far Behind Productivity
Output per Hour and Real Compensation per Hour, Nonfarm Business Sector
Percent of 2001:Q1 level
120
115
110
105
100
95
90
85
80
1998
2000
2002
2004
2006
Productivity
(output per hour)
Real Compensation
per hour
Recession
Source: JEC calculations based on data from the Bureau of Labor Statistics, U.S. Department of Labor and the National Bureau of Economic Research.