CHALLENGES FACING THE ECONOMY: THE VIEW OF THE FEDERAL RESERVE

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, JUNE 3, 2009

Serial No. 111–11

Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

U.S. GOVERNMENT PRINTING OFFICE

49–968 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

CONTENTS

CHALLENGES FACING THE ECONOMY: THE VIEW OF THE FEDERAL RESERVE

WEDNESDAY, JUNE 3, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Schwartz, Doggett, McGovern, Tsongas, Etheridge, McCollum, Yarmuth, Andrews, Scott, Langevin, Larsen, Bishop, Moore, Connolly, Ryan, Hensarling, Garrett, Mack, Campbell, Jordan, Lummis, Aderholt, Nunes, and Latta.

Chairman SPRATT. The committee will come to order.

We meet today to hear the distinguished Chairman of the Federal Reserve, Benjamin Bernanke, testify on the recession that is plaguing our economy and on the prospects of recovery.

Chairman Bernanke testified before our committee on October 20 of last year as we searched for ways to mitigate, if not avoid, a long recession. The Chairman acknowledged then that monetary policy has its limits. Without being specific, he welcomed a fiscal complement.

Congress had just passed a bipartisan bill authorizing $700 billion to dispose of troubled assets, so-called TARP. Backed by these funds, the Treasury, the Fed, and the FDIC have made extraordinary advances to banks and other financial institutions, recognizing what Chairman Bernanke told the Joint Economic Committee last month, that, quote, "A sustained recovery in economic activity depends critically on restoring stability to the financial system." This is one question we hope you will address today, Mr. Chairman: Just how strong and how stable are our financial institutions?

By February of this year, it was clear that TARP relief was a necessary but not sufficient solution. So Congress passed, on a partisan basis, an even bigger boost, the American Recovery and Reinvestment Act, which packed $787 billion of fiscal stimuli in the form of spending increases and tax decreases. We would like to know, Mr. Chairman, whether from the Fed's viewpoint this huge countercyclical thrust is working.

Bold action was necessary to head off a collapse of the financial system, but the steps taken also swell the Nation's deficit and the national debt. It is all but impossible to balance the budget when the economy is bucking a headwind like this recession, because what we do to make the economy better is likely to make the deficit worse. Yet, at the same time, we cannot add infinitely to the national debt without facing consequences in global credit markets or on our future capacity to borrow.

One purpose of this hearing is to explore both the advantages, and the potential downside risk of our bold and unprecedented response to financial turmoil. Should we be concerned that some of our swelling debt must be financed with foreign credit?

We hope that most of our outlays are for nonrecurring needs and that much of what has been advanced in recent months will in time be recovered, repaid, and used to pay down the debt that we are incurring. We would like to have your assessment, Mr. Chairman, of that possibility.

Despite bold, unprecedented action, the Director of the Congressional Budget Office told this committee on May 21st that our economy is still running at 7 percent or more below its capacity, or a trillion dollars per year below its potential. Recently there have been signs, however, of a turnaround. Business inventories are down; the stock market is up a bit; and so, too, to some extent, is the housing market. Our question to you, Mr. Chairman, is whether these are glimmers of hope or flashes in the pan.

To keep this recession from growing worse, the Fed has pumped enormous liquidity into the money markets, so much so that some critics even worry of inflation, lurking, to be sure, just over the horizon, but a threat nevertheless. The spread between short- and long-term Treasuries has widened to more than 2.5 percentage points. We would like to know, Mr. Chairman, if these are salutary signs of a recovery or ominous signs of inflation.

A month ago, Chairman Bernanke told the JEC that, quote, "We expect economic activity to bottom out and turn up later this year." But he went on to warn, "Even after the recovery gets under way, the rate of real economic growth is likely to remain below potential for a while, only gradually gaining momentum."

The old locomotives that pulled the economy out of the rut in the past—real estate, consumer durables—are unavailing now. This causes us to ask, Mr. Chairman, what will empower a turnaround in this dismal economy, and when can we expect to return to normality?

Mr. Chairman, as you can see, we have a lot of grist for our mill today. We thank you for being here, but, most of all, we thank you for your service to our Nation at this very crucial time.

Before proceeding to your statement, let me turn to Mr. Ryan for his opening remarks.

Mr. Ryan?

Mr. RYAN. Thank you, Chairman Spratt, for arranging this important hearing.

Chairman Bernanke, you come before this committee with the financial markets in a better position than in your previous appearance last fall. The economy is finally showing some signs of stabilizing, and that is encouraging. But despite these short-term glimmers of hope, I have become more concerned about the longer-term implications of our economic policies.

On the fiscal side, the Treasury is issuing record amounts of debt, over $2 trillion this year alone, to support record government spending and record deficits. Meanwhile, the Federal Reserve has injected an enormous amount of monetary stimulus into the economy and has even started purchasing longer-term Treasury bonds in an attempt to lower borrowing costs and further ease financial conditions.

This can be a dangerous policy mix. The Treasury is issuing debt, and the Central Bank is buying it. It gives the alarming impression that the U.S. one day might begin to meet its financial obligations by simply printing money. And we all know what happens to a country that chooses to monetize its debt. It gets runaway inflation and a gradual erosion of workers' paychecks and family savings.

There is an increased discussion in the financial press about the potential negative consequences of our economic policies. Just this week, the yield on the 10-year Treasury bond rose to a 6-month high, over 3 percent—3.7 percent—a sign that global investors are becoming concerned about debt levels and the possibility of future inflation. This is the bond market telling us that there is no free lunch. When you issue record amounts of debt in your central bank, as the monetary policy levers at full throttle, red flags begin to get raised and our borrowing costs go up.

There are some faint warning bells going off. The value of the dollar has slipped recently. The price of gold is back up to nearly $1,000 a troy ounce. And inflation compensation spreads in the Treasury bond market have risen to a 9-month high.

Now, I realize that some of these signs in the financial markets are likely reassuring to the Fed, since the predominant risk over the short term has been deflation, and that this could be signs of a recovery. But I am generally concerned that the Fed will be unable to unwind its considerable monetary policy stimulus in a timely manner to prevent a sharp rise in inflation over the medium term.

There are a number of technical challenges associated with shrinking your balance sheet and returning to a more normal monetary policy stance. But I am more concerned about the political challenges the Fed will face when you finally have to make this call. I imagine there will be substantial political pressure on the Fed to delay tightening its monetary policy while the unemployment rate is still rising, for instance. But the Fed's political independence is critical—it is critical and essential for safeguarding its commitment to price stability, which is the chief policy concern of every central bank. This clear commitment is all the more important at a time when the fine line between monetary policy and fiscal policy seems a bit blurry.

Despite the recent signs of stabilization in the economy, we policymakers should recognize that our most challenging period is going to be ahead of us as we try to right the ship and get back on the path of sustainable growth and job creation. That will clearly take a renewed sense of fiscal discipline to rein in spending and budget deficits, but it will also take a clear exit strategy on the part of the Fed and a firm commitment to price stability. We, in Congress, are committed to working with the administration to accomplish the former, and we trust the Fed will work diligently to ensure the latter.

Thank you, Chairman.

Chairman SPRATT. Thank you, Mr. Ryan.

Now, before proceeding with Chairman Bernanke, let me, as a housekeeping detail, ask for unanimous consent that all members be allowed to submit an opening statement for the record at this point.

So ordered.

[The statement of Mr. Connolly follows:]

PREPARED STATEMENT OF HON. GERALD E. CONNOLLY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. Chairman, thank you for holding this hearing and thank you, Chairman Bernanke, for your testimony on the state of our economy. I understand the complexity of issues affecting our economy and I respect the Federal Reserve's various efforts to stabilize the current crisis. There is, however, one critical area in which I believe the Fed has failed to act—the municipal bond market.

Municipal bonds are the primary funding mechanism for state and local capital projects, including the repair or construction of our schools, fire and police stations, libraries, water treatment plants and critically needed transportation infrastructure. Traditionally, state and local governments have sold an average of $280 billion in bonds each year.

The capital programs of our state and local governments, primarily funded by municipal bonds, have been one of the most effective engines for job creation throughout the country.

Yet, despite the historically solid performance and low default rate of municipal bonds, investors fled from the muni market to U.S. Treasury notes following the economic meltdown last fall. As a result, the nation's 55,000 state and local governments are experiencing limited access to the capital markets. Further complicating the issue is the fact that the private insurance market virtually disappeared overnight, eliminating a viable means of credit enhancement for many issuers.

If we do not address this serious problem, we could wind up in a situation where this squeezing of the municipal bond market has a counteractive effect on the benefits of our hard-fought economic recovery package. Municipal bonds are and have always been a tremendous source of economic stimulus that we cannot ignore.

Chairman Bernanke, you stated in your March 31st letter to Members of Congress that although fixed-rate municipal debt is available to the larger municipalities, the costs to those localities are elevated, and thousands of smaller entities remain unable to access credit. You further noted the additional stress on the floating rate debt.

According to Section 2a of the Federal Reserve Act, the Fed is required "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." To that effect, during the current recession, the Fed extended more than $2.1 trillion in credit through additional lending facilities to help spur the credit market.

Earlier this year I introduced H.R. 1669, the Federal Municipal Bond Marketing Support and Securitization Act, as a way to begin to address the problem. At its core, my proposal directed the Secretary of the Treasury and Federal Reserve Board to work together to strategically intervene in the municipal bond market to restore liquidity and spark local job creation.

The Congress now is considering several options, including authorizing a federal reinsurance program and a liquidity enhancement proposal to give the Federal Reserve the authority to fund a new liquidity facility for the purchase of variable rate demand notes.

The Federal Reserve is empowered to conduct Open Market Operations. I understand the Fed's traditional reluctance to purchase municipal securities; however, the current recession is truly an extraordinary and historic situation, requiring new and innovative tools to address.

Chairman Bernanke, you stated in your October 28, 2008 letter to Congressman Paul Kanjorski, "the Federal Reserve Act provides the Federal Reserve with only limited ability to purchase directly the obligations of states and municipalities."

If we are serious about promoting economic stimulus and recovery, then we must address the credit crisis that is paralyzing our state and local governments' capital programs—programs which represent one of the most significant job creation engines in the nation.

Chairman SPRATT. Let me further say that the Chairman's testimony has been received and will be, without objection, entered in the record, so that you may summarize as you see fit. I think it is an important statement, full in detail, and we would encourage you to plow all the way through it, Mr. Chairman.

One other very important detail. The Chairman has to leave at 12:30 today, so we will be riding the clock very closely on questions that members ask.

Mr. Chairman, the floor is yours. And thank you, sir, again for coming.

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

Mr. BERNANKE. Thank you, Mr. Chairman.

Chairman Spratt, Ranking Member Ryan, and other members of the committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the Federal budget.

The U.S. economy has contracted sharply since last fall, with real gross domestic product having dropped at an average annual rate of about 6 percent during the fourth quarter of 2008 and the first quarter of this year.

Among the enormous cost of the downturn is the loss of nearly 6 million jobs since the beginning of 2008. The most recent information on the labor market, the number of new and continuing claims for unemployment insurance through late May, suggests that sizeable job losses and further increases in unemployment are likely over the next few months.

However, the recent data also suggests that the pace of economic contraction may be slowing. Notably, consumer spending, which dropped sharply in the second half of last year, has been roughly flat since the turn of the year, and consumer sentiment has improved. In coming months, household spending power will be boosted by the fiscal stimulus program.

Nonetheless, a number of factors are likely to continue to weigh on consumer spending, among them the weak labor market, the declines in equity and housing wealth that households have experienced over the past 2 years, and the still-tight credit conditions.

Activity in the housing market, after a long period of decline, has also shown some signs of bottoming. Sales of existing homes have been fairly stable since late last year, and sales of new homes seem to have flattened out in the past couple of monthly readings, though they remain at depressed levels. Meanwhile, construction of new homes has been sufficiently restrained to allow the backlog of unsold new homes to decline, a precondition for any recovery in homebuilding.

Businesses remain very cautious and continue to reduce their workforces and their capital investments. On a more positive note, firms are making progress in shedding the unwanted inventories that they accumulated following last fall's sharp downturn in sales. The Commerce Department estimates that the pace of inventory liquidation quickened in the first quarter, accounting for a sizeable portion of the reported decline in real GDP during that period. As inventory stocks move into better alignment with sales, firms should become more willing to increase production.

We continue to expect overall economic activity to bottom out and then to turn up later this year. Our assessments that consumer spending and housing demand will stabilize and that the pace of inventory liquidation will slow are key building blocks of that forecast. Final demand should also be supported by fiscal and monetary stimulus, and U.S. exports may benefit if recent signs of stabilization in foreign economic activity prove accurate.

An important caveat is that our forecast also assumes continuing gradual repair of the financial system and an associated improvement in credit conditions. A relapse in the financial sector will be a significant drag on economic activity and could cause the incipient recovery to stall.

I will provide a brief update on financial markets in a moment.

Even after recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further. We expect that the recovery will only gradually gain momentum, and that economic slack will diminish slowly. In particular, businesses are likely to be cautious about hiring, and the unemployment rate is likely to rise for a time, even after economic growth resumes.

In this environment, we anticipate that inflation will remain low. The slack in resource utilization remains sizeable. And notwithstanding recent increases in the prices of oil and other commodities, cost pressures generally remain subdued. As a consequence, inflation is likely to move down some over the next year relative to its pace in 2008. That said, improving economic conditions and stable inflation expectations should limit further declines in inflation.

Conditions at a number of financial markets have improved since earlier this year, likely reflecting both policy actions taken by the Federal Reserve and other agencies, as well as a somewhat better economic outlook. Nevertheless, financial markets and financial institutions remain under stress, and low asset prices and tight credit conditions continue to restrain economic activity.

Among the markets where functioning has improved recently are those for short-term funding, including the interbank lending markets and the commercial paper market. Risk spreads in those markets appear to have moderated, and more lending is taking place at longer maturities.

The better performance of short-term funding markets in part reflects the support afforded by Federal Reserve lending programs. It is encouraging that the private sector's reliance on the Fed's programs has declined as market stresses have eased, an outcome that was one of our key objectives when we designed these interventions.

The issuance of asset-backed securities, backed by credit card, auto, and student loans, has also picked up this spring, and ABS funding rates have declined—developments supported by the availability of the Federal Reserve's Term Asset-Backed Securities Loan Facility, or TALF, as a market backstop.

In markets for longer-term credit, bond issuance by nonfinancial firms has been relatively strong recently. And spreads between Treasury yields and rates paid by corporate borrowers have narrowed some, though they remain wide. Mortgage rates and spreads have also been reduced by the Federal Reserve's program of purchasing agency debt and agency mortgage-backed securities.

However, in recent weeks, yields on longer-term Treasury securities and fixed-rate mortgages have risen. These increases appear to reflect concerns about large Federal deficits but also other causes, including greater optimism about the economic outlook, a reversal of flight to quality flows, and technical factors relating to the hedging of mortgage holdings.

As you know, last month, the Federal bank regulatory agencies released the results of the Supervisory Capital Assessment Program. The purpose of the exercise was to determine for each of the 19 U.S.-owned bank holding companies with assets exceeding $100 billion a capital buffer sufficient for them to remain strongly capitalized and able to lend to creditworthy borrowers, even if economic conditions over the next 2 years turn out to be worse than we currently expect.

According to the findings of the SCAP exercise, under the more adverse economic outlook losses of the 19 bank holding companies would total an estimated $600 billion during 2009 and 2010. After taking account of potential resources to absorb those losses, including expected revenues, reserves, and existing capital cushions, we determined that 10 of the 19 institutions should raise, collectively, additional common equity of $75 billion. Each of the 10 bank holding companies requiring an additional buffer has committed to raise this capital by November 9th. We are in discussions with these firms on their capital plans, which are due by June 8th.

Even in advance of those plans being approved, the 10 firms have among them already raised more than $36 billion of new common equity, with a number of their offerings of common shares being oversubscribed. In addition, these firms have announced actions that would generate up to an additional $12 billion of common equity. We expect further announcements shortly, as their capital plans are finalized and submitted to supervisors. The substantial progress these firms have made in meeting their required capital buffers and their success in raising private capital suggests that investors are gaining greater confidence in the banking system.

Let me turn now to fiscal matters. As you are well aware, in February of this year, Congress passed the American Recovery and Reinvestment Act, or ARRA, a major fiscal package aimed at strengthening near-term economic activity. The package included personal tax cuts, increases in transfer payments intended to stimulate household spending, incentives for business investment, increases in Federal purchases, and Federal grants for State and local governments.

Predicting the effects of these fiscal actions on economic activity is difficult, especially in light of the unusual economic circumstances that we face. For example, households confronted with declining incomes and limited access to credit might be expected to spend most of their tax cuts. But then again, heightened economic uncertainties and a desire to increase precautionary saving or pay down debt might reduce households' propensity to spend.

Likewise, it is difficult to judge how quickly funds dedicated to infrastructure needs and other longer-term projects will be spent and how large any follow-on effects will be. The CBO has constructed a range of estimates of the effects of the stimulus package on real GDP and employment that appropriately reflects these uncertainties. According to the CBO's estimates, by the end of 2010, the stimulus package could boost the level of real GDP between about 1 percent and a little more than 3 percent and the level of employment by between roughly 1 million and 3.5 million jobs.

The increases in spending and reductions in taxes associated with the fiscal package and the financial stabilization program, along with the losses in revenues and increases in income support payments associated with the weak economy, will widen the Federal budget deficit substantially this year.

The administration recently submitted a proposed budget that projects the Federal deficit to reach about $1.8 trillion this fiscal year before declining to $1.3 trillion in 2010 and roughly $900 billion in 2011. As a consequence of this elevated level of borrowing, the ratio of Federal debt held by the public, to nominal GDP is likely to move up from about 40 percent before the onset of the financial crisis, to about 70 percent in 2011. These developments would leave the debt-to-GDP ratio at its highest level since the early 1950s, the years following the massive debt buildup during World War II.

Certainly our economy and financial markets face extraordinary near-term challenges, and strong and timely actions to respond to these challenges are necessary and appropriate. Nevertheless, even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets require that we, as a Nation, begin planning now for the restoration of fiscal balance. Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby boom generation and continued increases in medical costs.

The recent projections from the Social Security and Medicare trustees show that, in the absence of programmatic changes, Social Security and Medicare outlays will together increase from about 8.5 percent of GDP today to 10 percent by 2020 and 12.5 percent by 2030. With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands.

Addressing the country's fiscal problems will require a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the administration, and the American people must confront is how large a share of the Nation's economic resources to devote to Federal Government programs, including entitlement programs.

Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. In particular, over the longer term, achieving fiscal sustainability—defined, for example, as a situation to which the ratios of government debt and interest payments to GDP are stable or declining, and tax rates are not so high as to impede economic growth—requires that spending and budget deficits be well-controlled.

Clearly, the Congress and the administration face formidable near-term challenges that must be addressed, but those near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth.

And let me close briefly with an update on the Federal Reserve's initiatives to enhance the transparency of our credit and liquidity programs. As I noted last month in my testimony before the JEC, I have asked Vice Chairman Kohn to lead a review of our disclosure policies, with the goal of increasing the range of information that we make available to the public.

That group has made significant progress, and we expect to begin publishing soon a monthly report on the Fed's balance sheet and lending programs that will summarize and discuss recent developments and provide considerable new information concerning the number of borrowers at our various facilities, the concentration of borrowing, and the collateral pledged.

In addition, the reports will provide quarterly updates of key elements of the Federal Reserve's annual financial statements, including information regarding the system open market account portfolio, our loan programs, and the special-purpose vehicles that are consolidated on the balance sheet of the Federal Reserve Bank of New York.

We hope that this information will be helpful to the Congress and others with an interest in the Federal Reserve's actions to address the financial crisis and the economic downturn. We will continue to look for opportunities to broaden the scope of the information and supporting analysis that we provide to the public.

Thank you, Mr. Chairman.

[The statement of Ben Bernanke follows:]

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

Chairman Spratt, Ranking Member Ryan, and other members of the Committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the federal budget.

ECONOMIC DEVELOPMENTS AND OUTLOOK

The U.S. economy has contracted sharply since last fall, with real gross domestic product (GDP) having dropped at an average annual rate of about 6 percent during the fourth quarter of 2008 and the first quarter of this year. Among the enormous costs of the downturn is the loss of nearly 6 million jobs since the beginning of 2008. The most recent information on the labor market—the number of new and continuing claims for unemployment insurance through late May—suggests that sizable job losses and further increases in unemployment are likely over the next few months.

However, the recent data also suggest that the pace of economic contraction may be slowing. Notably, consumer spending, which dropped sharply in the second half of last year, has been roughly flat since the turn of the year, and consumer sentiment has improved. In coming months, households' spending power will be boosted by the fiscal stimulus program. Nonetheless, a number of factors are likely to continue to weigh on consumer spending, among them the weak labor market, the declines in equity and housing wealth that households have experienced over the past two years, and still-tight credit conditions.

Activity in the housing market, after a long period of decline, has also shown some signs of bottoming. Sales of existing homes have been fairly stable since late last year, and sales of new homes seem to have flattened out in the past couple of monthly readings, though both remain at depressed levels. Meanwhile, construction of new homes has been sufficiently restrained to allow the backlog of unsold new homes to decline—a precondition for any recovery in homebuilding.

Businesses remain very cautious and continue to reduce their workforces and capital investments. On a more positive note, firms are making progress in shedding the unwanted inventories that they accumulated following last fall's sharp downturn in sales. The Commerce Department estimates that the pace of inventory liquidation quickened in the first quarter, accounting for a sizable portion of the reported decline in real GDP in that period. As inventory stocks move into better alignment with sales, firms should become more willing to increase production.

We continue to expect overall economic activity to bottom out, and then to turn up later this year. Our assessments that consumer spending and housing demand will stabilize and that the pace of inventory liquidation will slow are key building blocks of that forecast. Final demand should also be supported by fiscal and monetary stimulus, and U.S. exports may benefit if recent signs of stabilization in foreign economic activity prove accurate. An important caveat is that our forecast also assumes continuing gradual repair of the financial system and an associated improvement in credit conditions; a relapse in the financial sector would be a significant drag on economic activity and could cause the incipient recovery to stall. I will provide a brief update on financial markets in a moment.

Even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further. We expect that the recovery will only gradually gain momentum and that economic slack will diminish slowly. In particular, businesses are likely to be cautious about hiring, and the unemployment rate is likely to rise for a time, even after economic growth resumes.

In this environment, we anticipate that inflation will remain low. The slack in resource utilization remains sizable, and, notwithstanding recent increases in the prices of oil and other commodities, cost pressures generally remain subdued. As a consequence, inflation is likely to move down some over the next year relative to its pace in 2008. That said, improving economic conditions and stable inflation expectations should limit further declines in inflation.

CONDITIONS IN FINANCIAL MARKETS

Conditions in a number of financial markets have improved since earlier this year, likely reflecting both policy actions taken by the Federal Reserve and other agencies as well as the somewhat better economic outlook. Nevertheless, financial markets and financial institutions remain under stress, and low asset prices and tight credit conditions continue to restrain economic activity.

Among the markets where functioning has improved recently are those for short-term funding, including the interbank lending markets and the commercial paper market. Risk spreads in those markets appear to have moderated, and more lending is taking place at longer maturities. The better performance of short-term funding markets in part reflects the support afforded by Federal Reserve lending programs. It is encouraging that the private sector's reliance on the Fed's programs has declined as market stresses have eased, an outcome that was one of our key objectives when we designed our interventions. The issuance of asset-backed securities (ABS) backed by credit card, auto, and student loans has also picked up this spring, and ABS funding rates have declined, developments supported by the availability of the Federal Reserve's Term Asset-Backed Securities Loan Facility as a market backstop.

In markets for longer-term credit, bond issuance by nonfinancial firms has been relatively strong recently, and spreads between Treasury yields and rates paid by corporate borrowers have narrowed some, though they remain wide. Mortgage rates and spreads have also been reduced by the Federal Reserve's program of purchasing agency debt and agency mortgage-backed securities. However, in recent weeks, yields on longer-term Treasury securities and fixed-rate mortgages have risen. These increases appear to reflect concerns about large federal deficits but also other causes, including greater optimism about the economic outlook, a reversal of flight-toquality flows, and technical factors related to the hedging of mortgage holdings.

As you know, last month, the federal bank regulatory agencies released the results of the Supervisory Capital Assessment Program (SCAP). The purpose of the exercise was to determine, for each of the 19 U.S.-owned bank holding companies with assets exceeding $100 billion, a capital buffer sufficient for them to remain strongly capitalized and able to lend to creditworthy borrowers even if economic conditions over the next two years turn out to be worse than we currently expect. According to the findings of the SCAP exercise, under the more adverse economic outlook, losses at the 19 bank holding companies would total an estimated $600 billion during 2009 and 2010. After taking account of potential resources to absorb those losses, including expected revenues, reserves, and existing capital cushions, we determined that 10 of the 19 institutions should raise, collectively, additional common equity of $75 billion.

Each of the 10 bank holding companies requiring an additional buffer has committed to raise this capital by November 9. We are in discussions with these firms on their capital plans, which are due by June 8. Even in advance of those plans being approved, the 10 firms have among them already raised more than $36 billion of new common equity, with a number of their offerings of common shares being over-subscribed. In addition, these firms have announced actions that would generate up to an additional $12 billon of common equity. We expect further announcements shortly as their capital plans are finalized and submitted to supervisors. The substantial progress these firms have made in meeting their required capital buffers, and their success in raising private capital, suggests that investors are gaining greater confidence in the banking system.

FISCAL POLICY IN THE CURRENT ECONOMIC AND FINANCIAL ENVIRONMENT

Let me now turn to fiscal matters. As you are well aware, in February of this year, the Congress passed the American Recovery and Reinvestment Act, or ARRA, a major fiscal package aimed at strengthening near-term economic activity. The package included personal tax cuts and increases in transfer payments intended to stimulate household spending, incentives for business investment, increases in federal purchases, and federal grants for state and local governments.

Predicting the effects of these fiscal actions on economic activity is difficult, especially in light of the unusual economic circumstances that we face. For example, households confronted with declining incomes and limited access to credit might be expected to spend most of their tax cuts; then again, heightened economic uncertainties and the desire to increase precautionary saving or pay down debt might reduce households' propensity to spend. Likewise, it is difficult to judge how quickly funds dedicated to infrastructure needs and other longer-term projects will be spent and how large any follow-on effects will be. The Congressional Budget Office (CBO) has constructed a range of estimates of the effects of the stimulus package on real GDP and employment that appropriately reflects these uncertainties. According to the CBO's estimates, by the end of 2010, the stimulus package could boost the level of real GDP between about 1 percent and a little more than 3 percent and the level of employment by between roughly 1 million and 3½ million jobs.

The increases in spending and reductions in taxes associated with the fiscal package and the financial stabilization program, along with the losses in revenues and increases in income-support payments associated with the weak economy, will widen the federal budget deficit substantially this year. The Administration recently submitted a proposed budget that projects the federal deficit to reach about $1.8 trillion this fiscal year before declining to $1.3 trillion in 2010 and roughly $900 billion in 2011. As a consequence of this elevated level of borrowing, the ratio of federal debt held by the public to nominal GDP is likely to move up from about 40 percent before the onset of the financial crisis to about 70 percent in 2011. These developments would leave the debt-to-GDP ratio at its highest level since the early 1950s, the years following the massive debt buildup during World War II.

Certainly, our economy and financial markets face extraordinary near-term challenges, and strong and timely actions to respond to those challenges are necessary and appropriate. Nevertheless, even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance. Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in medical costs. The recent projections from the Social Security and Medicare trustees show that, in the absence of programmatic changes, Social Security and Medicare outlays will together increase from about 8½ percent of GDP today to 10 percent by 2020 and 12½ percent by 2030. With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands.

Addressing the country's fiscal problems will require a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including entitlement programs. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. In particular, over the longer term, achieving fiscal sustainability—defined, for example, as a situation in which the ratios of government debt and interest payments to GDP are stable or declining, and tax rates are not so high as to impede economic growth—requires that spending and budget deficits be well controlled.

Clearly, the Congress and the Administration face formidable near-term challenges that must be addressed. But those near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth.

FEDERAL RESERVE TRANSPARENCY

Let me close today with an update on the Federal Reserve's initiatives to enhance the transparency of our credit and liquidity programs. As I noted last month in my testimony before the Joint Economic Committee, I asked Vice Chairman Kohn to lead a review of our disclosure policies, with the goal of increasing the range of information that we make available to the public.[1] That group has made significant progress, and we expect to begin publishing soon a monthly report on the Fed's balance sheet and lending programs that will summarize and discuss recent developments and provide considerable new information concerning the number of borrowers at our various facilities, the concentration of borrowing, and the collateral pledged. In addition, the reports will provide quarterly updates of key elements of the Federal Reserve's annual financial statements, including information regarding the System Open Market Account portfolio, our loan programs, and the special purpose vehicles that are consolidated on the balance sheet of the Federal Reserve Bank of New York. We hope that this information will be helpful to the Congress and others with an interest in the Federal Reserve's actions to address the financial crisis and the economic downturn. We will continue to look for opportunities to broaden the scope of the information and supporting analysis that we provide to the public.

Chairman SPRATT. Thank you, Mr. Chairman.

Can we conclude from what you have just said and from what you are seeing that the favorable factors in our economy today may be glimmers of hope, may be harbingers of an economy that is recovering? You have used the words, "an incipient recovery." Do you see a recovery unfolding at this point in time?

Mr. BERNANKE. Yes, sir, our expectation is that we will begin to see growth in the economy, so the end of the technical recession, later this year.

Underlying that prediction is some stabilization in final demand, including consumer spending, as well as the importance of unwinding the inventory dynamic. Firms have been cutting back their production and, therefore, have lowered their stocks of unwanted inventories. As that process goes forward, they will be able to increase production as they no longer have to get rid of those extra inventories.

So we expect to see some growth, not robust growth but some positive growth, later this year. Unfortunately, since the growth rate, in the beginning of the process will be lower than potential, we expect unemployment to continue to rise into next year and to come down only slowly. So we will have a weak labor market for some time.

Chairman SPRATT. Without the extraordinary steps that we have taken, Fed has taken, the FDIC and the Treasury, without TARP and TALF and the Recovery Act, do you think we would be where we are, on the doorsteps of an incipient recovery?

Mr. BERNANKE. No, sir, I am quite sure we would not be.

---

[1] Ben S. Bernanke (2009), "The Economic Outlook," statement before the Joint Economic Committee, U.S. Congress, May 5, *www.federalreserve.gov/newsevents/testimony/bernanke20090505a.htm.*

I recognize that many people have raised concerns about various aspects of policies, financial risks that have been incurred, for example. And those are real and serious concerns. But I do think we need to keep in front of us the fact that without the concerted effort of the Federal Reserve, the Treasury, and other agencies like the FDIC, supported by the Congress and the administration, that last fall we very likely would have had a serious and perhaps global financial meltdown, with extraordinarily adverse implications for the U.S. and global economies.

I think having averted that and that we now seem to be on a process of slow and gradual repair, both of the financial system and of the economy, is a major accomplishment. And though, again, there are many issues that remain, we must keep in front us the fact that we averted, I think, a very, very serious calamity.

Chairman SPRATT. In undertaking these countercyclical steps, we have advanced large sums of money and taken back, in many cases, assets like preferred stock in the major banks which were recipients of TARP funds. In addition, the Fed has a TALF lending facility for asset-backed securities.

Can you give us some idea of what you expect in the way of recovery or repayment on these assets so that we can, in turn, look towards the recovery of some of these moneys to be used to pay off the debt that was incurred in advancing these loans in the first place?

Mr. BERNANKE. I think that, with respect to the TARP, I think our recovery will be excellent. In particular, a number of banks are looking to repay TARP, the Federal Reserve will announce a list of banks next week that we believe are sufficiently sound and are able to lend, that they are eligible to repay the TARP, with, of course, interest. And if the Treasury accepts that recommendation, then we will see some repayment of the initial TARP outlay.

With respect to the TALF, the Federal Reserve's program for asset-backed securities, we have extensive protections, which I would be happy to detail if you would give me a few minutes. But we are very comfortable that this program is, on the one hand, very effective in opening up the markets for consumer credit, including auto loans, student loans, small business loans, at the same time, I think, that the credit risks, especially to the Fed itself, are quite minimal.

Chairman SPRATT. Has the Fed done any work to determine what the likely pool of savings available for borrowing may be—foreign markets, world markets, global credit markets—and to what extent we will have to borrow substantially from those savings pools, capital pools, in order to meet our debt requirements in the foreseeable future?

Mr. BERNANKE. Yes, we have certainly looked at that. I think it is an interesting point. Even though as the Federal Government's borrowing has skyrocketed, that the U.S. current account deficit, which is essentially a measure of the amount of borrowing we do from abroad, is actually lower today than it has been in some years, which suggests that the increase in Federal borrowing has been substantially offset by a decline in private borrowing, as banks and households deleverage.

So, in a sense of there being an availability, there is an availability of credit to meet the needs of the U.S. Government and other governments. That being said, as I mentioned in my testimony, in order to make lenders willing to continue to finance us at reasonable interest rates, we do have to persuade them that we are serious about returning to a more balanced fiscal situation going forward.

Chairman SPRATT. Mr. Chairman, thank you very much for your testimony.

Mr. Ryan?

Mr. RYAN. Thank you, Chairman.

Good to see you again, Mr. Chairman.

Let's talk about our deficit and debt. The CBO, their re-estimate of the President's budget shows record deficits of 5.4 percent of GDP in 2019 and debt rising to 82.4 percent of GDP. Meanwhile, Medicare and Social Security will have already begun their pathway of permanent deficits.

Are you concerned about these levels of deficits and debt? And is this a sustainable and prudent fiscal policy course?

Mr. BERNANKE. Mr. Ryan, I certainly am concerned about that.

I think we face a double challenge. One is that we have to restore ourselves to a more balanced fiscal path after addressing the financial and economic crises that we currently are facing. But, in addition, that is complicated by the fact that with the retirement of the baby boom and the increase in medical costs that we are facing rising entitlement costs, which—this is no longer a long-term consideration. This is something that has got to happen in the next 5 or 10 years. So that is extraordinarily challenging.

My rough rule of thumb to the Congress would be, given that we have seen this increase in the debt-to-GDP ratio, that we should hope to try to at least stabilize it at the higher level and over time to try to reduce it. But certainly we cannot allow ourselves to be in a situation where the debt continues to rise, that means more and more interest payments, which then swell the deficit, which leads to an unsustainable situation. So it is very, very important that we——

Mr. RYAN. So what matters is the trajectory. The path of the trajectory is really what kind of matters here in the long term; is that right?

Mr. BERNANKE. That is right. The CBO shows alternative simulations that involve the debt essentially exploding, which it would if it got so high that interest payments became unmanageable.

Mr. RYAN. Let's turn to inflation. Your colleague at the Philadelphia Fed, Charles Plosser—and I have spoken to some other Fed bank presidents who seem to concur—he recently gave a speech in which he said that the economic forecasters rely too heavily on measures of the so-called "output gap" as a predictor of inflation. These forecasters argue that inflation will remain low for some time, given the large current output gap. He notes that other indicators, more forward-looking economic models, suggest a much higher risk of inflation over the medium term.

Are we looking at the right indicators to gauge the risk of future inflation? Gold and inflation compensation spreads and the Treasury bonds markets are rising. So what indicators are you using to measure inflation, and why are they the right indicators?

Mr. BERNANKE. Well, Congressman, we look at a whole range of indicators, absolutely.

I do think that when output gaps reach the level that we are currently seeing that it is no longer the case that we can really debate that the output gap exists. I think there is clearly an output gap.

And the experience is that, in previous recessions, that inflation has tended to fall after the recession. That, I think, is a reliable empirical regularity. And the size of the current output gap will be a drag on inflation.

Mr. RYAN. So you fall into the output gap camp.

Mr. BERNANKE. Mr. Plosser does, as well. He is simply saying we shouldn't put too much weight because it is very difficult to measure them. But what I am saying is that, currently, there is not much doubt that there is an output gap, and that, therefore, there would be a downward effect on inflation. That being said, there are other factors as well, including the currency, including commodity prices and so on, and we watch those very carefully.

I think I would note that, if you look around for evidence of inflation, inflation expectations, you are not going to find very much. If you look, for example, at surveys of consumers, if you look at the forecast of professional forecasters, if you look at the spreads between indexed and nonindexed bonds, all of those things are quite consistent with inflation remaining stable and well within the bounds that the Federal Reserve believes is consistent with price stability.

Mr. RYAN. Are you concerned that today's models, which reflect yesterday's models, are not fast enough to pick up on changing expectations? What I mean when I say that is, in the 21st-century economy, information spreads much faster. Opinions are formed much more quickly because data is more available than it was, say, in the 20th century.

Are you concerned that the models we use today do not fully reflect the fact that expectations can change a whole lot faster than they could in the past, and then we will be too late to catch it when it occurs?

Mr. BERNANKE. Well, of course, we always have to keep modifying our models and addressing new situations. But we have a lot of ways of checking on expectations, including monthly surveys of both businesses and households, the daily behavior of the TIPS market, the daily behavior of commodity prices, and other factors.

And, in particular, you know, inflation expectations can only result in inflation if they actually affect wage and price setting. And what we are seeing in the markets is that prices of manufactured goods, for example, and wages in nominal terms are not showing any signs of a wage-price spiral. To the contrary, they are showing quite a slow rate of growth.

So, first of all, I want to say that in the medium to longer term we are very focused on the price stability issue, and I understand your concerns about that. But, as best we as can tell within the uncertainties of the forecasting, we don't see any inflation risk in the near term.

Mr. RYAN. So when the time comes where you do see that concern—my last question is basically this: one about your exit strategy and one about the independence of the Federal Reserve.

You have four big policy tools that are being deployed at full tilt: targeting zero interest rates; a program of quantitative easing; you have a balance sheet around $2 trillion, $2.1 trillion, some of which has longer-term paper on the balance sheet now than before; and you are buying Treasury bonds. That is a lot of policy that is out there that you would have to unwind very quickly in order to turn the corner.

What is the exit strategy of the Fed? And what kind of confidence do you have that you will be able to wind all this down when the moment comes, question number one?

Question number two is it was inevitable, I would argue, that your dealings with the Treasury were unprecedented. You had to do a lot in the last year to fight deflation, and I think everybody recognizes that. However, that has in some ways blurred the distinction of the independence between the administration, the executive branch, and the Federal Reserve and its unique independent role.

What do you think of that concern? And what are you doing to reassert the independence of the Federal Reserve, not just in structure but in the impression of the marketplace?

Mr. BERNANKE. That is a very long question, but I would like to address it, if I might.

First of all, on the technical aspects of unwinding, we are confident that we can unwind this process. What we need to be able to do is raise short-term interest rates to tighten policy in the normal way.

In order to do that, we have a sequence of things that can happen. First, short-term lending, short-term programs can either decline because of lack of demand, which we are seeing—we have seen a very substantial decline in the usage of our short-term programs over the last couple of months. Secondly, of course, as conditions return to normal we can simply shut down those short-term programs. That is step number one.

Step number two and very important is the interest on Reserve's authority that the Congress gave us last year. By setting an interest rate on reserves close to our target for the short-term interest rate, we make it very unlikely that banks would want to lend out in the overnight Federal funds market at a rate below that interest rate.

Mr. RYAN. Is that your biggest tool? Is that the most powerful tool you have?

Mr. BERNANKE. That is a very important tool, and many central banks around the world effectively use that tool. We have additional ones, though, including reverse repurchase agreements and, if necessary, sales. But there are a number of ways that we can address this problem. So I think, from a tactical point of view, we are able to address the current level of our balance sheet.

Politically, there are several points here. First, as you point out, I think the American people would want the Federal Reserve and other agencies like the FDIC to work closely with the Treasury in trying to address these critical financial problems, which is what we have done. But we have done so on an equal basis, from a perspective of an independent agency. In particular, our supervisory decisions have been independent and have been made on our own information and our own decisions.

So we have maintained our independence, even as we have collaborated closely with the Treasury, in trying to address the financial crisis. In that respect, that is consistent with previous financial crises when different agents of the government have worked together.

On monetary policy, independence is, of course, crucial. We have not experienced any threats to our independence from Congress, the administration, or elsewhere. We have made all our decisions of monetary policy on a strictly independent basis, and we feel quite confident that we can continue to do that going forward.

We face, as always, the same difficult decision about what is the right moment to begin to remove accommodation. You don't want to remove accommodation so soon as to prevent the recovery from taking hold. On the other hand, you don't want to wait so long as to lead to an inflation in the medium term. But that decision is the same difficult decision we always face when we come to a point to remove a monetary accommodation. And we are fully confident that, although that is a difficult decision in terms of balancing the risks on both sides, we are fully confident from a political independence point of view that we are able to make that decision as we need to make it.

Mr. RYAN. It will clearly occur in an atmosphere of more pressure than I think you have seen in the past, given where we are right now.

Thank you.

Chairman SPRATT. Mr. Doggett?

Mr. DOGGETT. Thank you, Mr. Chairman.

And thank you, Mr. Chairman.

While the $700 billion bailout, which you urged Congress to adopt last September, has received continued scrutiny and debate, the Federal Reserve is apparently committing about three times that amount in public money, much of it through the emergency lending powers.

Certainly, independence and secrecy may be important in the Fed's normal operations, but this use of expansive emergency powers relying on a vague statutory provision that has not been used in about seven decades is certainly not normal. The Fed, indeed, seems to have sprung into action through the backdoor as a way for some to avoid another request of the Congress for public funds through the front door.

One of the few safeguards that we have in the taxpayer-financed portion of the bailout is the congressional oversight panel. Yet the Fed has not responded to that panel's April request for specific information about your continued assistance to AIG, even though our oversight panel told you that the lack of information, quote, "has substantially hampered oversight."

Meanwhile, we have learned that the AIG bailout was also a bailout of Goldman Sachs and some of the world's largest foreign banks, all of whom were not asked to accept a penny of losses.

I have four questions or question areas for you that are all closely related. I will try to state them and then just ask you to respond at the end.

The first one is just directly, when will you have a thorough and complete response to every query that the oversight panel asked you in April?

The second is that that same congressional oversight panel concluded that a third of the taxpayer moneys that the Treasury gave away under TARP was wasted. You have not disclosed sufficient details to permit a similar independent analysis of what the Fed has been doing to determine what value the Fed is getting for its investment of our public money. What meaningful assurances can you provide the American people that we are not being fleeced again? Have you done a full review of what kind of deal the taxpayers are getting? And, if so, will you provide the complete documentation for the basis of that assessment?

Third, while the Fed's secrecy regarding which banks are borrowing from its discount window is understandable, the situation is far different with your newly discovered emergency powers. There is little difference between those you are aiding in secret and those the Treasury is aiding in public. How can there be effective oversight, any protection, really, for the public, when you are not disclosing who the Fed is helping, how much they are getting, and on what terms? And I am not talking about just adding a table to your Web site or a summary report on a monthly basis. My question is, when will you be able to provide the identity of participants, transactions implemented, profits or losses posted from specific transactions to the oversight panel, the Fed inspector general, the GAO and this Congress?

And, finally, relying upon the Federal Reserve instead of the Treasury for bailouts can also mask the true cost to the public in terms of our soaring national debt. Any losses on assets on loans through these riskier, abnormal emergency power activities could result in the Fed, of course, remitting less money to the Treasury. Have you undertaken a comprehensive analysis of the risk to the taxpayer from the assets that you are requiring in the loans that you are making? I am not referring to a conclusive statement that everything is fine, but if you have done such an analysis, can you provide it to us this month?

Mr. BERNANKE. Congressman, on the oversight panel request, I am sure we will respond to that. I am not aware of the status of that request.

I would just note that the Senate—I think the Congress passed a rule recently that would allow the GAO to directly audit AIG and other individual banks or other interventions, and we are perfectly comfortable with that. We have provided extensive information to the Congress on AIG in those other rescues, including monthly reports required by Congress on all 13(3) lending. So we have been quite open about it. If there are specific issues, I would be——

Mr. DOGGETT. Well, how about the specific issues on the specifics? Who gets the money? What are the terms? What are the——

Mr. BERNANKE. On what program?

Mr. DOGGETT. On any programs under your emergency powers, where you rely on emergency powers. Certainly on the approximately trillion dollars that you say you will be doing in mortgage-backed securities.

Mr. BERNANKE. Well, mortgage-backed securities, so if you look at our balance sheet, the bulk of it is in two things: short-term lending to financial institutions, which goes up to a trillion, is now down to about $600 billion, $700 billion because of payback, basically—the naming of those institutions relates to the concern that you mentioned earlier, which is that if you name the institutions they will not be willing to take the liquidity backstop, which is necessary for stabilizing financial markets.

But I would like to point out that your concern was about credit risk. These are extremely safe, short-term loans, well-collateralized, with recourse, and with supervisory oversight. To my knowledge, we have never lost a penny. We have actually made money on those loans. So that is a big part of it.

The other big part of our balance sheet is securities, which are Treasuries, GSE, the debt and mortgage-backed securities. Those are standard securities that are guaranteed by the U.S. Government. There is no loss to the Fed from that. And there is nothing to be disclosed about that, other than the fact that they are just conventional securities.

So those are the two biggest components of our balance sheet. Then, of course, there is about $100 billion, about 5 percent of our balance sheet is dedicated to the Bear Stearns and AIG rescues. As I said, those things are now open to audit by the GAO, and we will cooperate in every way and provide whatever information is needed on that.

So I would urge you to look at our new monthly report that we will issue very shortly. And we will respond to the congressional oversight panel, and I hope we can meet your——

Mr. DOGGETT. But you have declined to provide any of the specific details?

Mr. BERNANKE. You will have to be more specific about what you need. I think, in the case of the short-term financial liquidity provision, I think there are good policy reasons not to provide that. But we have provided extensive information about the programs, about the collateral we accept, about the number of borrowers. And in cases where TARP money is concerned, we will provide all the information that SIGTARP would want or anyone else that needs to have an enforcement authority.

Chairman SPRATT. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Welcome, Chairman Bernanke.

If the staff could put up chart 10, please.

Mr. Chairman, as you well know, we are looking at an explosion of debt over the next 10 years. Now, presently, our Federal debt is at 41 percent of GDP. I know this is well-known to you. CBO says that it will increase to 82 percent of GDP in 10 years.

In your testimony, you speak of the need to have prompt attention to questions of fiscal sustainability in order to maintain the confidence in our financial markets. So, certainly, the case has been made for short-term Federal intervention in our marketplace. I believe that in testimony by the head of CBO their estimate is that we will reach positive GDP growth in the third quarter of this year and that unemployment will level off, I believe, I think, the second quarter of next year. OMB had a rosier scenario. And today, in your testimony, you speak of an incipient recovery, and I believe you said economic activity should turn up later this year.

So my question is, if OMB, CBO, and the Federal Reserve are predicting positive GDP growth, an upturn in economic activity somewhere in the next 6 to 18 months, we have concerns about the fiscal sustainability of these levels of debt. Having our debt go from 41 percent of GDP to 82 percent of GDP in 10 years, tripling the national debt in 10 years, does this meet your definition of prompt attention to questions of fiscal sustainability?

Mr. BERNANKE. Well, Congressman, I am not sure whose CBO projection, I guess, that is. I would say that that picture is concerning not only because of the level but because of the fact that it continues to rise. Sustainability means—there are countries that have 80 percent or 100 percent debt-to-GDP ratios. I am not recommending that. But, clearly, you can't have a debt-to-GDP ratio which continues to rise indefinitely.

So it is very important that we have now or very soon a plan to stabilize, at least, the debt-to-GDP ratio so that it doesn't go into a continued increase, which, because of interest payments, would make sort of a vicious circle going forward.

Mr. HENSARLING. I have seen one analysis that, clearly, to keep the debt at today's level, 41 percent of GDP, that either, number one, you are going to have to monetize the debt and essentially inflate the money supply 100 percent, or that tax increases across the board in the neighborhood of 60 percent would be necessary to balance the budget in 10 years.

Has the Federal Reserve done its own calculations? Does this seem to be an accurate analysis?

Mr. BERNANKE. We haven't done that particular analysis. I don't think it is realistic to get back to 41 percent that quickly.

Mr. HENSARLING. Which means perhaps some level of tax increase, spending decrease, or inflating the money supply is going to be necessary?

Mr. BERNANKE. Relative to that CBO baseline, I mean, it is evident that either cuts in spending or increases in taxes will be necessary to stabilize the fiscal position.

Mr. HENSARLING. Will the Federal Reserve monetize this debt?

Mr. BERNANKE. The Federal Reserve will not monetize the debt. And I think it is important to point out that, notwithstanding our purchases of Treasuries as part of a program to strengthen private credit markets, even when we complete the $300 billion purchase that we have committed to, we will still hold less Treasuries, a smaller volume of Treasuries than we had before the crisis began.

Mr. HENSARLING. If the Fed will not monetize the debt and if the Congress refuses to deal with the spending curve, which will average about 23 percent of GDP for the next 10 years, that is either going to leave us with a massive tax increase or massive borrowing. But yet, apparently, as we send representatives to China to encourage them to continue to buy our debt, they are shifting to commodities; they are indicating concerns about the level of our debt. Recently, as I believe you know, S&P downgraded UK's debt on May 21st from stable to negative.

So what is going to happen if the U.S. loses its AAA rating, or what happens if we have a 60 percent tax increase over the next 10 years to deal with this massive infusion of debt?

Mr. BERNANKE. At some point, you have to have a path of spending and taxes that will give you a stabilization of the debt-to-GDP ratio. If you don't, then fear that the debt will continue to rise will make it very difficult to finance it. And, at some point, you will hit a point where you will have to have both very Draconian cuts and very large tax increases, which is not something we want.

So, in order to avoid that outcome down the road, we need to begin now to plan how we are going to get the fiscal situation into a better balance in the medium term.

Mr. HENSARLING. Thank you.

Chairman SPRATT. Mr. Scott of Virginia?

Mr. SCOTT. Thank you, Mr. Chairman.

The gentleman from Texas just showed a chart that showed how bad things have happened since 2000. What he didn't show is how we got there. This chart shows that when the Clinton administration came into office we made some tough choices and ran up a surplus that was to be surpluses, as far as the eye could see, kind of locked into the budget. In 2001, that is when the budget deficit exploded.

The next chart shows the fact that, had nothing happened after 2001, we had a $5.6 trillion 10-year surplus. Because, as the gentleman from Texas has shown, that has gone into additional deficit. In fact, his chart, if you will think back to the chart that he showed, only showed less than a $4 trillion debt held by the public. We had enough continuous surplus to pay off the entire national debt. In fact, it was projected to have been paid off by last year, all of the debt held by the public, if we hadn't messed up the budget.

So I think the entire budget process should be shown, not just what happened starting in 2001. We had things under control; we were able to pay off the entire national debt. But the wrong choices were made in 2001, and we went directly into the ditch.

One of the first things we have to do, of course, is to get the economy back in order. And I noticed, on page 6 of your testimony, you showed that the stimulus package may only create 1 million to 3.5 million jobs. Is that correct?

Mr. BERNANKE. That is the CBO estimate.

Mr. SCOTT. Now, what parts of the stimulus were more effective in creating jobs than others?

Mr. BERNANKE. I think, dollar for dollar, the infrastructure spending, the direct government spending is probably most effective—although it takes a longer period of time. The increased transfer payments and tax cuts work more quickly, but, because part of them are saved, the impact might be somewhat smaller.

Mr. SCOTT. You mentioned the TARP funding. Can you tell me the effect—if the banks wanted to pay back the TARP funds, what effect would cashing in the warrants have on the cost of paying back?

Mr. BERNANKE. So, besides paying back the preferred shares, as you know, there are warrants also, which give the public some upside on the stock values of the companies.

The Treasury is trying to determine, you know, how to price those warrants and how to go forward with that. There is a bit of a complication, as I understand it, because in the law the banks have the right of first refusal in terms of purchasing those warrants before the warrants can be auctioned in a public market. So that requires some analysis of the value of the warrants, which I understand Treasury is undertaking.

So I assume that——

Mr. SCOTT. Will we necessarily cash in? Because some have complained that the cost of the warrants would make the cost of the loan actually excessive.

Mr. BERNANKE. Well, the point of the warrants was that if things turned around and got better, that the public would share in some of that gain. I would say that TARP has been pretty successful in terms of stabilizing the banks and helping to get them back on their feet and get our banking system back on its feet. And stock prices, although they are still relatively low on an historical basis, have done a lot better lately, and some of that gain should go to the public.

Mr. SCOTT. Some banks have also complained that the additional FDIC fees will reduce their lending capacity and, therefore, have an adverse effect on the economy.

Do you have a comment on that?

Mr. BERNANKE. Do you mean the assets for the Deposit Insurance Fund?

Mr. SCOTT. Yes.

Mr. BERNANKE. That is a concern because, given the losses to the banking system, if those losses were made up very quickly, it would be a fairly heavy tax on banks, including community banks. And for that reason, my understanding is the FDIC is trying to arrange to spread that assessment over a longer period of time, which would be, I think, desirable in the sense that this is not a time to be putting sort of a tax, essentially, on the banking system when we need them to be making loans.

Mr. SCOTT. Because that would convert directly into reduced lending capacity?

Mr. BERNANKE. To the extent that it reduces capital, that is correct.

Mr. SCOTT. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. Thank you, Dr. Bernanke.

If I look at the bills we have had here on the floor over the last couple of weeks we were in session and this week, virtually everything we are doing either authorizes or appropriates more money—spending—even, in many cases, than what is anticipated in the charts that we have talked about today.

What are the economic consequences of continuing that sort of trend?

Mr. BERNANKE. Well, Congressman, as I have indicated, we, as a country, are going to have to make some hard choices. We can't expect to continue to borrow—certainly not 12 percent of GDP, but not even 4 or 5 percent of GDP—indefinitely, and so we need to make a plan, some decisions about how we are going to bring the budget closer to balance over the medium term. And that means that as you discuss various programs that include spending, you need to think about the revenue resources that would be related to that. If you don't do that, then again you will see interest rates rise, and you will see reluctance of lenders to provide credit to the U.S. Government. That would be a very bad outcome. And I believe there is a great deal of confidence in the markets that the U.S. Government will take the necessary steps to restore fiscal discipline, but it is essential that this body, and Congress in general, do that hard work and get that done.

Mr. CAMPBELL. Chancellor Merkel of Germany yesterday was very critical of central banks worldwide, but specifically of the Fed. Would you like to make any comment? I presume you have read what she said. Would you like to make any comments relative to her comments?

Mr. BERNANKE. Only that I respectfully disagree with her views. The U.S. and global economies, including Germany, have faced an extraordinary combination of a financial crisis unlike any seen since the Great Depression, plus a very serious downturn. And in that context, I think strong action on both the fiscal and monetary sides is justified to try to avoid an even more severe outcome.

I am comfortable with the policy actions that the Federal Reserve is taking. And as I have described to Mr. Hensarling and Mr. Ryan, we are comfortable that we can exit from those policies at the appropriate time without inflationary consequences, and therefore we are comfortable with our policy position.

Mr. CAMPBELL. Are the current powers of the Fed, in your estimation, inadequate, excessive, or adequate?

Mr. BERNANKE. Well, I think there are some changes that are worth making. And I would mention specifically, I was asked a question a moment ago about AIG, for example. It was with great, great reluctance the Federal Reserve got involved in that kind of situation, there being no good alternative to avoid a collapse of a major financial firm and the consequences that would have for the financial system and for the economy.

As I have said a number of times for at least a year, I think a very critical step that the Congress needs to take is to develop a resolution regime that would allow the government—not the Fed, but the government to step in when a major financial firm is near default and the financial system is in crisis. That would be parallel to what we already do now for banks through the fiduciary system.

If we could have such a system in place, then the Fed would no longer be in the "Hobson's choice" of either standing aside and letting the system collapse or taking these actions using a 13(3) authority, which are very, very uncomfortable for us. So that would be an area where we would be happy to withdraw or pull back on our activity if the government would provide a good system for addressing that issue.

Mr. CAMPBELL. We discussed a little bit the Treasury bill rates, and specifically the 10-year Treasury, which according to my thing right now is 3.58 percent yield. Most adjustable-rate mortgages reset on the 10-year Treasury number. If that 10-year Treasury yield were to increase some more this year, what impacts might that have on potential second-wave and mortgage-backed security failures or ARM resets?

Mr. BERNANKE. I would like to check the data on that, but my impression is that most ARMs actually reset on shorter term interest rates, like the LIBOR rate, which is very, very low right now, or the Treasury bill rate.

Since the Federal Reserve brought interest rates down to such a low level in the last year or so, concerns about resets in the mortgage market have considerably been reduced. There certainly are very serious concerns about affordability and about principal mortgages being underwater because of principal declines, but the interest rate reset problem on ARMs has been considerably moderated by the low level of short-term interest rates.

Mr. CAMPBELL. Last quick question. TARP money was originally intended to stabilize the markets, but also to give banks capital from which to do more lending. As they want to give it back in order to avoid the restrictions being placed on them, isn't that, in effect, going to reverse part of the original intent, which was to provide them more capital from which to lend, and therefore reduce potential lending in the marketplace?

Thank you.

Mr. BERNANKE. Yes, that was part of the original intent. Unfortunately, because of the restrictions and other reasons, including just bad publicity, many banks want to repay the TARP. So it won't be able to serve that function. On the other hand, after the stress test and our supervisory reviews, many banks are raising private equity, which will I think be a more permanent form of capital, a higher quality form of capital in which they will be more willing to base their lending strategy.

Chairman SPRATT. Mr. Bishop.

Mr. BISHOP. Thank you, Mr. Chairman. And Mr. Chairman, thank you for your testimony.

I have just two questions. Earlier—I think I am accurately paraphrasing your testimony—you indicated that in your opinion both the TARP funding and the stimulus legislation averted a tragedy. Is that essentially correct?

Mr. BERNANKE. That is right.

Mr. BISHOP. And in response to questions from Mr. Scott, you indicated that you thought direct government spending was the most effective means by which we would either stabilize jobs or create jobs?

Mr. BERNANKE. Well, I think it is important to have a mix, but in terms of immediate impact on the economy, government spending doesn't have the issue that tax cuts do, which is part of it may be saved. But that being said, I think a good mix is useful.

Mr. BISHOP. The stimulus package that was passed had round numbers, $500 billion worth of spending, $300 billion worth of tax cuts. Those are round numbers. When that legislation was on the floor, the Republican alternative offered was a package of essentially $500 billion worth of tax cuts.

Can you estimate what the impact would have been had we passed simply a $500 billion package worth of tax cuts as opposed to some stimulative spending?

Mr. BERNANKE. No. I really am not able to do that on the fly. But in any case, I am sure that part of the motivation for the tax cuts was the incentive effects of tax cuts as well as the direct spending effects. So that would have to be factored into some comparison. But I would prefer not to get into that detailed level.

Mr. BISHOP. Understood.

One of the policy issues before us over the next several months will be to deal with the President's recommendations with respect to higher education policy. One of his recommendations is to move away from what is referred to as FFEL lending to 100 percent direct lending, monies provided by the Treasury. There are arguments for doing that, and there are arguments that would suggest we should not do that. One of the arguments raised that suggest that we should not do it is that the increased borrowing would be detrimental to our both short and long-term fiscal stability.

What is your assessment of that argument?

Mr. BERNANKE. I don't think that is a very strong argument because you are either directly making the loans or you are guaranteeing the loans. And as far as the potential loss to the Treasury is concerned, the guarantee is the same, essentially, as making the loan. So it is really an accounting difference, not a real economic difference.

I think there are a lot of other issues that you point out. There are arguments on both sides for using a private lender who may be better at making the loans or may not be versus having the direct lending. I would just point out that if you were to continue using the private lenders, one of the problems that emerged last year was a mismatch between the interest rate they were allowed to charge and the interest rate in which their cost of funding was determined. So there were some technical issues that would have made that situation better. But again, that fundamental question of private versus public, a lot of issues there.

Mr. BISHOP. Thank you.

Mr. Chairman, thank you. I yield back the balance of my time.

Chairman SPRATT. Mr. Latta.

Mr. LATTA. Chairman, thank you very much for being with us.

Mr. Chairman, over Easter, I was in Latta, South Carolina. We were driving down that way. And I had to take a picture with my kids by the sign there of the corporation so they could say they were there.

But thank you very much for being with us. And to give you a little background about where I am from, I am from the Fifth Congressional District. My district is the largest manufacturing district in Ohio. It is also the number one agriculture district in the State of Ohio. I butt up against Indiana on my west, Michigan on my north. So just kind of giving you a picture right there, we are in tough times.

I have the highest unemployment rate of the counties in the State of Ohio, one over 16 percent now. And as we have been on our break, I have criss-crossed my district during that time, and also when I am at home every weekend, going through factories and talking to businesses across the region and also the people that work there. And I am finding folks who are out there in the business sector, especially in these factories, they can't shed any more jobs. If they shed any more jobs, they are not going to be operating. So a lot of them are just hanging on by their fingernails right now. And there have been pay cuts that people have taken. They have reduced the number of hours that they are working per week. So it is a very, very tough time.

And when we have been doing this, going out and across the district, one of the things I would just like to ask is, in your testimony, on page one, you are saying that consumer spending has been relatively flat and consumer sentiment has improved, but you also say in the coming months household spending power will be boosted by the fiscal stimulus program. I was at another town hall last night, and folks were telling me what they are doing and were not buying. But what in the fiscal stimulus package out there is going to help the Fifth Congressional District in the next few months in our area?

Mr. BERNANKE. Well, in reference to my specific comment about boosting household income, the "make work pay" tax cuts and the UI insurance and other transfer payments, Social Security, veterans payment will of course go to your constituents like anyone else in the country. So they will get extra income. As I mentioned also in my testimony, how much of that they will spend and how much they will use to pay down debt or to squirrel away is an open question. But we saw already just this week, we have seen an increase in personal income, and a lot of that is coming from government support.

Mr. LATTA. I guess the next question, we were talking about income and things like that, and also jobs. You quoted a little bit earlier the CBO. By the end of 2010, CBO said there would be about a 1 to 3 percent increase, or 1 to 3.5 million jobs being created. Are we talking about private sector jobs, or are we talking about government jobs?

Years back I was a county commissioner. Back in the 1991-1992 recession we had other elected officials come before us and they said we can get this government money. And we always asked them the same question, how long is that job going to last? Because after that 1 year or 18 months is over, we are not going to fund it because we didn't have the money in the accounting budget.

So when we are looking at that CBO, which you mentioned, are we talking private sector jobs being created or federally created jobs that might just last a short period of time?

Mr. BERNANKE. Well, it depends a bit on the baseline that you are comparing it against. But I think it is fair to say that the preponderance of the jobs will be private sector jobs. And they would be permanent if the economy has, by the end of this period, come closer to a better employment situation so that we are closer to a more normal labor market situation. So in that respect you are putting people to work 2 years earlier than they otherwise would have been put back to work. And that is the sense in which employment is being created.

Mr. LATTA. I guess real quickly, when you say more of a normal situation, the situation that we are in right now, would you consider that normal for the time? Or are we looking at a longer period of time that these jobs are going to have to be created over, especially getting back to work in the private sector?

Mr. BERNANKE. Well, the stimulus program, roughly speaking, only puts out a quarter of the money in 2009, half the money in 2010, and a quarter of the money even beyond that. So if it takes several years for unemployment rates to come back down to sort of more normal levels, the fiscal program will be having some effect over that 2-to-3-year window.

Mr. LATTA. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being here this morning at this critical time.

Along with Congress and the Treasury Department, the Federal Reserve is taking action to try and ensure the health of the credit markets, and you have talked about that a little bit already, and we thank you for that. As you have said, it is one of the toughest downturns we have seen in the financial sector since the Great Depression.

Let me ask two questions. You have touched on this some. You touched a little bit on the sectors improving, but let me go back to that on the credit markets. Which ones are improving? What are the areas that are still lacking that need attention to improve? And specifically, I am thinking about how long will it take for additional credit to be available for consumers and small businesses.

Because I was home this past week, and I talked to a lot of folks. They are still tight in the business sector. Car dealers are having a difficult time in a lot of places getting people qualified to buy the vehicle that actually is available, and they want to buy, and actually have pretty good credit. So I would be interested in your thoughts on that. Are there other things Treasury or the Federal Reserve needs to do or some things that we need to do here? Because there are people that are still hurting, and I think it is bleeding over into the farm sector as well in some areas. I would be interested in your thoughts on that.

Mr. BERNANKE. Certainly. There has been a pretty widespread improvement in financial markets; credit spreads are down through most types of credit markets, activity is up. This is true both in the short-term money markets, and it is also true in the longer-term corporate markets.

As you point out, an area which is still quite tough is consumer lending and small business lending. And that is true for a couple of reasons. And the Fed is trying to address both of them. It is true, first of all, because consumers and small businesses rely very heavily on banks. And banks have not only had their capital reduced by losses, but they have become more reluctant to extend credit to these customers either because they are worried about losses or because they are worried about their own financial positions.

In this respect, we have heard complaints that bank examiners from the Fed and other agencies are too prone to prevent banks from making loans in the interest of safety and soundness. We had a joint statement, the Federal Reserve and the other banking agencies, last fall making the point that making loans to creditworthy borrowers, maintaining credit relationships is profitable for banks and therefore good for banks. And that in addressing whether or not certain types of loans should be made, the examiner should balance the need for conservatism in a difficult situation and the need to allow creditworthy borrowers to receive credit.

Mr. ETHERIDGE. Mr. Chairman, I don't want to interrupt you, but it may be time to send that note back out again.

Mr. BERNANKE. Well, it is very, very difficult to get that message from the very top down to the examiners. We have been having workshops and so on. We will continue to try to get that message out.

The second reason for the problems is that banks, after they make these loans, have traditionally wanted to securitize them in the secondary market; those markets have not been functioning. Our TALF program has brought those spreads down, has increased activity. For example, in auto loans, we have seen some better availability and lower rates. So as we continue in that area, we expect that will help.

You asked me where there are still problems. One area I would mention besides small business and consumer lending is commercial mortgage-backed securities, commercial real estate. That is an area where we are also going to try to address that. But currently, getting refinancing for existing commercial projects is very, very difficult.

Mr. ETHERIDGE. Thank you. Let me just say, as a student of— not only a student, probably, but a world-renowned specialist in the Great Depression, what are your thoughts on avoiding these kinds of economic crises in the future? And are there lessons the Fed has learned from its role in the banking supervision that we have gone through so far that we, as a body, might pay attention to and help with?

Mr. BERNANKE. Sir, in dealing with a situation like this, there is the immediate emergency response and then there is the longer-term actions you want to take.

On the emergency response, the two lessons I learned from studying the Great Depression are, first, that monetary policy has to respond aggressively. The Fed did not respond in the early thirties, and we, of course, have done that. The second is that maintaining financial stability is absolutely critical. And as you know, we have taken a number of measures—some of them quite extraordinary—working with the Treasury to prevent a meltdown in the financial system. And I believe that we have averted a much worse outcome by taking those steps.

Going forward, we certainly want to avoid this kind of crisis happening in the future. We have learned a lot of lessons from the recent experience. I think we will have to have stronger oversight of the large firms, maybe higher capital. We need to have resolution regimes, as I mentioned earlier, to help resolve failing firms. And I believe we need to strengthen the financial infrastructure. But I would also say that I think we do need to take a more system-wide approach to regulation. Instead of looking only at individual firms where agency A is responsible for firm one and agency B is responsible for firm two, that there needs to be a more collaborative approach that looks at the whole system and make sure they aren't building risks in one area that are being ignored because they don't bear on a particular firm. So I think a more macro-prudential or system-wide approach would be helpful.

Mr. ETHERIDGE. Thank you, sir. Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

Chairman Bernanke, the other hat I wear is in Financial Services. And when you come over there, the issue that is often discussed is the term "the system risk," the systemic risk regulator. And as you know, of all the hearings that we have had, no one has really yet defined exactly what it is, what authority they will have, what they will regulate, so on and so forth.

But one thing out of both of these committees that I serve on seems to be pretty emphatic—and I will be taking a page out of Paul Ryan's comments here—and that is that one thing that is a systemic risk is the unfunded debt that is out there, as Paul was alluding to before. For this country, it is up to $56.4 trillion, and the numbers vary on that.

Interestingly enough, we have had expert after expert for the last 6 years come before the committee. They all say the same thing, and we hear it from both sides of the aisle. But in the budget that we got this year, unfortunately it really isn't addressed. Obviously, we spend more. The numbers you already said before. We are looking at the national debt would double in just 10 years, pushing the debt north of 100 percent of GDP. And interestingly, on those numbers—maybe somebody else referenced this—is what has happened over in the United Kingdom with S&P's downgrading them, going from stable to negative. And their situation, in some perspective, one economist is saying not quite as bad as where we are, and where our trajectory is, that we are going to be worse than them.

So your comment already is, I think, that this is probably the looming largest issue that we need to address?

Mr. BERNANKE. I would say that is right.

Mr. GARRETT. And I wonder, everything else we do besides that is almost that, besides the point; is that a correct——

Mr. BERNANKE. I wouldn't go that far, but there are many other issues we face.

And I want to say that you have had a lot of experts. And it is easy for us to sit at this table and tell you that you have to solve this problem, and it is a very hard problem to solve. But it is critical that we address that.

Mr. GARRETT. All right. So I over-strayed by saying it is besides the point, but the other aspect is trying to get our overall budget in order and trying to get those numbers down.

Now, Secretary Geithner was over in China just this past week and he made a statement to their concerns about where we are on our spending. He said, well, don't worry, we are going to try to rein things in. And the reports I read was the response from the Chinese was just laughter to that. I guess they just don't believe it. About a month ago, I think it was, our President said that he was going to start tackling it. And the way he said he is going to start tackling it is he is going to save $100 million. Where would you put that $100 million savings in the whole scheme of things; significant, large, major, or just totally irrelevant to the entire picture that we are dealing with as far as our unfunded liabilities and our budget as well?

Mr. BERNANKE. Well, $100 million obviously by itself is not a very big amount of money relative to these problems. I think the important issue is the commitment that the administration and Congress have both talked about and need to put into play.

Mr. GARRETT. But do you see any commitment from the administration based upon the $100 million so far or from the budget that has been presented so far?

Mr. BERNANKE. A lot of the budget that was presented was placeholders and broad plans and themes. I think the proof will be in the pudding, as they say, how Congress and the administration actually begin to implement health care reform or climate change policy. Those details about how the spending and revenues will be matched will be the critical issue.

Mr. GARRETT. Well, regardless of how we spend them, let's assume for the moment that we spend them on all the best things in the world, the deficit numbers don't change and the debt numbers don't change. We are still going to spend that $634 billion, whether it is on health care or something else, we are still going to spend this money on something, so the bottom-line numbers don't change.

Mr. BERNANKE. Well, my understanding was that $634 billion placeholder came with some prospective revenue offsets from the carbon permits and from upper-class tax increases. Mr. Ryan says no.

Mr. GARRETT. I will yield to him.

Mr. RYAN. Half from Medicare cuts and half from the upper tax increase.

Mr. BERNANKE. Well, prospectively, there was a match there. But as I say, this is all about execution, and that is the key issue.

Mr. GARRETT. When the CBO was here I guess about 2 weeks ago, one of the questions that I referenced to you as well, being a historian on this, was during the Great Depression—and I am not saying this is a depression—is that you actually say two depressions, one before Roosevelt and then one afterwards. With regard to the recession that we are in, is there the possibility that we will see what we are in right now, and that if the stimulus—and their description of the stimulus, my words, not theirs, was it started out small and will peter out altogether next year—if it doesn't have the impact that they suggest, that we will see that second bottom of a W then in next year's economy?

Mr. BERNANKE. It is very difficult to forecast that far in advance. If the fiscal program is not effective, then of course that would be a negative going forward.

Mr. GARRETT. They said that next year is going to have minimal impact, that basically you saw the impact now on the tax side of the question and basically it was of minimal impact as of next year. So if the stimulus is not having the impact, then what would?

Mr. BERNANKE. My understanding again is that about half of the effect will be in 2010, is my understanding of the timing of the stimulus package. But there are other factors at work as well. I mean, as confidence returns, private sector activity ought to increase, low-interest rates will stimulate demand. The rest of the world is strengthening. There are a lot of other factors that would provide support for growth outside the fiscal package.

That being said, again, there are a lot of issues to be resolved, such as excessive leverage, for example, that are likely to be headwinds as the economy tries to get back to a sustainable growth path.

Chairman SPRATT. Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

And Mr. Chairman, thank you for your testimony and for your comments, both about the reality of the situation fiscally and economically, but also going forward.

I wanted to ask two questions, if I may, that really relate more to households and some of the things that we hear about in our districts. And I think Mr. Latta alluded to it on the issue of unemployment as one that is very significant more so in his district than maybe even mine in the Philadelphia area. Fortunately, while not great, it is still in the 10 percent, 9 percent. It is not what we want it to be, but it is not as hard hit as other regions of the country.

With that said, when I hear and when my constituents hear that we are seeing maybe some stabilization, maybe some signs of growth that are positive, we still do keep hearing that the unemployment rates are going to continue to be high and not recover—you said so yourself in the testimony. Could you elaborate in any way, both on the expectations about unemployment, but maybe more so what more we can do about it? Some of these are projections based on previous recessions, previous actions. We don't know that there won't be some changes because we are taking different actions and you are as well.

Could you speak briefly just about whether there are additional actions or whether we can actually have more hope that we will see an increase in employment so that families in our district, businesses in our district are really starting to see that personal recovery?

Mr. BERNANKE. Well, the historical experience is that the labor market tends to lag the business cycle. So even as the economy begins to recover, unemployment can still remain high. In particular, if growth is relatively slow, it won't be fast enough to absorb workers coming into the labor force.

Ms. SCHWARTZ. So one of the last decisions businesses make is new employees and a commitment to new employees.

Mr. BERNANKE. That is right. So this is a very serious problem. Because besides the very important fact that people without jobs have difficulty meeting their house payments and other bills, people who are out of the labor force for a few years tend to lose their skills, tend to lose their connection to the labor force, and maybe when the economy recovers they may not even be employable. It is possible. So there are a lot of costs involved in this.

And if I had an easy answer, I would give it to you. All I can say is that, as you know, the Federal Reserve has been very aggressive in trying to support the economy, and the Congress has been as well. We might look at trying to help people retain their skills through educational programs or other kinds of training programs.

Ms. SCHWARTZ. So maybe while people are on unemployment, we might want to actually get them into other kinds of job training or education?

Mr. BERNANKE. At least it is an opportunity, if you are unemployed, to fine-tune your skills and perhaps be prepared when jobs begin to open up.

Ms. SCHWARTZ. And maybe look at future jobs; jobs that might be opening up, what kind of industries are growing, looking at what is next.

Mr. BERNANKE. It is the strength of our country and our economy that we have, in our technical schools and junior colleges and all kinds of other formats, we have a lot of ability for people to retool even in mid-life.

Ms. SCHWARTZ. Maybe something we should do, I know we did under TAA, Trade Adjustment Assistance, I added some provision that said that you would be eligible for job training and education benefits if your industry was certified as one of those industries affected by international trade, even if your own company and your own facility hadn't closed yet, with the notion that why not get people new skills and the ability to move on. Maybe that is something we ought to look at as we are dealing with a great many people who are unemployed who are going to need some additional skills. It is a good point. Maybe that is something we can work on.

Just very briefly, because I only have a minute, we have talked before about an interest of mine in helping to make sure that Americans learn to save. One of the interesting aspects of this recession is that people's fear about stagnant wages and unemployment is to actually hold the money and to actually begin to pay down debt and save.

Could you speak very briefly about how, while we want people to be spending in the sense of encouraging use of consumer products and stimulating the economy that way, we don't want people to lose this notion that actually saving and preparing for a rainy day, being able to have some cushion personally is important. We have forgotten to do that in the last 10 years, at least, maybe 20 years. Could you speak briefly to what else we might want to do to hang on to this concept that Americans ought to be saving some part of their income if they could?

Mr. BERNANKE. You are absolutely right. Over the last couple of decades, in part because of rising house prices and stock prices, people have sort of felt not necessary to save. Now they are saving more for the reasons you have mentioned. And it is interesting to note that people who grew up during the thirties, even in prosperity 30 years later, are still saving much more than their children. So this experience is of course a very negative one, but one benefit might be it is going to have some impact on people's savings behavior.

There are other things that can be done to try to increase saving, such as using only opt-outs from 401(k) participation, things of that sort. There is no magic bullet. And, indeed, attitudes and psychology seem to be important, and this certainly is having an influence on that.

Ms. SCHWARTZ. Well, maybe it is something we can do together in the sense of really encouraging Americans to think about continuing to save.

Mr. BERNANKE. Yes.

Ms. SCHWARTZ. Thank you.

Mr. Chairman, I yield back.

Chairman SPRATT. Mr. Nunes.

Mr. NUNES. Welcome, Mr. Bernanke. I am going to switch over to the Fed's involvement in mortgage-backed securities. There has been a report out recently that says—I think Wall Street Journal ran a report that said you are about 10 percent underwater on these mortgage-backed securities. There is currently $480 billion worth, I think is the number that they use.

As we look forward, I have a couple different questions related to this. Are you concerned that the risk of the Fed purchases will outweigh the benefits? That is the first question. The second question would be this; the Fed has said that they will buy up to a maximum of $1.25 trillion of mortgage-backed securities. Do you plan to go up to that limit? And if so, by when?

Mr. BERNANKE. On the first issue, I am not sure about the correctness of that calculation because we have a mix of securities, not just ones we purchased recently, but it is not our anticipation to be selling those off in the market in the near term. Right now we are financing those MBS, which pay coupons of 4 percent or so, using funds which cost us one-fourth of 1 percent. And so there is a substantial flow of revenue that comes in that will offset losses that might occur down the road. So we are pretty comfortable. Obviously there are some issues there, but we are pretty comfortable that this will be providing revenue to the Treasury.

That being said, I think the first question is trying to get this economy moving again. And since we took very aggressive actions in the March FOMC meeting to expand our mortgage-backed security purchases and initiate some Treasury purchases, I am not saying this was the only reason, but since then we have seen some significant improvement in financial markets and in the economic outlook. And of course that is the first order, that is the most important thing.

What was your other question?

Mr. NUNES. The $1.25 trillion; are you going to go up to that limit?

Mr. BERNANKE. Well, this is a decision of the Federal Open Market Committee. It is like a monetary policy decision. So we will meet and we will evaluate the state of the economy, the state of that market, the state of credit markets in general, and we will have to make a decision. But I can't preview that, we have to make that decision as a committee.

Mr. NUNES. There is some concern out there and there are some numbers that float out there that basically the Federal Government, in some form or fashion, is involved in 75 percent of all mortgage-backed securities, of all mortgages out there. And I think there is a concern out there that this could create another bubble, a different type of bubble long term where essentially you have the Federal Government owning everyone's home or their mortgage. Do you see this trend continuing? Do you agree with the 75 percent number? Is it lower than that?

Mr. BERNANKE. Well, it is true that currently almost all mortgages—not all, but a very large proportion of mortgages being originated are passing through Fannie or Freddie or the FHA, which means that they are getting a government guarantee. Those are the only mortgages right now that can be sold into the private markets. So the Fed has nothing to do with that. We are buying Fannie and Freddie's mortgages, but they have already been guaranteed by those agencies, which are now, of course, in conservatorship in the government.

Mr. NUNES. But we are on the hook for it long term.

Mr. BERNANKE. You are on the hook for it. And I believe that one of the things that this body will want to look at is reform of Fannie and Freddie and figure out how the government's intervention in the housing market ought to be conducted. I think many people are convinced that the way Fannie and Freddie were set up before was not entirely satisfactory, and we need to have some rethinking about what role the government should play in the housing market.

Mr. NUNES. I want to switch topics just real quick here. I want to go to cap-and-trade and the global warming legislation that is supposedly going to move through this body. And I will be very up front with you, I am strongly opposed, I am strongly against this policy of adding any type of energy tax at all to the American public, especially at this time.

I have a real concern about how we are going to compete with China and India and Brazil, who are putting billions of dollars into making energy and making energy cheaper and more available to their people, to their population. And you are an independent guy, you are supposed to operate outside of the Congress. And if someone of your stature would come out and say this is the wrong time to do an energy tax, I think it would send a message to this Congress to stop this energy tax. And so I would request that if you believe this is the wrong time to do an energy tax, that you would come out and say that. I think it would be a powerful statement.

Mr. BERNANKE. I think just from a short-term cyclical consideration, to the extent that there is an energy tax, it would make sense to rebate it somehow so that the net purchasing power is not diminished too much by such an action. But that would be the short-term consideration I would mention.

Mr. NUNES. So you are not willing to go all the way and say we should not do an energy tax at all?

Mr. BERNANKE. In the long run, this clearly depends on the assessment of the Congress on the importance of reducing carbon greenhouse gas emissions. I am not a scientist, I can't judge that. If those costs are perceived to be large enough, then some intervention is justified.

In addition, though, and I think a point that one should make, is that our doing this alone would probably not help the greenhouse gas situation that much. And so part of our strategy, if in fact we go this way, ought to be to negotiate or work with China and other countries to get them to do the same.

Mr. NUNES. Well, thank you, Mr. Chairman.

I think what we need to do, just to finish up, Mr. Chairman, is that nuclear power is where we should be putting our efforts to have clean energy in this country, not into an energy tax.

Thank you, Mr. Bernanke.

Chairman SPRATT. Mr. Larsen.

Mr. LARSEN. Chairman Bernanke, there are some escape hoods right here in front if you need one to try and get away from that question.

Mr. BERNANKE. That is okay.

Mr. LARSEN. But I wanted to chat a little bit and ask a question, but I do want to clear something up. I was just in China as well this last week visiting with a lot of their leaders on the economy, asking some questions and trying to get some perspective. And the characterization that my colleague from New Jersey made about Mr. Geithner's reception was inaccurate. It may have been a little bit accurate when he spoke at Peking University, but I have never talked to a group of college students that didn't take me on either. So there is, perhaps, a disconnect there.

But in our discussions with folks from the Central Bank and from the Ministry of Commerce, as well as Vice Premier Wang and some others, there is a real desire for cooperating on the economy with the Chinese. I want to give you a few assessments and ask a few questions, if I might, based on those meetings.

The first headline is "Concerned, Yet Confident." There was a general concern shared to us regarding the potential of inflation in the U.S., but not over the next 12 or 18 months, but kind of beyond that time frame. Even then, that concern was tempered by an expressed confidence in the dynamism of the U.S. economy and understanding that the steps we took were necessary and are necessary for our own economic health.

"A signal on the deficit" would be another headline. The Chinese seem to be looking for a signal on the fiscal deficit, not that it disappears, but that it decreases over time. That is certainly consistent with what you said.

The third, "The Scare Is Gone"—to paraphrase B.B. King. There is an agreement on the assessment "the worst has passed," but there is still not enough signs of improvement.

And finally, exit strategy. And this gets to Mr. Ryan's question. I am hoping you can be a little bit more particular about it. Though there is this expectation of some inflation, the Chinese are looking for an exit strategy that gradually withdraws an appropriate amount of liquidity from the market and decreases the chance that you have to purchase our own debt issuance over time.

And so the question I have is, what can you tell us about inflation expectations and the Fed's exit strategy with regards to this concern expressed by the Chinese?

Mr. BERNANKE. Certainly. And I think, not just for the benefit of the Chinese, but for the benefit of the United States and for our own people, we need to explain how we are going to restore fiscal sustainability and avoid inflation.

On that latter issue, let me just begin by saying that the Federal Open Market Committee of the Federal Reserve is strongly committed to price stability. We will ensure price stability. Price stability means neither deflation nor inflation. And in the near term, our concern for a time at least was that the recession would be so severe that we would see deflation, and we have taken strong actions to try and avoid that. And I think the fear of deflation has receded somewhat, and that is a positive development.

Now, for the time being, we still need to maintain a strong, supportive position in order to help this economy begin its recovery. But as that begins, at some point we are going to need to begin to withdraw the policy of accommodation so that we can avoid any inflation down the road.

Basically, the exit strategy is that when the time comes, we need to begin to raise interest rates. That is the usual way that the Federal Reserve tightens policy as the economy begins to recover. And the question is, will we be able to raise interest rates given the size of our balance sheet? My answer is yes.

First of all, as I mentioned earlier, many of our programs are short term and can be wound down. That will reduce the size of our balance sheet. Secondly, and very importantly, our ability to pay interest on reserves means that we can raise interest rates by raising the interest rate we pay on the reserves because banks will not be willing to lend in the Federal funds market at rates below what they can earn by just holding their cash at the Fed. We can raise interest rates and then we can tighten policy.

Beyond that, we have additional tools. For example, we can do reverse repurchase agreements which will allow us to fund our balance sheet outside the banking system and therefore doesn't have the same effects on the money supply or interest rates. And if worse came to worse, we could sell some of our assets, but that is not a big part of the plan certainly in the near term.

There are still other possibilities that we are looking at and that perhaps we can discuss with Congress at some point. But we are certainly, as we look forward and decide what further actions we want to take, we want to be sure that we will be able to remove accommodation at an appropriate time and an appropriate speed to be sure that we don't have an inflation risk down the road. It is not going to be an easy call, but we will have to balance the risk on both sides, not going too soon and stunting the recession, not going too late and having a bit of inflation, but we will get price stability after we get out of this recession.

Chairman SPRATT. Mrs. Lummis.

Mrs. LUMMIS. Dr. Bernanke, thank you for being here today. I want to visit a bit about that balance between taxes and spending in the medium term.

If Congress just increases taxes to eliminate the deficit in 10 years, let's say, without cutting spending, could that have an effect on our economic recovery, a negative effect?

Mr. BERNANKE. So as I was trying to make the distinction earlier that in an economy in recession, tax cuts or tax increases have two effects. One is the incentive effects, which are more long-term effects, but also withdrawing purchasing power, taking away income from consumers. And in a short-term recessionary situation, I think that latter effect is more important. So if you raise taxes during a recession, you probably want to offset it with a tax cut elsewhere, for example.

Over a longer period of time, you have to weigh the implications of higher taxes on incentives and on potential growth against the benefits of what you are using the revenue for. So there is a cost-benefit tradeoff to be made there.

So in particular, I believe the Congress will want to look at both sides, both the tax and the spending side, and try to find a reasonable balance between those two.

Mrs. LUMMIS. Mr. Chairman, you mentioned just a few minutes ago that many of the programs at the Fed are temporary and could be wound down. Well, such is the case with the Congress also, and this stimulus bill comes to mind.

If Congress were to freeze spending at 2009 fiscal year levels and freeze release of the TARP funds at the end of the this fiscal year, do you believe the economy will have recovered adequately that we could then begin to address the debt and deficit problem and focus on it? Because you mentioned that as a very important looming issue. So I am looking at the point at which we can actually, as a Congress, also enact an exit strategy from trying to stimulate economic growth because the economy is finally leveling out, and then begin to address that great looming issue that you mentioned as a concern—that I agree is a huge concern—that being both the deficit and the debt.

Mr. BERNANKE. I think it is very important, as I mentioned in my testimony, to begin the planning process as soon as possible so it will have a persuasive exit strategy that will not only give us a plan but will also help to reassure lenders in the bond markets that in fact the U.S. Government is going to find a fiscally sustainable path going forward.

You asked about 2009. No one knows the future of course, but based on our best projections we think that the economy will be pretty weak albeit starting to grow at the end of 2009 and the unemployment rate will probably still be rising. So would unlikely be a period of robust growth at that point.

Mrs. LUMMIS. Mr. Chairman, suppose if we froze spending of the Federal Government's budgets at 2009 level and then let the stimulus package continue to work, would that be a way to begin to address the deficit and the debt as well as allow the stimulus monies to continue to flow into the economy?

Mr. BERNANKE. Congresswoman, I think that there are lots of ways that you could structure this, and I don't think I want to try to pick one, particularly on the fly here. So you really need to think about maybe not just the total amount of spending but the various programs and the various needs we have from health, and defense, and benefits payments, everything else, and think about those programs and try to think about how we are going to structure them in a way that over the next few years we are going to return to a more balanced situation. So I think a longer term perspective is probably necessary.

Mrs. LUMMIS. Thank you, Mr. Chairman.

A quick question about government intervention in our economy, given the degree and depth of the government intervention in the economy, which is the highest since World War II, can you estimate how long it might take for the government to unwind its immersion in the markets?

Mr. BERNANKE. It is going to depend on the market. For example, in some of the short-term markets, like the commercial paper market, we are already seeing an unwinding going on now as those markets stabilize. For other parts of the economy, like the TARP investment in banks or some of the longer term holdings of the Fed, it may take a few more years. But I would say that 4 or 5 years from now I hope that as a government we will be pretty much out of those financial markets and that things will be operating on a more normal basis.

Mrs. LUMMIS. Thank you, Mr. Chairman.

Chairman SPRATT. Ms. Tsongas.

Ms. TSONGAS. Thank you, Mr. Chairman, and thank you, Chairman Bernanke, for being here with us.

When we spoke last year, as we were considering our response to the downturn in the economy and we were trying to consider the parameters of a recovery package, I asked, and you stated, that helping the States prevent cutbacks in services could have a stimulative effect and indicated support for addressing weaknesses in the municipal bond market. The Recovery Act we passed did include money for state stabilization and created several flexible bond options to help our State and local governments. And this past week when I was in Massachusetts as part of the break and happened to meet with our Governor as well as our State senator who chairs the Ways and Means Committee, I can tell you how grateful they were for the fact that we included significant funds to help the States deal with the downturns in their revenues and the impacts on their budget. I think it is one of the most difficult places to be today, in State and local government. So I want to thank you for that, and also for your reiterating your support today for what we have done with the recovery package and the necessity for it.

In your testimony you just stated that about one-quarter of the funds will come out either through tax cuts or direct benefits and direct spending this year, one-half next year, and possibly the last quarter in 2011. Are you concerned that we are meeting that timetable, and how important is the timetable as we go forward beyond the tax cuts that have showed up in people's paychecks today?

Mr. BERNANKE. Well, it is the very early days. At this point I think something on the order of 5 percent of the monies appropriated have entered the economic bloodstream, so to speak. It is important that there not be extensive delays in that process because it would possibly give you a fiscal stimulus exactly at the wrong time when the economy was already in a substantial recovery mode. But I don't have any information to the effect that the stimulus is not being disbursed at a reasonable pace. I think it is just too early to know how quickly the monies will get out.

Ms. TSONGAS. So you are confident that the administration is moving in a timely fashion, especially within the various departments where they have to put in place a regulatory framework, the process of people applying for the funds, that that is going along in a manner that should be helpful?

Mr. BERNANKE. As far as I know. But we all recognize that this is, from a bureaucratic point of view, a very challenging task. But so far, of course I think payments are underway and the planning process is underway.

Ms. TSONGAS. So the impact we see today, given the fact that only 5 percent is moved out, what do you attribute that to?

Mr. BERNANKE. The recent improvement in the economy?

Ms. TSONGAS. Yes.

Mr. BERNANKE. It is partly the fact that we had this very sharp decline in the latter part of last year related to the financial crisis that caused a big buildup of inventories. Very importantly, as I discussed earlier, we seem to have achieved a good deal of progress in stabilizing the financial system. That has helped restore confidence. Finally, demand is beginning to stabilize. We still had a very bad first quarter and we may yet have a negative second quarter because of the need to work down those inventories, but because the financial markets are doing better, because there is more confidence in the economy, in the financial system, as those inventories work down, we should begin to see a modest increase in growth.

So I would put the internal dynamics of the economy in terms of inventories, and so on, as being part of it, but I also would like to give credit to actions taken by the Treasury, the Fed, the FDIC, and the Congress to help stabilize the financial system.

Ms. TSONGAS. Thank you, and I yield back.

Chairman SPRATT. Ms. Moore.

Ms. MOORE. Thank you very much, Mr. Chairman, and thank you, Mr. Chairman, for being patient.

I have three questions, but I want to start out with your certainty that we won't be facing inflation and your certainty that we have gotten a handle on deflation. Just your last answer to Mrs. Tsongas about the buildup of inventory, and certainly there has been a loss of value in the housing market, given the unemployment rate that is going to continue to rise—even recently from the GM and Chrysler restructuring—given the high unemployment and the buildup of inventory and the loss of value in housing, how can you say that deflation is not a risk and we are not having these fire sales to get rid of inventory or losses being taken in the housing market?

I guess I don't understand how we have we are going to avoid deflation.

Mr. BERNANKE. Well, you correctly point out that we have a balancing act between on the one hand deflation risk and on the other hand potential medium-term inflation risk. We have to look at both sides of that equation. Recently, since the outlook seems to have improved some, since confidence is up somewhat, because inflation expectation is measured by a lot of different means seem to be pretty stable, I put a lower probability now on a deflation than I would have a few months ago. That is not to say it is completely——

Ms. MOORE. If people don't have jobs, how are they going to buy the built up inventory? What is going to happen when people just have to sell their houses and they have lost 30 percent value?

Mr. BERNANKE. Well, that has a very negative effect on the economy and we expect the employment to keep rising. I agree with you that the economy remains quite weak, but consumer spending, though at a lower level, it seems to be stabilizing, not growing great guns but it seems to be stabilizing, and those kinds of considerations, we think the deflation risk has receded. But we are certainly going to continue to follow that carefully.

Ms. MOORE. Let me go on before my time expires.

There has been a lot of talk about the Fed being named as a super regulator or alternatively a systemic risk regulator. Mr. Ryan earlier asked about the independence of the Federal Reserve, and I just want your comment about whether or not you think you are the appropriate agency to be either a super regulator or a systemic risk regulator and whether or not that would be a little bit incestuous.

Mr. BERNANKE. Well, first of all let me say that I do think there is a benefit to going toward a more system-wide regulatory approach because so many things that caused problems in the recent crisis sort of slipped under the radar because there was nobody looking at it. So we do need to have a system whereby the large systemically critical firms are being appropriately overseen, where we have a way to address the potential failure of large financial firms, where we make sure that risks that build up in the system are——

Ms. MOORE. Should that be you? Before my time expires?

Mr. BERNANKE. The Federal Reserve needs to be part of that process. But given our expertise, given our historical role in financial crisis management, given the fact that we are the lender of last resort, we should have a substantial role in that. The exact structure of the arrangements I think remains to be discussed. The administration hasn't even come out with their proposal yet.

Ms. MOORE. I want to ask a question about what monetary policy should we be pursuing, given that the Chinese seem to be putting up a challenge to the dollar as the reserve currency. This would be a great loss to us were we seriously challenged. What should we be doing to maintain the dollar as our reserve currency?

Mr. BERNANKE. Well, first, I don't see any risk in the foreseeable future to the dollar status as reserve currency.

Ms. MOORE. You don't see the Chinese and the Brazilians that are now using their own currency for reserve currency, the Chinese concern about the strength of the dollar as being a challenge?

Mr. BERNANKE. Well, a share of reserves held by all countries in dollars, that share has actually gone up a bit recently. With that being said, we do have a responsibility to make sure our economy is appropriately run, and my view is that the best way to get a strong dollar is to get a strong economy and to get the economy back on a growth path with high productivity, good amount of savings. That is the best way to get the dollar strong, and that is why I think it is important to get us turned around, get the financial crisis fixed, and get the economy growing again, and that is what the Federal Reserve's policy is trying to achieve.

Ms. MOORE. Thank you, I yield back.

Chairman SPRATT. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman. And Chairman Bernanke, thank you for your patience. Most of my questions will be yes and no, and but I want to begin by saying that very privileged and powerful bankers in our country have hurt our Nation deeply, yet it seems that they get special treatment by the Federal Reserve and other financial regulatory agencies that should be protecting the public interest. And these bankers have earned huge profits for themselves, but when their imprudent behavior causes vast economic dislocation, they throw the cost of that on the backs of the taxpayers, raising our national debt. Taxpayers who are hurt, homeowners lose their homes, people lose jobs, people lose their companies, bankruptcies go up, but they don't get the same treatment.

So I am interested in the favoritism exhibited towards these bankers as well as the non-transparency of financial rescues being arranged by the Fed and other Federal regulatory agencies.

The presidents of the regional reserve banks of the Fed extraordinarily have been expressing concern about what is going on and the power of the New York Fed, Kansas City Fed, Saint Louis Fed, the Richmond Fed, shockingly, signed an agreement with you, an unprecedented agreement where you agreed to absorb any losses that would be incurred by the Fed. The Treasury actually signed that agreement.

And so my first question is, yes or no, do you support the concept of having the presidents of each of the Federal Reserve banks join the ranks of your Board of Governors and be nominated by the President and confirmed by the Senate to have a more representative Fed?

Mr. BERNANKE. No.

Ms. KAPTUR. Thank you.

For the record, before this month is out, how much TARP money will AIG, can you provide for the record, before this month is out, how much TARP money AIG has disbursed since January 1 of this year and who were the recipients. Can you provide that for the record?

Mr. BERNANKE. I think so, but I can't do that here.

Ms. KAPTUR. Can you do it within the month?

Mr. BERNANKE. They have already produced the information on their counterparties. I think that information is in the public domain.

Ms. KAPTUR. How many of these disbursements and which derivative contracts were paid out at 100 percent on the dollar and which were not?

Mr. BERNANKE. All contracts, of which there was a legal contract binding, were paid out 100 percent because there was no bankruptcy allowed. We need a system where we can renegotiate those things, but we don't have a system like that.

Ms. KAPTUR. Well, we are going to want as much detail as you can provide for the record, because the Fed is really heavily involved in that, am I correct?

Mr. BERNANKE. The Fed is involved very unwillingly because there is no good system for addressing the failure of a major financial institution.

Ms. KAPTUR. How much more of our rising debt is being provided by foreign creditors now as our debt rises? Can you provide that for the record?

Mr. BERNANKE. Actually less, less than it has been, because we know the current account deficit has been declining. And that current account deficit measures the flow of new lending from foreign creditors to the United States.

As the Federal deficit has gone up, the private borrowing has gone down.

Ms. KAPTUR. Thank you. We would like that for the record.

How many no-bid contracts has the Fed now signed with the private money management firm BlackRock and any of its subsidiaries.

Mr. BERNANKE. We have signed several. Because of exigencies of time, all that information is going to be provided in this monthly report, which we are now releasing to the Congress.

Ms. KAPTUR. Will the contracts be released to the Congress?

Mr. BERNANKE. I believe so, yes.

Ms. KAPTUR. What is the value of assets being managed by BlackRock and any of these contracts in total?

Mr. BERNANKE. I don't have information.

Ms. KAPTUR. Will that be provided for the record?

Mr. BERNANKE. Oh, yes.

Ms. KAPTUR. What is the Fed providing for BlackRock in services. Will that be provided for the record?

Mr. BERNANKE. We have a committee, which has gone through and made a whole set of recommendations based on carefully considered analysis and consultation, and that will be providing a great deal of information. I don't remember every single decision that they made, but I would like to defer to their decisions.

Ms. KAPTUR. Do you know, Mr. Chairman, which foreign countries and companies are a part of BlackRock's transactions?

Mr. BERNANKE. I don't understand the question.

Ms. KAPTUR. What other business does BlackRock do besides service the Fed?

Mr. BERNANKE. They have a very large asset management business.

Ms. KAPTUR. But you wouldn't necessarily be aware of what those relationships are. Yes or no?

Mr. BERNANKE. Not necessarily.

Ms. KAPTUR. Are you aware that one of the contracts BlackRock manages for the Fed may be compromised, and that is the one, probably more than one is compromised, dealing with Freddie Mac and Fannie Mae? And I just wish to state this for the record.

Laurence Fink, who is the head of BlackRock, which now is 47 percent owned by Bank of America, in which the—Mr. Summers, who heads the National Economic Council, is a major investor, just got several no-bid contracts from the Fed, including one to manage Freddie Mac and Fannie Mae's troubled portfolios. I think that is one of the contracts you signed with BlackRock.

Did the Fed know that Mr. Fink is the person who first created the collateralized mortgage obligation when he headed First Boston, and then he brought that instrument to Freddie Mac and initially sold it to them for over $1 billion of such obligations, making huge profits for himself and his firm. He is now the Fed's go-to man through his firm on Freddie Mac workouts.

I have a question about the revolving door, and how do you protect the public, again, against his potential and that company's potential conflict of interest or possible self-dealing that relate to his own and his firm's historic involvements with those mortgage portfolios?

Mr. BERNANKE. The Federal Reserve is a separate institution from Freddie Mac. We have nothing to do with Freddie Mac. I don't understand your question.

Ms. KAPTUR. You have signed a contract with BlackRock to manage the Freddie and Fannie portfolios, have you not, the troubled mortgages within those portfolios?

Chairman BERNANKE. Not to my knowledge.

Ms. KAPTUR. I understood it was one of the four or five contracts that you had signed with BlackRock.

Mr. BERNANKE. I will have to go back and check on that.

Ms. KAPTUR. We would appreciate that very much.

[Questions for the record submitted by Ms. Kaptur follow:]

QUESTIONS FOR THE RECORD SUBMITTED BY CONGRESSWOMAN KAPTUR

How much TARP money AIG has disbursed since January 1 of this year and who were recipients?

How much more of our rising debt is being provided by foreign creditors now as our debt rises?

COPIES OF THE CONTRACTS BETWEEN THE FED AND BLACKROCK

What is the value of assets being managed by BlackRock and any of these contracts in total?

What is Blackrock being paid for each contract?

Do you know which foreign countries and companies are part of Black Rock's transactions?

ADDITIONAL QUESTIONS FOR THE RECORD

- What actions are taken by the Fed to examine and prevent conflicts of interest of any kind when awarding no bid contracts? What processes are in place? Please include copies of the documents of the evaluation of conflict of interest in regard to all BlackRock contracts, both those that BlackRock might have bid on and those that were no-bid contracts.
- Can you explain to me why the Federal Reserve Bank of New York is expected to regulate Wall Street, and yet on its board are Wall Street Executives? Isn't this a conflict on interest from perspective? Please elaborate here. Do we really trust Wall Street to regulate itself?
- Why does the Federal Reserve buy Treasury notes? Isn't this just money shuffling, especially since the Treasury has $200 billion deposited in the Fed right now through the Treasury Supplemental Financing Program?
- The Federal Reserve Bank of New York is the only bank of the 12 with an established vote on interest rates; the seven governors have a vote, the Federal Reserve Bank of New York has a vote, and the other 11 banks rotate through the other 4 votes. Why is the NY Fed so special?
- How much was now Secretary Geithner involved in the drafting of the trust agreement between the Federal Reserve Bank of New York and AIG—at the time Mr. Geithner was service as President of the Federal Reserve Bank of New York.
- Do you think it is appropriate for the President of the Federal Reserve Bank of New York to have close ties with the CEO's and other key management of the very banks one is regulating?
- Given that the taxpayers are at this time currently losing money through the obligations accrued through the purchases of securities from AIG and Bear Sterns, is there any real hope that the taxpayers will paid back in full?
- Can you give me your thoughts on why AIG was saved, and Chrysler and GM allowed to enter bankruptcy? Sure you were involved in each discussion to some degree.
- Why do you think that Chrysler and GM were given far less money than the banks through TARP with restrictions and conditions on what was to happen at each before there was any more infusion of capital from the TARP into the companies, and the banks can keep coming back and are barely asked to do even reporting in return?

- Were you present in any meeting in which the Bank of America acquisition of Merrill Lynch was discussed? Please state when each meeting took place, where each meeting was held, the other attendees of the meeting, and go into detail on what was discussed. In addition to the aforementioned, how involved were people such as Larry Summers and other Members of the President's Economic Advisory Council or the President's Working Group on Financial Markets? Other bank CEO's? Do you feel it was appropriate for the federal government to play a role in the activities of private banks, and in particular, the matter of Bank of America and Merrill Lynch?
- Would you welcome a full audit of the PIPP program now and regularly? Why or why not?
- Do you resolution authority and a financial product safety commission? Why or why not on each item?
- You have been quoted as stating that in looking back, it was probably a mistake to let Lehman fail. Please elaborate on this matter.

[Mr. Bernanke's responses to Ms. Kaptur's questions follow:]

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

BEN S. BERNANKE
CHAIRMAN

October 20, 2009

The Honorable Marcy Kaptur
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the questions you posed following the June 3, 2009, hearing before the House Budget Committee on "Challenges Facing the Economy." Your questions dealt with the Federal Reserve's Term Asset-Backed Securities Loan Facility and with monetary policy and inflation. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

I hope this information is helpful. Please let me know if I can provide any further assistance.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congresswoman Marcy Kaptur in connection with the June 3, 2009, hearing before the House Budget Committee:

1. How much TARP money has AIG disbursed since January 1, of this year and who were the recipients?

As part of the restructuring by the U.S. Treasury Department and the Federal Reserve of the government's assistance to the American International Group, Inc. (AIG), announced on March 2, 2009, the U.S. Treasury created a new preferred stock facility under which the Treasury has committed for five years to provide funds from the Troubled Asset Relief Program (TARP) of up to $29.835 billion. As of August 31, 2009, AIG has drawn down $3.21 billion of this facility to improve the capitalization of various operating companies. This facility is in addition to the $40 billion in preferred securities of AIG the Treasury purchased in November 2008, the proceeds of which were used to repay amounts outstanding on the Federal Reserve 's Revolving Credit Facility for AIG approved in September 2008.

2. How much more of our rising debt is being provided by foreign creditors now as our debt rises?

Foreigners purchased about $351 billion of U.S. Treasury securities in 2009 through July 1. However, they sold about $127 billion of U.S. agency, or government sponsored enterprise (GSE), securities through July (including periodic coupon repayments on agency asset-backed securities). Therefore, foreign net purchases of U.S. government debt totaled $224 billion for the first seven months of 2009. At an annualized rate of $384 billion, foreigners are acquiring U.S. government debt at a slower pace than in 2008, when foreign net purchases totaled an unusually high $536 billion. The slower pace results primarily from fewer net purchases of U.S. Treasury securities.

3. Copies of the contracts between the Fed and BlackRock.

The Federal Reserve Bank of New York has retained BlackRock Financial Management, Inc. (BlackRock) as the investment manager for three special purpose vehicles, which hold assets acquired in connection with the Federal Reserve Bank of New York's loans to facilitate the acquisition of Bear Stearns, Maiden Lane LLC (Maiden Lane I) and to stabilize AIG, Maiden Lane II LLC (Maiden Lane II) and Maiden Lane III LLC (Maiden Lane III). BlackRock was also retained to serve as one of four investment managers for the Federal Reserve's Agency Mortgage-Backed Securities Purchase Program (Agency MBS Program). Effective September 15, 2009, BlackRock, along with two of the three other investment managers, no longer serves as an investment manager for the Agency MBS program. BlackRock does continue to provide portfolio analytics services to the Agency MBS program. Finally BlackRock has been engaged to provide advisory services in connection with the arrangement among

Citigroup Inc., the Federal Reserve, the Federal Deposit Insurance Corporation and the Department of the Treasury. Copies of all of these contracts are available on the public website of the Federal Reserve Bank of New York.
http://www.newyorkfed.org/aboutthefed/vendor_information.html.

4. What is the value of assets being managed by BlackRock and any of these contracts in total?

The only assets currently managed by BlackRock are the assets of the three Maiden Lane entities. As of September 30, 2009, the fair value of the net portfolio holdings of these entities was as follows: Maiden Lane I, approximately $26.26 billion; Maiden Lane II, approximately $14.75 billion; and Maiden Lane III, approximately $20.57 billion. These amounts reflect paydowns of principal and accrual of interest through September 30, 2009, and valuations as of June 30, 2009. Valuations are updated quarterly and the third quarter revaluations will be available in the H.4.1 at the end of October 2009.

5. What is BlackRock being paid for each contract?

The fees the Federal Reserve Bank of New York has agreed to pay BlackRock are specified in exhibits to the contracts for each of the BlackRock engagements. These contracts and fee schedule exhibits are available on the public website of the Reserve Bank. In negotiating fees with BlackRock for these engagements, the Federal Reserve has been committed to pay only fees that are commercially reasonable and are as consistent as possible with fees assessed to clients in comparable investment management engagements.

6. Do you know which foreign countries and companies are part of BlackRock's transactions?

During the time that BlackRock served as an investment manager for the Agency MBS Program, BlackRock, along with all of the other investment managers, were authorized to purchase only U.S. Agency MBS and only through trades with primary dealers in U.S. government securities, which include certain U.S. broker-dealers that are owned by foreign banks. The following is the current list of authorized dealers:

BNP Paribas Securities Corp.
Banc of America Securities LLC
Barclays Capital Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.
Credit Suisse Securities (USA) LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Goldman, Sachs & Co.
HSBC Securities (USA) Inc.
J. P. Morgan Securities Inc.
Jefferies & Company, Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
RBC Capital Markets Corporation
RBS Securities Inc.
UBS Securities LLC.

In managing the assets held by each of the three Maiden Lane entities, BlackRock's primary objective as investment manager is to maximize long-term cash flows generated by the portfolio assets and their disposition to pay off the loans to the entities from the Federal Reserve Bank of New York. In carrying out these objectives, BlackRock may trade with those financial firms that deal and invest in the types of assets involved, including U.S. mortgage-related securities, U.S. dollar-denominated residential and commercial loans, and associated hedges (Maiden Lane I), U.S. dollar-denominated residential mortgage-backed securities (Maiden Lane II), U.S. dollar-denominated collateralized debt obligations (Maiden Lane III), and short-term U.S. Treasury and agency obligations (all three entities). BlackRock is required to carry out each transaction through an intermediary that offers the "best execution." These intermediaries may include foreign-owned firms if the firms meet this requirement.

7. What actions are taken by the Fed to examine and prevent conflicts of interest of any kind when awarding no bid contracts? What processes are in place? Please include copies of the documents of the evaluation of conflict of interest in regard to all BlackRock contracts, both those that BlackRock might have bid on and those that were no-bid contracts.

BlackRock was selected as the manager of the assets of the three Maiden Lane entities under an exception to the normal competitive bidding procedures required by the New York Reserve Bank's Acquisition Guidelines that allows for sole source contracts in exigent circumstances. The Reserve Bank determined in each case that the unique time pressures associated with the unexpected and rapid collapse of Bear Stearns and AIG prevented the Bank from following the normal bidding procedures. Consequently, senior management at the New York Reserve Bank carefully considered the issue and determined that an exception to the competitive bidding provisions of the Acquisition Guidelines was appropriate with respect to the selection of an investment manager. BlackRock was retained as the investment manager for the Maiden Lane entities because of its technical expertise with respect to the portfolio assets involved, its operational capacity, and its track record.

BlackRock was selected as one of four investment managers for the Agency MBS Program through a public and competitive bidding process that was employed to select the investment managers and a custodian. A competitive request for proposal ("RFP") process was employed because of the size and complexity of the Program. The selection criteria were based on the institution's operational capacity, size, overall experience in the MBS market and a competitive fee structure.

The New York Reserve Bank has extensive procedures in place to guard against conflicts of interest in the procurement of services for the Bank, both in competitive solicitations and in procurements under exceptions to the competitive solicitation policy. For instance, the Bank's contract representatives are prohibited from participating personally and substantially in an acquisition in which, to the representatives' knowledge, the representatives or certain related interests have a financial interest that is directly impacted by the decision to select a particular vendor.

Moreover, the contracts with BlackRock require BlackRock to have in place conflict of interest policies and procedures that are designed to identify material conflicts of interest, that require reporting of such conflicts, and that prevent the use of confidential information obtained in the course of the engagement from being used outside of the engagement. These provisions are integrated into each contract as enforceable terms. The Reserve Bank monitors BlackRock's compliance with the terms of its contract, as appropriate.

8. Can you explain to me why the Federal Reserve Bank of New York is expected to regulate Wall Street, and yet on its board are Wall Street Executives? Isn't this a conflict of interest from your perspective? Please elaborate here. Do we really trust Wall Street to regulate itself?

By statute, the boards of directors of each of the Reserve Banks are composed of nine members divided into three classes of three directors each. 12 U.S.C. § 302-305. Under the statute, Class A directors are elected by the commercial banks that hold stock in the Reserve Bank and are required to be "representative of" these member commercial banks. Accordingly, in virtually every case, Class A directors are affiliated with, and own stock in, banks or bank holding companies that are supervised by the Reserve Bank on whose board they serve.

Also by statute, Class B directors are elected by the member banks of the Reserve Bank, and Class C directors are designated by the Board of Governors. Class B and Class C directors must represent the public and be elected or designated with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. No Class B or Class C director may be an officer, director, or employee of any bank or bank holding company. In addition, Class C directors are prohibited from owning stock of any bank or bank holding company.

To the extent the statutorily prescribed structure of Reserve Bank boards of directors may give rise to potential conflicts of interest, there are statutory and policy protections in place to address improper conflicts in the governance of the Reserve Banks. With respect to the supervisory responsibilities of Reserve Banks over individual banking institutions, the directors of the Banks are not involved. Supervision over banking organizations is conducted by the Reserve Banks pursuant to authority delegated to the Banks by the Board of Governors, and the directors of the Reserve Bank are not consulted regarding examinations, possible enforcement actions, merger or other supervisory approvals, or other supervisory issues that involve organizations being supervised by their Bank.

In addition, Reserve Bank directors are explicitly included among the officials subject to the federal conflict of interest statute. 12 U.S.C. § 208. This statute imposes criminal penalties on Reserve Bank directors who participate personally and substantially as a director in any particular matter that, to the director's knowledge, will affect the director's financial interest or those of his immediate family or businesses interests. Reserve Banks routinely provide training for their new directors that includes specific training on the federal conflicts of interest statute and Reserve Bank corporate secretaries have the expertise to respond to inquiries by directors regarding possible conflicts of interest in order to assist them in complying with the statute. Moreover, the Board of Governors' policy on Reserve Bank directors provides that their personal financial dealings should be above reproach and information obtained by them as directors should never be used for personal gain. The policy provides that, in carrying out their Federal

Reserve responsibilities, directors should avoid any action that may result in or create the appearance of conflicts of interest.

9. Why does the Federal Reserve buy Treasury notes? Isn't this just money shuffling, especially since the Treasury has $200 billion deposited in the Fed right now through the Treasury Supplemental Financing Program?

The Federal Reserve is buying longer-term Treasury securities, as well as securities issued or guaranteed by the federal housing agencies, to help put downward pressure on longer-term interest rates and more generally to improve conditions in private credit markets. By putting downward pressure on yields such as those on mortgage securities and corporate bonds, the Federal Reserve's asset purchases help lower the cost of borrowing to households and firms. Lower financing costs in turn help support spending, which promotes output, employment, and income growth. The Treasury's Supplemental Financing Program contributes to the Federal Reserve's ability to control the federal funds rate, which is its primary means of implementing monetary policy in routine circumstances.

10. The Federal Reserve Bank of New York is the only bank of the 12 with an established vote on interest rates; the seven governors have a vote, the Federal Reserve Bank of New York has a vote, and the other 11 banks rotate through the other 4 votes. Why is the NY Fed so special?

The Federal Reserve Act provides that the Federal Reserve Bank of New York has a permanent vote on the Federal Open Market Committee. The status accorded the New York Fed is in recognition of the unique role that the Bank plays in the Federal Reserve System. For example, because the New York Fed is located in the financial capital of the United States, all of the open market operations--the buying and selling of U.S. government securities in the secondary market to influence money and credit conditions in the economy--that the Federal Reserve conducts are carried out by the New York Fed. Moreover, in light of its close proximity to, and interactions with, major financial institutions, the New York Fed plays a particularly important role in gathering financial information that is used by the Federal Open Market Committee in making monetary policy.

11. How much was now Secretary Geithner involved in the drafting of the trust agreement between the Federal Reserve Bank of New York and AIG – at the time Mr. Geithner was serving as President of the Federal Reserve Bank of New York?

As a condition of the Federal Reserve's Revolving Credit Facility for AIG approved on September 16, 2008, AIG was required to issue to a trust for the sole benefit of the U.S. Treasury convertible preferred stock with voting power equal to approximately 78 percent of AIG's common stock. The agreement relating to this trust was drafted by the Federal Reserve Bank of New York, in consultation with the Board of Governors and the Treasury Department, beginning in late September 2008. Subsequently, certain terms of the trust agreement were negotiated with the three individuals who were appointed as trustees under the trust. The trust agreement was executed in final on January 16, 2009. In late November 2008, because of his status as the apparent nominee for Secretary of the Treasury in the new administration, Mr. Geithner removed himself from involvement in the day-to-day affairs of the New York Reserve Bank. Prior to that time, Mr. Geithner was informed of developments relating to the terms of the trust as part of his oversight of the Reserve Bank's relationship with AIG, but was not involved in the actual drafting or negotiation of the provisions of the trust agreement.

12. Do you think it is appropriate for the President of the Federal Reserve Bank of New York to have close ties with the CEO's and other key management of the very banks one is regulating?

Like all employees of the Federal Reserve Banks, the President of the Federal Reserve Bank of New York is prohibited from having financial ties with the financial institutions that are regulated by the Federal Reserve that could give rise to potential conflicts of interest. In particular, Reserve Bank employees, including the Presidents of the Reserve Banks, are prohibited generally by the Banks' codes of conduct from owning debt or equity interests in depository institutions or their affiliates and, if the employee has access to confidential information of the Federal Open Market Committee, such as a Reserve Bank President, in any primary securities dealer or a company that owns a primary dealer. Reserve Bank employees, including the President of the Reserve Bank, additionally are generally barred from accepting gifts, meals, and entertainment from institutions that are supervised by the Federal Reserve. Reserve Bank employees are also directed to avoid any situation that might give rise to an actual or even apparent conflict of interest. Like Reserve Bank directors, Reserve Bank officers and employees, including the President of the Reserve Bank, are subject to the federal conflicts of interest statute, which imposes criminal penalties on officers and employees who participate personally and substantially as an officer or employee in any particular matter that, to the person's knowledge, will affect the person's financial interest or those of his or her immediate family or businesses interests.

Each Reserve Bank President collects information from the institutions, including banks, industrial firms, consumer groups, labor organizations, small businesses, and other local leaders, about the state of the economy and business activities in the Bank's district. The Reserve Bank Presidents serve as the eyes and ears of the Federal Reserve in the financial markets and must be sensitive to developments in those areas. The Federal Reserve Board and the Federal Open Market Committee take the information gathered by the Presidents and weigh it along with all the other information the System collects to set monetary policy.

13. Given that the taxpayers are at this time currently losing money through the obligations accrued through the purchases of securities from AIG and Bear Stearns, is there any real hope that the taxpayers will be paid back in full?

The portfolio holdings of each of Maiden Lane LLC ("Maiden Lane"), Maiden Lane II LLC ("ML-II") and Maiden Lane III LLC ("ML-III") are revalued in accordance with generally accepted accounting principles ("GAAP") as of the end of each quarter to reflect an estimate of the fair value of the assets on the measurement date. The fair value determined through these revaluations may fluctuate over time. In addition, the fair value of the portfolio holdings that is reported on the weekly H.4.1 Statistical Release reflects any accrued interest earnings, principal repayments, expense payments and, to the extent any may have occurred since the most recent measurement date, realized gains or losses. The fair values as of September 30, 2009--and reported in greater detail in the H.4.1 release for that date--are based on quarterly revaluations as of June 30, 2009.

Because the collateral assets for the loans to Maiden Lane, ML-II, and ML-III are expected to generate cash proceeds and may be sold over time or held to maturity, the current reported fair values of the net portfolio holdings of Maiden Lane, ML-II, and ML-III do not reflect the amount of aggregate proceeds that the Federal Reserve could receive from the assets of the respective entity over the extended term of the loan to the entity. The extended terms of the loans provide an opportunity to dispose of the assets of each entity in an orderly manner over time and to collect interest on the assets held by the entity prior to their sale, other disposition, or maturity. Each of the loans extended to Maiden Lane, ML-II, and ML-III is current under the terms of the relevant loan agreement.

In addition, JPMorgan Chase will absorb the first \$1.1 billion of realized losses on the assets of Maiden Lane, should any occur. Similarly, AIG has a \$1 billion subordinated position in ML-II and a \$5 billion subordinated position in ML-III, which are available to absorb first any loss that ultimately is incurred by ML-II or ML-III, respectively. Moreover, under the terms of the agreements, the FRBNY is entitled to any residual cash flow generated by the collateral assets held by Maiden Lane after the loans made by the FRBNY and JPMorgan Chase are repaid, and 5/6ths and 2/3rds of any residual cash flow generated by the collateral held by ML-II and ML-III, respectively, after the senior note of the FRBNY and the subordinate position of AIG or its affiliates for these facilities are repaid.

14. Can you give me your thoughts on why AIG was saved, and Chrysler and GM allowed to enter bankruptcy? Sure you were involved in each discussion to some degree.

As I explained in greater detail in my testimony on AIG before the House Financial Services Committee in March, the Federal Reserve, with the support of Treasury, supplied emergency liquidity to AIG in September 2008 under section 13(3) of the Federal Reserve Act to avoid the imminent bankruptcy of the company, which, under prevailing conditions, would have posed unacceptable risks for the global financial system and our economy. A failure of AIG would likely have resulted in harm to the holders of policies issued by AIG's insurance subsidiaries, to state and local governments that lent funds to AIG, to workers whose 401(k) plans had purchased insurance from AIG, to global banks and investment companies that were counterparties of AIG in loans and derivatives transactions, and to money market mutual funds and other investors that held AIG's commercial paper. Moreover, as broad market dislocations precipitated by the bankruptcy of Lehman Brothers have shown, there was a serious risk that the harm of an AIG default would spread to the financial system as a whole. As I explained in my testimony, an AIG failure could have exacerbated problems in the commercial paper market, could have led to a run on the broader insurance industry by policyholders and creditors, and could have led financial market participants to pull back even further from commercial and investment banks.

Certain federal financial assistance to General Motors and Chrysler has been provided by the Treasury from the TARP, subject to certain conditions. Pursuant to section 3(9)(B) of the

Emergency Economic Stabilization Act of 2008, given that the disorderly bankruptcy of GM or Chrysler likely would result in material job losses and place further, meaningful downward pressure on U.S. economic performance, I concurred with the determination of the Secretary of the Treasury that the loans to be provided to GM and Chrysler and the equity instruments to be acquired in connection with these loans are financial instruments that may be purchased as troubled assets with TARP funds. The decisions relating to whether further assistance under this Program should have been provided to these companies prior to their recent bankruptcy filings are within the authority of the Treasury.

For non-financial businesses like General Motors and Chrysler, the reorganization regime contained in the Bankruptcy Code can, with financial assistance and oversight from the Treasury, serve as an effective mechanism to avoid the negative systemic effects of a disorderly failure and to work with the company's creditors to restructure its core business and preserve the residual value of the franchise. However, this regime does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and the economy. The damaging effects of a disorderly insolvency of such an institution would be much more quickly and pervasively transmitted to the financial system.

15. Why do you think that Chrysler and GM were given far less money than the banks through TARP with restrictions and conditions on what was to happen at each before there was any more infusion of capital from the TARP into the companies, and the banks can keep coming back and are barely asked to do even reporting in return?

The Administration, through its Auto Task Force, set the terms and conditions under which Chrysler and GM were granted assistance from the government and determined the actions each company would be required to take as their part of the agreement. As you know, the largest banks that received TARP capital in October 2008 were asked to take that capital in order to prevent a collapse in lending to households and businesses and a breakdown of some financial markets. A couple of these firms that subsequently requested additional TARP capital are subject to reporting on lending and a number of constraints, such as those on executive compensation, and are being closely reviewed by their supervisors. In addition, the 19 largest banks have been subjected to a rigorous supervisory capital assessment, aimed at ensuring that they will have sufficient capital on hand to allow them to withstand a harsher-than-expected macroeconomic climate over the next two years and still emerge with sufficient capital to allow them to continue performing their critical role of providing credit to credit-worthy businesses and households. Through the course of that assessment, these institutions were required to divulge a great deal of detailed information to their supervisors about loss rates, portfolio compositions, and earnings prospects. As of the beginning of October 2009, ten of these firms that had TARP capital have returned approximately $67 billion to the U.S. Treasury.

16. Were you present in any meeting in which the Bank of America acquisition of Merrill Lynch was discussed? Please state when each meeting took place, where each meeting was held, the other attendees of the meeting, and go into detail on what was discussed. In addition to the aforementioned, how involved were people such as Larry Summers and other Members of the President's Economic Advisory Council or the President's Working

Group on Financial Markets? Other bank CEOs? Do you feel it was appropriate for the federal government to play a role in the activities of private banks, and in particular, the matter of Bank of America and Merrill Lynch?

My involvement and the involvement of other Federal Reserve personnel in the acquisition by Bank of America Corporation of Merrill Lynch & Co. is described in detail in my statement on June 25, 2009, before the House Committee on Oversight and Government Reform. A copy of that statement is attached. I believe that Mr. Summers was made aware of the broad outlines of the Bank of America/Merrill Lynch situation, but he was not actively involved to any significant degree in the details of the response to that situation as far as I am aware. We did not consult with the CEOs of other banking organizations about the Bank of America/Merrill Lynch acquisition.

17. Would you welcome a full audit of the PPIP program now and regularly? Why or why not?

The Public-Private Investment Partnership (PPIP) program is part of the Administration's Financial Stability Plan for implementing the Troubled Asset Relief Program (TARP) and restoring confidence in, and liquidity to, the financial system. Under the PPIP program, the Treasury will co-invest with private investors in newly established public-private investment funds (PPIFs) that will purchase legacy assets from U.S. banking organizations and financial institutions. The FDIC also may guarantee debt issued by PPIFs that purchase legacy loans from banking organizations. Purchases of legacy assets by PPIFs are designed to help free up capital at financial institutions to make new loans, strengthen the balance sheets of the selling institutions, and promote liquidity and price discovery in the markets for legacy assets. The program is administered by the Treasury and the FDIC and specific questions with respect to the program are best addressed to those agencies.

18. Do you [support creation of a] resolution authority and a financial product safety commission? Why or why not on each item?

The Board supports development of a new resolution regime that would facilitate the orderly wind down of systemically important nonbank financial institutions, including bank holding companies. In our view, such a regime is a key element of a comprehensive strategy to contain systemic risk and to address the related problem of too-big-to-fail institutions.

In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, the Lehman and AIG experiences are powerful support for the proposition that there needs to be a third option between the choices of bankruptcy and bailout.

The Administration's recent proposal for strengthening the financial system would create such an option by allowing the Treasury to appoint a conservator or receiver for a systemically important nonbank financial institution that has failed or is in danger of failing. The conservator or receiver would have a variety of authorities--similar to those provided the Federal Deposit

Insurance Corporation with respect to failing insured banks--to stabilize and either rehabilitate or wind down the firm in a way that mitigates risks to financial stability and to the economy. For example, the conservator or receiver would have the ability to take control of the management and operations of the failing firm; sell assets, liabilities, and business units of the firm; and repudiate contracts of the firm. Importantly, the Administration's proposal also would allow the government, through a receivership, to impose "haircuts" on creditors and shareholders of the firm, either directly or by "bridging" the failing institution to a new entity, when consistent with the overarching goal of protecting the financial system and the broader economy. This aspect of the proposal is critical to addressing the too-big-to-fail problem and the moral hazard effects that it engenders.

We believe the contours of the resolution framework included in the Administration's proposal for systemically important financial institutions would significantly improve the resiliency of the financial system and the government's ability to protect the public's interest. We look forward to working with the Congress, the Administration, and other interested parties to elaborate the details of a resolution mechanism as the legislative process moves forward.

The Administration's proposal also would create a new agency--the Consumer Financial Protection Agency--and transfer to such agency broad responsibility for writing and enforcing consumer protection regulations concerning consumer financial disclosures, unfair practices in financial transactions, and fair lending. Currently, much of this authority is vested with the Federal Reserve alone in the case of rule-writing, and is shared among the Federal Reserve, the other federal banking agencies, and the Federal Trade Commission in the case of enforcement.

In considering this proposed change, I believe it is important for Congress to carefully weigh the costs, as well as the potential benefits, of transferring rule-writing and enforcement authority to an agency that did not also have prudential supervision responsibilities. Both the substance of consumer protection rules and their enforcement are complementary to prudential supervision. Poorly designed financial products and misaligned incentives can at once harm consumers and undermine financial institutions. Indeed, as with subprime mortgages and securities backed by these mortgages, these products may at times also be connected to systemic risk. At the same time, a determination of how to regulate financial practices both effectively and efficiently can be facilitated by the understanding of institutions' practices and systems that is gained through safety and soundness regulation and supervision. Similarly, risk assessment and compliance monitoring of consumer and prudential regulations are closely related, and thus entail both informational advantages and resource savings.

We understand that a good case can be made for creating a dedicated single-mission consumer protection agency. We also believe that the Federal Reserve is well-positioned to address consumer protection issues in the financial services marketplace. In the last three years, the Federal Reserve has adopted strong consumer protection measures in the mortgage and credit card areas. These regulations benefited from the supervisory and research capabilities of the Federal Reserve, including expertise in consumer credit markets, retail payments, banking operations, and economic analysis. Involving all these forms of expertise is important for tailoring rules that prevent abuses while not impeding the availability of sensible extensions of credit.

One important issue that should be addressed going forward, regardless of whether a new consumer protection agency is established, is the large supervisory and enforcement gap for independent nonbank lenders and financial services providers. Currently, these entities are regulated by a combination of the Federal Trade Commission (FTC) and the states. However, the FTC does not have the authority, tools, or resources to conduct routine on-site examinations of these entities to monitor and enforce compliance, which is the norm for depository institutions. And, while several states have put forth noteworthy efforts in this regard, the state enforcement scheme across the country is still uneven, with inadequate resources being a primary concern.

19. You have been quoted as stating that in looking back, it was probably a mistake to let Lehman fail. Please elaborate on this matter.

As I have explained in previous public statements, before its failure in September 2008, Lehman Brothers was a large and complex investment bank that was deeply embedded in our financial system. As the firm approached default, the Treasury and the Federal Reserve sought private-sector solutions, but none was forthcoming. With respect to public sector solutions, we determined that the available collateral fell well short of the amount needed to secure a Federal Reserve loan sufficient to pay off the firm's counterparties and continue operations. Because Lehman Brothers experienced its crisis during the financial stress that preceded enactment of the Emergency Economic Stabilization Act of 2008 (EESA), the Treasury did not have the authority to provide capital to the company. Accordingly, the failure of Lehman Brothers was unavoidable given the legal constraints and the absence of any alternative solution. The Federal Reserve and the Treasury had no choice but to try to mitigate the fallout from that event using the limited tools available. Specifically, the Federal Reserve sought to cushion the effects by implementing a number of measures, including substantially broadening the collateral accepted by the Federal Reserve's Primary Dealer Credit Facility and the Term Securities Lending Facility to ensure that the remaining primary dealers would have uninterrupted access to funding. Following the failure of Lehman Brothers, Congress enacted EESA, which made funds available from the Troubled Assets Relief Program to deal with financial strains facing institutions important to the financial system. In addition, to address the kind of concerns that arose from the Lehman Brothers bankruptcy, the Federal Reserve recommends that Congress enact a new resolution process for systemically important nonbank financial firms that would allow the government to wind down a troubled systemically important firm in an orderly manner.

Attachment: Chairman Bernanke's June 25, 2009, statement before the House Committee on Oversight and Government Reform.

[Prepared statement of Mr. Bernanke before the House Committee on Oversight and Government Reform follows:]

BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
U.S. HOUSE OF REPRESENTATIVES,
Washington, DC, June 25, 2009.

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

Chairman Towns, Ranking Member Issa, and other members of the Committee, I appreciate the opportunity to discuss the Federal Reserve's role in the acquisition by the Bank of America Corporation of Merrill Lynch & Co., Inc. I believe that the Federal Reserve acted with the highest integrity throughout its discussions with Bank of America regarding that company's acquisition of Merrill Lynch. I will attempt in this testimony to respond to some of the questions that have been raised.

BACKGROUND

On September 15, 2008, Bank of America announced an agreement to acquire Merrill Lynch. I did not play a role in arranging this transaction and no Federal Reserve assistance was promised or provided in connection with that agreement. As with similar transactions, the transaction was reviewed and approved by the Federal Reserve under the Bank Holding Company Act in November 2008. It was subsequently approved by the shareholders of Bank of America and Merrill Lynch on December 5, 2008. The acquisition was scheduled to be closed on January 1, 2009.

As you know, the period encompassing Bank of America's decision to acquire Merrill Lynch through the consummation of the merger was one of extreme stress in financial markets. The government-sponsored enterprises, Fannie Mae and Freddie Mac, were taken into conservatorship a week before the Bank of America deal was announced. That same week, Lehman Brothers failed, and American International Group was prevented from failing only by extraordinary government action. Later that month, Wachovia faced intense liquidity pressures which threatened its viability and resulted in its acquisition by Wells Fargo. In mid-October, an aggressive international response was required to avert a global banking meltdown. In November, the possible destabilization of Citigroup was prevented by government action. In short, the period was one of extraordinary risk for the financial system and the global economy, as well as for Bank of America and Merrill Lynch.

DISCUSSIONS REGARDING THE POSSIBLE TERMINATION OF AGREEMENT TO ACQUIRE MERRILL LYNCH

On December 17, 2008, senior management of Bank of America informed the Federal Reserve for the first time that, because of significant losses at Merrill Lynch for the fourth quarter of 2008, Bank of America was considering not closing the Merrill Lynch acquisition. This information led to a series of meetings and discussions among Bank of America, the regulatory agencies, and Treasury. During these discussions, Bank of America's CEO, Ken Lewis, told us that the company was considering invoking the Material Adverse Event clause in the acquisition contract, known as the MAC, in an attempt to rescind its agreement to acquire Merrill Lynch.

In responding to Bank of America in these discussions, I expressed concern that invoking the MAC would entail significant risks, not only for the financial system as a whole but also for Bank of America itself, for three reasons. First, in light of the extreme fragility of the financial system at the time, the uncertainties created by an invocation of the MAC might have triggered a broader systemic crisis that could well have destabilized Bank of America as well as Merrill Lynch. Second, an attempt to invoke the MAC after three months of review, preparation, and public remarks by the management of Bank of America about the benefits of the acquisition would cast doubt in the minds of financial market participants—including the investors, creditors, and customers of Bank of America—about the due diligence and analysis done by the company, its capability to consummate significant acquisitions, its overall risk-management processes, and the judgment of its management. Third, based on our staff analysis of the legal issues, we believed that it was highly unlikely that Bank of America would be successful in terminating the contract by invoking the MAC. Rather, an attempt to invoke the MAC would likely involve extended and costly litigation with Merrill Lynch that, with significant probability, would result in Bank of America being required either to pay substantial damages or to acquire a firm whose value would have been greatly reduced or destroyed by a strong negative market reaction to the announcement. For these reasons, I believed that, rather than invoking the MAC, Bank of America's best option, and the best option for the system, was to work with the Federal Reserve and the Treasury to develop a contingency plan to ensure that the company would remain stable should the completion of the acquisition and the announcement of losses lead to financial stress, particularly a sudden pullback of funding of the type that had been experienced by Wachovia, Lehman, and other firms.

Ultimately, on December 30, the Bank of America board determined to go forward with the acquisition. The staff of the Federal Reserve worked diligently with Treasury, other regulators, and Bank of America to put in place a package that would help to shore up the combined company's financial position and reduce the risk of market disruption. The plan was completed in time to be announced simultaneously with Bank of America's public earnings announcement, which had been moved forward to January 16, 2009, from January 20, 2009. The package included an additional $20 billion equity investment from the Troubled Asset Relief Program and a loss-protection arrangement, or ring fence, for a pool of assets valued at about $118 billion. The ring-fence arrangement has not been consummated, and Bank of America now believes that, in light of the general improvement in the markets, this protection is no longer needed.

Importantly, the decision to go forward with the merger rightly remained in the hands of Bank of America's board and management, and they were obligated to make the choice they believed was in the best interest of their shareholders and company. I did not tell Bank of America's management that the Federal Reserve would take action against the board or management if they decided to proceed with the MAC. Moreover, I did not instruct anyone to indicate to Bank of America that the Federal Reserve would take any particular action under those circumstances. I agreed with the view of others that the invocation of the MAC clause in this case involved significant risk for Bank of America, as well as for Merrill Lynch and the financial system as a whole, and it was this concern that I communicated to Mr. Lewis and his colleagues.

DISCLOSURES

The Federal Reserve also acted appropriately regarding issues of public disclosure. As I wrote in a letter to this Committee, neither I nor any member of the Federal Reserve ever directed, instructed, or advised Bank of America to withhold from public disclosure any information relating to Merrill Lynch, including its losses, compensation packages or bonuses, or any other related matter. These disclosure obligations belong squarely with the company, and the Federal Reserve did not interfere in the company's disclosure decisions.

The Federal Reserve had a legitimate interest in knowing when Bank of America or Merrill Lynch intended to disclose the losses at Merrill Lynch. Given the fragility of the financial markets at that time, we were concerned about the potential for a strong, adverse market reaction to the reports of significant losses at Merrill Lynch. If federal assistance to stabilize these companies were to be effective, the necessary facilities would have to be in place as of the disclosure date. Thus, our planning was importantly influenced by the companies' planned disclosure schedule. But the decisions and responsibilities regarding public disclosure always remained, as it should, with the companies themselves.

A related question is whether there should have been earlier disclosure of the aid provided by the U.S. government to Bank of America. Importantly, there was no commitment on the part of the government regarding the size or structure of the transaction until very late in the process. Although we had indicated to Bank of America in December that the government would provide assistance if necessary to keep the company from being destabilized, as it had done in other cases during this time of extraordinary stress in the financial markets, those December discussions were followed in January by significant and intense negotiations involving Bank of America, the Federal Reserve, the Treasury, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency regarding many key aspects of the assistance transaction, including the type of assistance to be provided, the size of the protection, the assets to be covered, the terms for payments, the fees, and the length of the facility. The agreement in principle on these items was reflected in a term sheet that was not finalized until just before its public release on January 16, 2009. The Federal Reserve Board and the Treasury completely and appropriately disclosed the information as required by the Congress in the Emergency Economic Stabilization Act of 2008.

In retrospect, I believe that our actions in this episode, including the development of an assistance package that facilitated the consummation of Bank of America's acquisition of Merrill Lynch, were not only done with the highest integrity, but have strengthened both companies while enhancing the stability of the financial markets and protecting the taxpayers. These actions were taken under highly unusual circumstances in the face of grave threats to our financial system and our economy. To avoid such situations in the future, it is critical that the Administration, the Congress, and the regulatory agencies work together to develop a new framework that strengthens and expands supervisory oversight and includes a broader range of tools to promote financial stability.

I would be pleased to take your questions.

Chairman SPRATT. Mr. Ryan has one final question.

Mr. RYAN. Since we are before you have to leave, Mr. Chairman, I figured I would ask you a second.

We are going to make two big fiscal policy decisions just this summer, talked about cap-and-trade briefly and then health care legislation. And those are the two big fiscal dockets. And that is going to impact our borrowing and our deficits, no two ways about it.

The bill that is moving to the floor that is already out of the Commerce Committee on cap-and-trade auctions off 88 percent of the permits, which therefore dramatically reduces the ability to do the rebates such as you discussed as needed to be offsetting to blunt the negative fiscal impact on the economy—gives away, yes, did I say auctions off—gives away 88 percent of the permits.

Given that the legislation that we are looking at gives away 88 percent of the permits, drying up the money to do rebates, do you think that that has a negative effect on the economy?

Mr. BERNANKE. My understanding is that they will be given away and then passed through to consumers; is that correct?

Mr. RYAN. No, they are given away to various industries.

Mr. BERNANKE. If you give it away to the industries but prices still reflect the cost of the permit, then it is basically money being given to the industries.

Mr. RYAN. But the targets will be the same. So the emission targets will be as aggressive. But the point I am trying to make is the revenue from auctions which are needed to do rebates will not be there because the permits will be given away to the firms.

Mr. BERNANKE. It is certainly true. If the permits are given away, then you don't get the revenue from the auctions, absolutely.

Mr. RYAN. And, therefore, if there is not an offsetting rebate anywhere close to one for one, do you think that that therefore has negative effects on the economy?

Mr. BERNANKE. It could, yes. But, again, my understanding is that some of these auctions, some of these permits that are being given away that are being required to be passed through to consumers, which has a different effect in terms of spending but to some extent goes against the premise of the policy, which is to try to reduce energy consumption, since if consumers don't see higher prices you won't reduce their consumption.

Mr. RYAN. Yes. I think a lot of us would question the efficacy or logic of it being passed through to the consumers, because it counts against the whole notion of the program.

Mr. BERNANKE. That is right.

Mr. RYAN. Let me ask you one final question. Do you think it makes sense that we need to spend more on entitlements in order to save money on entitlements? What I mean when I get at that is we are in the middle this health care debate, the discussion revolves around raising about 1.3, 1.2 trillion in new revenues to spend on a new entitlement program that will be created for health care for the under 65 population. We already spend more than 2.5 times per person on health care compared to any other country in the world.

Is it a good idea from a fiscal standpoint to increase that by another 1.2, 1.3 trillion over the next 10 years? And is that the best way to save more money in the long run with these entitlement programs? So we have two health care entitlement programs already, Medicare and Medicaid. We are going to create a third one now with a huge expenditure requirement, with a revenue stream that may or may not meet that expenditure requirement.

Nevertheless, it is a larger tax and spend program than what we have right now. Is that the right way to go down toward containing our fiscal problems, in your opinion?

Mr. BERNANKE. From a fiscal perspective, the reforms to health care need to address the cost issue. Now, the question is about how to change the structure of the health care system or whether to do it or not or how the government's role should change, if at all.

But if you don't get control of the cost of health care, then the fiscal issues are very serious. And, in particular, for example, Medicare trustees assumed that health care costs were going to grow at only 1 percent faster than per capita income. In fact they have been growing at 2.5 percent faster than per capita income. So we need some substantial cost controls just to get down to the Medicare trustees' prediction.

Mr. RYAN. Do you think that creating a new entitlement and more spending and taxing is the way to contain those costs?

Mr. BERNANKE. Part of the reform effort has got to be addressing the cost somehow, the cost of per capita health care and the growth in that rate. So that has got to be a big part of that program. If you don't do that, then just adding programs would be a big problem, yes.

Mr. RYAN. Thank you.

Chairman SPRATT. I ask unanimous consent that before concluding that members who did not have an opportunity to ask questions of our witness be given 7 days to submit questions for the record.

Mr. Chairman, thank you very much for your testimony and, in particular, for your forthright, clear, and very insightful answers.

We appreciate your being here again today, and we look forward to working with you in the future. Thank you very much indeed.

The committee is now adjourned.

[Questions for the record submitted by Mr. Connolly follow:]

QUESTIONS FOR THE RECORD SUBMITTED BY MR. CONNOLLY

Chairman Bernanke, would you agree that the municipal credit market is still in distress?

Chairman Bernanke, while a federal reinsurance program may be a worthwhile action, do you believe it is the only necessary action in returning the municipal bond market to its pre-recession condition?

Chairman Bernanke, would the high interest rates currently facing state and local governments and the lost employment potential as needed municipal capital projects remain idle be actionable concerns under the Fed's purview?

Chairman Bernanke, if the Federal Reserve has the authority to purchase municipal debt, given the extraordinary economic situation facing the nation, the extreme hardships facing our states and localities, and the immediate benefits that their capital programs will provide to our economic recovery, shouldn't the Fed consider this option as a tool?

[Mr. Bernanke's responses to Mr. Connolly's questions follow:]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, DC, June 30, 2009.

Hon. GERALD E. CONNOLLY,
U.S. House of Representatives, Washington, DC.

DEAR CONGRESSMAN: Enclosed are my responses to the questions you submitted following the June 3, 2009, hearing before the House Committee on the Budget entitled "Challenges Facing the Economy: The View of the Federal Reserve." I have also forwarded a copy to the Committee for inclusion in the hearing record.

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

Sincerely,

BEN S. BERNANKE,
Chairman.

Chairman Bernanke subsequently submitted the following in response to written questions received from Congressman Gerald Connolly in connection with the June 3, 2009, hearing before the House Committee on the Budget:

Chairman Bernanke, would you agree that the municipal credit market is still in distress?

The functioning of the primary market for municipal debt market has improved significantly since late last year. For example, the spread between the interest rate paid on long term fixed-rate municipal debt and that on comparable-maturity Treasury bonds has fallen significantly since November, and average yields on fixed-rate municipal bonds are currently quite low by historical standards. The seven-day SIFMA swap index, a measure of yields for high-grade variable rate demand obligations (VRDOs), has also declined sharply since November, which suggests that this part of the market is functioning quite well for higher-rated Issuers. Moreover, gross issuance of municipal bonds has been fairly well maintained so far this year.

To be sure, some segments of the municipal debt market remain stressed. One symptom of this stress is that the spread between municipal bonds rated AA versus those rated A remains high by historical standards despite its recent narrowing. In the market for floating-rate municipal debt, some market participants report that the cost of liquidity support and credit enhancement for VRDOs remains sharply higher than it was a year ago, and auctions of most remaining auction rate securities continue to fail. (The value of municipal auction rate securities outstanding has diminished by at least half since 2007.) In addition, some VRDOs have reportedly been put to their liquidity providers, turning them into "bank bonds," which typically carry penalty interest rates and can eventually be subject to accelerated amortization. The combination of a higher interest rate and accelerated amortization can cause a sudden and substantial increase in the debt service payments required of the issuing municipality.

Chairman Bernanke, while a federal reinsurance program may be a worthwhile action, do you believe it is the only necessary action in returning the municipal bond market to its pre-recession condition?

The stress in municipal debt markets reflects several different factors. One important factor is the underlying fiscal weakness of the issuing municipalities. Investors are responding to this weakness by drawing distinctions among different jurisdictions, and they are charging higher rates to states and localities with weaker fiscal conditions. But there are other contributing factors as well, including the diminished financial strength and capacity of the financial guaranty industry and the pressures on banks and other providers of liquidity backstops and credit enhancement, in response to which those entities have reduced the availability and increased the cost of their support for municipal debt. The Congress could choose to provide assistance to states and localities by addressing anyone of these factors, or all of them. Indeed, as you are. well aware, some policy actions have already been taken, including the fiscal stimulus package now in the process of being implemented as well as the many steps taken by the Federal Reserve to improve the functioning of financial markets. These policy actions have already had some positive effect and should continue doing so in the future. Whether to undertake further action in support of state and local governments is an issue that must be weighed by the Congress in light of the overall federal fiscal situation and the competing potential uses of the resources that might be devoted to this purpose.

Regardless of the policy actions the Congress may decide to implement, it may also wish to consider ways to minimize the potential for distortions in the market for municipal bonds. One effect of the current financial crisis has been to expose some important vulnerabilities of the municipal debt market. For example, because contracts for letters of credit and standby bond purchase agreements are typically of short duration, municipalities face significant "rollover" risks for their VRDOs that raise serious questions about whether these securities should remain a significant vehicle for municipal finance in the long term. Congress may wish to tailor any government intervention in the municipal bond market relatively narrowly to avoid perpetuating such vulnerabilities, to encourage market participants to seek private-sector solutions, and to facilitate the government's exit from the market.

Chairman Bernanke, would the high interest rates currently facing state and local governments and the lost employment potential as needed municipal capital projects remain idle be actionable concerns under the Fed's purview?

As I mentioned in response to the first question, average yields on municipal bonds are currently quite low by historical standards. Of course, some municipalities are facing difficult financing conditions at a time when the recession is causing tax revenues to fall and required spending to rise.

The Federal Reserve seeks to promote the objectives of maximum employment and price stability as mandated by Congress. In striving to attain these objectives, the Federal Reserve takes account of the full range of factors impinging on the current economic situation and the outlook for economic conditions in the future. One of those factors is the demand for goods and services that states and localities are likely to generate. To the extent that conditions in municipal debt markets impede that demand, we will certainly modulate our policy stance in an offsetting manner, all other factors being equal.

Chairman Bernanke, if the Federal Reserve has the authority to purchase municipal debt, given the extraordinary economic situation facing the nation, the extreme hardships facing our states and localities, and the immediate benefits that their capital programs will provide to our economic recovery, shouldn't the Fed consider this option as a tool?

While Federal Reserve policies have helped and should continue to help promote better conditions in municipal securities markets, we have important misgivings about assuming a more direct role in those markets. In particular, given the extensive fiscal relationships between the federal government and state and local governments, it seems more appropriate for the Congress to lead the way in addressing issues in municipal debt markets. lndeed, this is one reason why the Federal Reserve Act imposes limits on the ability of the Federal Reserve to purchase municipal debt, including a six-month maturity limit. Our misgivings also reflect our determination that we should be mindful of the need to protect both the Federal Reserve and federal taxpayers from credit losses; and that we should design all our interventions in the current financial crisis with a careful eye to allowing a clear exit strategy, thereby helping to ensure our ability to raise the federal funds rate from its current level once the Federal Open Market Committee determines that such a move is necessary to promote the mandate given to us by the Congress to foster maximum sustainable employment and price stability. For all these reasons, we believe that direct policy action, if deemed necessary, is better suited to fiscal authorities than to the central bank.

[Prepared statement and questions for the record submitted by Mr. Langevin follow:]

PREPARED STATEMENT AND QUESTIONS SUBMITTED BY HON. JAMES R. LANGEVIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF RHODE ISLAND

Chairman Bernanke, thank you for your testimony today. One of the central challenges facing American businesses and families has been a lack of access to adequate credit. The inability to obtain consumer and business loans has been a paralyzing force to the economic and fiscal well being of the nation.

I am encouraged by recent indications that the recession may be slowing, but ensuring the proper liquidity of our credit markets continues to be a top priority. I am particularly interested in your efforts to stimulate lending for small businesses, as they are the economic backbone of Rhode Island and the Country.

1. Can you please discuss the progress that has been made under the Term-Asset-Backed Securities Loan Program (TALF), which was instituted in March to ease credit and help stabilize the financial system?

2. One of the goals of TALF is to free up lending for small businesses and consumers; however, many small businesses in my home state of Rhode Island are still unable to access and maintain adequate lines of credit. When do you expect small businesses and consumers to have access to the lending they need?

3. Various new outlets (Reuters and AP) reported yesterday that demand for Fed loans rose to about $11.5 billion, up 8 percent from May and up 145 percent from the first round in March. Do these numbers meet with your expectations for growth under TALF?

4. As credit markets begin to thaw and the recession slows, the infusion of more than $1 trillion dollars into our economy could present another significant challenge—ensuring the strong value of the dollar by guarding against inflation. Are there currently any economic indications that inflation might be a risk? What actions does the Fed plan to take to avert the potential concerns of inflation?

[Mr. Bernanke's responses to Mr. Langevin's questions follow:]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, DC, July 7, 2009.

Hon. JAMES R. LANGEVIN,
U.S. House of Representatives, Washington, DC.

DEAR CONGRESSMAN: Enclosed are my responses to the questions you posed following the June 3, 2009, hearing before the House Budget Committee on "Challenges Facing the Economy." Your questions dealt with the Federal Reserve's Term Asset-Backed Securities Loan Facility and with monetary policy and inflation. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

I hope this information is helpful. Please let me know if I can provide any further assistance.

Sincerely,

BEN S. BERNANKE,
Chairman.

Chairman Bernanke subsequently submitted the following in response to written questions submitted by Congressman James Langevin in connection with the June 3, 2009, hearing before the Committee on the Budget:

1. Can you please discuss the progress that has been made under the Term Asset? Backed Securities Loan Program (TALF), which was instituted in March to ease credit and help stabilize the financial system?

Under the TALF, the Federal Reserve Bank of New York (FRBNY) extends loans to finance purchases of certain newly issued highly rated asset-backed securities (ABS) that are in turn backed by loans to small businesses and households. The Board established the TALF after a near-shutdown in the ABS market last fall contributed to a reduction in credit availability. By supporting new issuance of ABS, the program is designed to encourage new lending to small businesses and households.

As initially announced, the ABS eligible to collateralize TALF loans include ABS backed by auto loans, credit card loans, student loans, and small business loans guaranteed by the Small Business Association. The Board subsequently added ABS backed by several different types of business loans and leases, and also new and existing commercial mortgage-backed securities.

In March and April, about $3 billion in TALF loans were extended each month, a bit below our expectations, in part because it took time for investors to work out the necessary legal arrangements associated with TALF financing, and reportedly also because investors were concerned about participating in a government program. In May and June, however, as investor comfort with the program increased, lending picked up to about $11 billion a month.

In May and June, ABS issuance increased to levels approaching those recorded prior to the slowdown in the ABS market last fall. Investors have purchased and pledged as collateral for TALF loans ABS of nearly all the eligible types, including ABS backed by auto loans, consumer loans, student loans, small business loans, loans to small businesses to purchase property and casualty insurance, and loans to finance purchases of business equipment. The strengthening of investor demand for ABS has contributed to a narrowing in ABS spreads. Importantly. some ABS is now being issued without TALF financing at yields that are below the TALF lending rate, an indication that markets are normalizing.

In addition, the expansion in May to new and existing commercial mortgage-backed securities (CMBS) should help revive the CMBS market, in which there has been no new issuance since the spring of 2008, facilitating the extension of new commercial mortgage credit and the refinancing of existing credit when it matures. No TALF loans collateralized by CMBS have yet been made, in part because CMBS take some time to arrange.

2. One of the goals of TALF is to free up lending for small businesses and consumers; however, many small businesses in my home state of Rhode Island are still unable to access and maintain adequate lines of credit. When do you expect small businesses and consumers to have access to the lending they need?

We recently surveyed lenders that have issued ABS with support from the TALF. The issuers reported that the availability of TALF financing enabled them to increase lending to small businesses and consumers. Several noted that they would have substantially reduced lending without the TALF.

While the TALF and other government programs have helped prevent an even more severe contraction in credit availability, credit still remains difficult for many small businesses and households to obtain. The Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices has recorded a net tightening in standards on loans to small business for eight consecutive quarters. In the survey, banks point to a weak economic outlook as the principal reason for tightening standards. Credit to small businesses and households will likely become more readily available as the economic outlook improves and a sustained economic recovery gets under way.

3. Various news outlets (Reuters and AP) reported yesterday that demand for Fed loans rose to about $11.5 billion, up 8 percent from May and up 145 percent from the first round in March. Do these numbers meet with your expectations for growth under TALF?

As indicated above, although TALF lending in March and April was below our expectations, activity picked up in May and June. Our objective in establishing the TALF was to support the extension of credit to households and businesses rather than to achieve prespecified volume targets for the TALF. The narrowing of spreads in the ABS market and the increase in ABS issuance suggests that the TALF is being successful in promoting that objective.

4. As credit markets begin to thaw and the recession slows, the infusion of more than $1 trillion into our economy could present another significant challenge—ensuring the strong value of the dollar by guarding against inflation. Are there currently any economic indications that inflation might be a risk? What actions does the Fed plan to take to avert the potential concerns of inflation?

I do not currently see any economic indications that an increase in consumer price inflation is a major risk to the economy. The total price index for personal consumption expenditures edged up just 0.1 percent over the 12 months ending in May, while the core PCE price index, which excludes the direct effects of movements in food and energy prices, rose 1.8 percent over the same period, about 112 percentage point less than in the previous 12-month period. In addition, although the prices for crude oil and other commodities have risen recently, we have not seen the sort of run up in labor costs and inflation expectations that could lead to a deterioration in the longer term outlook for inflation. In particular, wages appear to have decelerated noticeably in recent quarters, and although some indicators of inflation expectations have increased a little recently, long-term inflation expectations still appear to be reasonably well anchored.

Thus, as was noted in the Federal Open Market Committee (FOMC) statement released on June 24, with the substantial amount of resource slack that has opened up both here and abroad likely to dampen cost pressures going forward, members of the FOMC expect that inflation will remain subdued for some time. Some observers have argued that the expansion of the Federal Reserve balance sheet associated with our policy actions during the financial crisis poses inflationary risks to the economy. However, we at the Federal Reserve have judged these actions as appropriate in light of the economic weakness and significant strains in financial markets, and indeed we anticipate that our policy actions will contribute to a gradual resumption of sustainable economic growth in a context of price stability. In this regard, I would also emphasize that we have the necessary tools to remove monetary stimulus in time to head off inflationary pressures if they were to emerge. More generally, I can assure you that the Federal Reserve remains committed to its dual mandate of fostering full employment and price stability, and we will continue to adjust our policies in response to the evolving economic outlook and conditions in financial markets in order to promote these objectives.

[Articles for the record submitted by Ms. Kaptur follow:]

[Published in the June 2009 issue of Bloomberg Markets Magazine]

BlackRock Is Go-To Firm to Divine Wall Street Assets

By Kambiz Foroohar and Sree Vidya Bhaktavatsalam

MAY 8 (Bloomberg)—Got assets you can't value? Call Larry Fink.

That's what Federal Reserve Chairman Ben S. Bernanke and Treasury Secretary Timothy Geithner have done, as have many heads of banks and insurance companies, including Robert Willumstad, former chief executive officer of American International Group Inc., and current AIG CEO Edward Liddy.

Fink, 56, is CEO of BlackRock Inc., the U.S.'s biggest publicly traded asset management firm, with $1.3 trillion under management for clients that include Ford Motor Co. and Microsoft Corp. BlackRock, like many other money managers, has taken some hits in the credit crisis. It also loaded up on Lehman Brothers Holdings Inc. stock, for example, buying shares last June at $28 only three months before Lehman declared bankruptcy. One BlackRock fund that rushed in to buy distressed debt in September 2007 saw its value plunge 25 percent during the following 12 months.

More recently, mirroring results at rival firms, BlackRock's first quarter profits fell 65 percent to $84 million after stock and bond market declines hurt its fees.

DOMINANT

Fink has a way of making good money in bad times. A decade ago, he created a subsidiary called BlackRock Solutions, looking to capitalize on ever-more-sophisticated risk-management analytics that the firm was running for clients, including mortgage giant Freddie Mac, that needed help in assessing stressed portfolios or in deciding whether an investment made sense.

In the unfolding credit crisis, BlackRock Solutions has become the dominant player in evaluating and pricing distressed assets such as mortgage-backed securities by winning more contracts from the government, investment banks and insurance companies than other firms.

"It's our fastest-growing unit," says Robert Kapito, BlackRock's president, citing revenue that doubled to $400 million last year. In the latest quarter, the unit's revenue more than doubled to $140 million from $60 million a year earlier.

"BlackRock has established itself as the go-to firm when you have problems," says Terrence Keeley, a managing director at UBS AG, which sold a $22 billion portfolio of subprime mortgages to a fund managed by BlackRock.

DESPERATE CUSTOMERS

The terms—in which UBS offered a $7 billion discount and provided $11.25 billion in financing—demonstrate how desperate banks are to get distressed assets off their books. "It's hard to replicate the BlackRock approach because they built their systems, tools and analytics a long time ago," Keeley says.

The Federal Reserve and U.S. Treasury Department have awarded contracts to BlackRock Solutions to manage $130 billion in distressed debt formerly on the books of investment bank Bear Stearns Cos. and crippled financial giant AIG. The Fed called on the company in September to analyze the assets of Fannie Mae and Freddie Mac after the government took an 80 percent stake in the two mortgage giants. BlackRock is also one of four co-managers of a $500 billion Fed program, announced in November and expanded to $1.25 trillion in March, to buy residential mortgage-backed securities.

Fink began his career as a bond trader who three decades ago helped pioneer collateralized-mortgage obligations, the forerunners of the complicated derivatives at the heart of the present crisis.

LUCRATIVE WORK

Over time, Fink and BlackRock Solutions stand to earn tens of millions or even hundreds of millions of dollars in fees, primarily from lucrative private-sector toxic-asset work, according to Fink and people familiar with the contracts.

"We're managing hundreds of billions for governments," Fink says. Asked for details about whom else BlackRock is working for and how it actually goes about its tasks, he demurs. "I have to be opaque," he says. "It's hundreds of billions and not necessarily for the U.S. government."

The Fed and Treasury, beyond confirming Fink's contracts, also have little to say about the exact nature of the work—a stance that worries some. Janet Tavakoli, president of Chicago-based Tavakoli Structured Finance Inc. and the author of three books on derivatives, says the government should be more forthcoming.

NEED FOR TRANSPARENCY

"The Federal Reserve and the Treasury would do the world a favor by giving us more transparency on AIG and Bear Stearns assets," she says. "The regulators have just given up and are just throwing the assets with BlackRock and saying 'Manage this.'" (Bloomberg News filed a Freedom of Information Act lawsuit in November asking a federal judge to require the government to disclose data about the Bear Stearns assets.)

Not content to be a manager of toxic assets with no transparent value, Fink is also planning to buy them. He says BlackRock Inc. wants to raise $5 billion to $7 billion from investors to participate in a government plan, announced March 23 by Geithner, to finance up to $1 trillion of such purchases. BlackRock intends to apply to become one of the five managers under the plan, known as the Treasury Department's Public-Private Investment Program. Fink says he sees no conflict of interest in being one of the Treasury's managers and participating in the plan.

"I don't get any inside information, and it's a competitive auction pool," he says.

RESCUE PLANS

In theory, BlackRock Solutions has competition. Goldman Sachs Group Inc., for example, has its own risk management teams. Pacific Investment Management Co., the world's largest bond manager, has a risk management component, as does Legg Mason Inc., a Baltimore-based asset management company.

As Bear Stearns collapsed during a frantic weekend in mid-March 2008, JPMorgan Chase & Co. called on a BlackRock team of 50 analysts and number crunchers who worked around the clock to assess Bear Stearns's most illiquid assets.

At the end of the weekend, Geithner, then chairman of the Federal Reserve Bank of New York, called Fink personally to ask him to oversee $30 billion in soured mortgage debt that had been cleaved from Bear Stearns's books before its viable assets were sold to JPMorgan.

Likewise, the Fed considered no other company for managing an additional $100 billion in AIG assets that the government steered Fink's way last November, according to comments from an investigator for U.S. Senator Charles Grassley.

BlackRock had also undertaken a crash mission at the behest of AIG's Willumstad during his four-month run as CEO, in a last-ditch effort in the summer of 2008 to avoid a government takeover of the firm.

ADVANCED ANALYTICS

He had them run analytics on his company's portfolio of collateralized-debt obligations and credit-default swaps. The government intervened before Willumstad could put together a rescue plan. That drama unfolded shortly before the government began injecting huge amounts of taxpayer capital—$182.5 billion as of April of this year—to keep AIG afloat.

"We had the expertise; we had already evaluated the assets," Fink says. "It's not that we're being opportunistic. We've been in this advisory business since 1994."

During hearings in Congress in January, Grassley, an Iowa Republican and ranking member of the Senate Finance Committee, questioned the no-bid government contracts awarded to BlackRock. "Why is it that BlackRock is the only firm qualified to manage the assets of special-purpose vehicles?" he asked.

Geithner supplied the answer. "They come with a world-class reputation," he said. "We thought the interest of the American taxpayer would be best served by having them there on our side as we made those consequential judgments."

DISTRESSED DEBT LOSSES

BlackRock's asset management unit, which accounted for 87 percent of the company's revenue last year, has stumbled by investing in assets similar to those the government is now calling on BlackRock Solutions to manage.

In April 2008, after the collapse of Bear Stearns, Fink said U.S. Treasuries had become too expensive and investors should put money into riskier debt such as MBSs. Merrill Lynch & Co.'s U.S. High Yield Master II index, which tracks corporate bonds, fell 30 percent between March 31 and year-end.

On June 13, 2008, as Lehman Brothers' troubles began to unfold, Kapito, BlackRock's president, said, "We have confidence in the firm, in the leadership." On Sept. 15, Lehman filed for bankruptcy.

The $3 billion BlackRock Credit Investors LP fund, created in September 2007, sank hundreds of millions of dollars into distressed bank loans that continued to plummet as the credit crisis deepened. Investors, including pension funds, saw the value of their holdings shrink by 25 percent during the next 12 months, according to the New Jersey State Investment Council.

'GOOD MONEY AFTER BAD'

BlackRock remained bullish and urged investors to increase their holdings, and many did. In October 2008, the NJSIC added about $144 million to the $400 million it had originally put in. The Oregon Investment Council added $72 million to its $200 million investment in the same fund.

"We were throwing good money after bad," says Jim Marketti, retired president of the Communications Workers of America Local 1032, who sits on the board of New Jersey's Division of Investment. "They say these investments will perform well in the long run. Well, in the long run, we're all dead."

BlackRock was hardly alone in racking up losses. One fund set up by rival Pimco to buy troubled mortgages lost 38 percent last year, according to investors in the fund who declined to be named. (Pimco declined to comment.) "Even with the best and brightest, BlackRock missed what has been a glaring risk," says Michael Herbst, an analyst at Chicago-based investment research firm Morningstar Inc.

LONG-TERM OPTIMISM

Fink, while contrite, maintains his long-term optimism. "Clearly, I've been early in calling for clients to take more risks, as our balance sheet losses show," Fink says. "In the long term, they'll be good investments."

For BlackRock's fans, there's no mystery as to why the government picked BlackRock Solutions to analyze—without competitive bids—distressed portfolios.

The company's more than a decade of experience coupled with its advanced analytics give it an edge over rivals, says Peter Federico, Freddie Mac's treasurer.

You won't get an argument from Morgan Stanley.

After Lehman's bankruptcy, Morgan Stanley shares went into free fall, declining 74 percent in four weeks. The investment bank founded by Henry Morgan—the grandson of J. Pierpont Morgan—and Harold Stanley needed a lifeline. Mitsubishi UFJ Financial Group Inc. was chewing over a possible $9 billion investment.

'PROCTOLOGY EXAM'

Lazard Ltd., Mitsubishi's adviser, called BlackRock to analyze Morgan Stanley's most illiquid commercial-backed securities, since Mitsubishi, Japan's largest bank, wouldn't act without reliable data on these assets' values.

One Morgan Stanley executive described the experience as a "proctology exam," yet after BlackRock delivered its results, Mitsubishi went ahead with the $9 billion investment.

Cleaning up a tainted balance sheet is complicated. Bad assets have to be identified and isolated from viable ones, removed from a financial institution's books, somehow valued and eventually sold off into a secondary market. While that process unfolds, the assets also have to be managed. Some are securities that still throw off cash in the form of dividends. "The computations are complex and time-consuming," Federico says. "BlackRock has the most sophisticated and widest range of expertise across all fixed income."

LACK OF OSTENTATION

In a photo gallery of archetypes, Laurence Douglas Fink would stand out as the middle-aged banker that he is: the tailored suits spiced up with the occasional flashy tie, the receding hairline and a demeanor rendered slightly professorial by his glasses. At a lectern, he tends to gesture a lot with his hands.

Save for the oblong A. Lange & Sohne watch he wears—an artsy German brand whose intricate models can cost $40,000—and a fondness for San Pietro, a pricey Manhattan power eatery, Fink shuns most of the trappings of Wall Street.

It's not like he can't afford them. He earned $21 million in 2008, down 26 percent from $26.4 million in 2007, according to company filings.

There have been no John Thain-style million-dollar office renovations for Fink. He holds forth in a modest, light-filled, fifth-floor office sporting a couch, a heavy rosewood-colored desk and a mundane view of 52nd Street in midtown Manhattan. A green china vase filled with striking purple orchids graces a filing cabinet.

SHOE-STORE EXPERIENCE

His prized adornment is a framed platinum CD by Maroon 5, a Grammy-winning Los Angeles band signed to the record company that Fink helped to fund. It leans against a wall. Acquaintances trace Fink's lack of ostentation to his roots in Van Nuys, a working-class town in California's San Fernando Valley, where he grew up counting laces and stacking polish in his father's shoe store.

His brother Steven B. Fink, now a Los Angeles venture capitalist, helped out in the store, too. He recalls Larry as a trenchant observer of customers and what they wanted. "That's a skill that Larry learned: being cognizant of other people's needs and desires," he says.

After attending public school in Van Nuys, Fink majored in political science at the University of California, Los Angeles. He stayed on at UCLA to earn a Master of Business Administration in 1976 from what's now known as the Anderson School of Management.

'BRILLIANT MIND'

Fred Weston, a professor who taught Fink at the management school, was so impressed with him that he put a note in his file predicting future business triumphs. "He had an unusually brilliant mind," Weston says. "I predicted that he'd be a great success."

After getting his MBA, Fink took a job selling bonds at New York-based investment bank First Boston Corp. (now a part of Zurich-based Credit Suisse Group AG), rising to managing director by the age of 28. Bond trading, say colleagues who knew him then, made Fink rich but didn't affect his West Coast affability.

Fink's diplomatic skills were on display in 2003, when as a director at the New York Stock Exchange, he worked out a deal to persuade then Chairman Richard Grasso to step down during a controversy over Grasso's $140 million pay package.

"He's very sensitive to the fairness of what he does," says Kenneth Langone, a founder of Home Depot Inc. who served with Fink on the NYSE board and was a vocal supporter of Grasso. "Fink is a voice for reason."

SCOLDING CONGRESS

That doesn't mean he can't get riled up. On Sept. 29, 2008, as the Dow Jones Industrial Average was falling more than 700 points, Fink lashed out at the rhetoric coming out of Congress as it debated the need for the government to rescue the banks.

"It's abhorrent that Congress is trying to say that this is a bailout of Wall Street," Fink said during an interview on CNBC. "This package is a bailout of Main Street, and if we don't solve this, Main Street is going to feel some very ill effects." He went on to suggest that the Congressional naysayers—almost all of them at that point Republicans—ought to be fired in the next elections.

Fink has remained married for 34 years to his high-school sweetheart, Lori Weider. They have three grown children, including one who runs a hedge fund. Fink lives in a co-op on Manhattan's Upper East Side in the same neighborhood as other Wall Street leaders such as private equity tycoon Henry Kravis.

MAROON 5 GOLD

And while hedge fund managers and stock traders who play in garage bands are a dime a dozen, Fink in 2000 took his baby boomer affection for rock-and-roll and along with eight colleagues provided $5 million in startup capital for an independent record label called Octone Records. The company, now known as A&M/Octone, scored big when it signed a pop band known as Maroon 5.

The group has recorded four CDs and sold 15 million albums worldwide. Maroon 5 played at BlackRock's 2006 holiday party for 4,000 people at the Jacob K. Javits Convention Center in Manhattan.

Fink's rocketlike rise at First Boston was largely a result of his creative work with MBSs: the then novel idea of slicing and pooling mortgages and selling them as bonds. Fink took his concept to Freddie Mac, where he sold the mortgage company's board on a $1 billion package of what became known as collateralized-mortgage obligations, or CMOs. The $1 billion was three times what he was expecting to sell, he says. "What Fink did was a tremendous success and created a huge market," says Richard Roll, a professor of finance at the Anderson School.

SWINGS IN FORTUNE

By 1986, a decade into his First Boston stint, Fink was among the firm's rainmakers, along with mergers and acquisitions specialists Bruce Wasserstein and Joseph Perella. In the first quarter alone, Fink's team made $130 million by amassing a huge position in securities known as Z-tranche CMOs: zero-coupon bonds whose value is driven down if interest rates fall and prepayments on the bonds climb.

Fink's hero status was short-lived. The next quarter, interest rates fell, and he was hammered. His group posted a loss of $100 million.

"Fink vowed never to be in that situation again," says Gregory Fleming, a former president of Merrill Lynch who first met Fink in the mid-1990s and who helped BlackRock go public in 1999. "Larry has an appropriate sense of paranoia. He thinks bad things can happen and often do."

A FORM OF 'COMMUNISM'

In 1988, Fink joined forces with Ralph Schlosstein, a friend and managing director at Lehman Brothers, to start the firm that would become BlackRock. It began life as Financial Management Group within private equity firm Blackstone Group LP. Blackstone provided an office, a telephone line and a $5 million line of credit in return for a 40 percent stake in the company. In its early days, the firm was an egalitarian place. For the first two years, the six original partners drew the same salary.

"We could focus on building the company without worrying about individual incentives," says Susan Wagner, one of those partners and now BlackRock's chief operating officer. "Larry and Ralph thought it was communism but agreed."

In 1994, BlackRock parted company with Blackstone. Fink and Blackstone cofounder Stephen Schwarzman had a falling-out over how much equity should be awarded to new BlackRock hires. (Schwarzman didn't return calls seeking comment.) PNC Bank Corp. of Pittsburgh bought Fink's group for $240 million.

TURNING POINT

A turning point in BlackRock's fortunes came the next year, when it helped General Electric Co. dispose of $10 billion in distressed MBSs left over after the Fairfield, Connecticut, company's sale of its Kidder, Peabody & Co. brokerage unit to PaineWebber Group Inc. GE's financial unit, GE Capital, had tried to sell the assets, only to get low-ball bids from investment banks.

BlackRock was convinced that it could run its sophisticated computer models to more accurately assess the value of GE's distressed assets.

"We said, 'We'll analyze the risks and auction the assets,'" Fink recalls. "'That way, you are not dependent on one price.'"

It was BlackRock's analytics that allowed the company to accomplish this, says Charles Morris, a New York banker, lawyer and financial writer who wrote a book on the global credit crisis called The Trillion-Dollar Meltdown (Public Affairs, 2008). "They had every security on a real-time system so they could see what each portfolio was doing every minute," Morris says.

BIGGEST PAYDAY

Within six months, BlackRock had disposed of the portfolio for far more than GE expected—saving GE $1 billion. Fink, says Dennis Dammerman, who was then CEO of GE Capital, had no idea how to price the service he had just rendered. "If you think we did a good job, pay us what you think," Dammerman remembers Fink saying.

The result was a $7 million payday—the biggest fee BlackRock had ever received, Fink recalls.

By 1998, as the use of derivatives and other arcane instruments spread throughout finance, Fink saw an opportunity to turn BlackRock's risk management services into a separate business.

Today, BlackRock Solutions occupies three floors of its own Manhattan high-rise, directly across the street from the asset managers. There, amid arrays of open offices and banks of computers, Charles Hallac, head of BlackRock Solutions' day-to-day operations, oversees an army of 950 analysts, programmers, economists and other number crunchers.

PARSING COMPLEXITY

The group includes 18 Ph.D.'s in such areas as mathematics, nuclear physics and aerospace and electrical engineering. BlackRock Solutions' client list includes companies and pension funds, such as the California State Teachers' Retirement System, that collectively control about $7 trillion of assets. The Solutions team is in the business of parsing complexity.

In 1983, when Fink sold the first CMO to Freddie Mac, it had only three tranches, or portions, that paid a different interest payment. It took a First Boston mainframe a whole weekend to model the payment scenario.

By the 1990s, some of the CMOs contained 125 tranches that were almost impossible to understand, Morris says. Those instruments seem simple compared with the collateralized debt obligations, or CDOs, that are at the heart of the global meltdown. CDOs are pools that bundle high-yield subprime mortgages with high-yield loans. The hitch: higher-than-anticipated default rates among the subprime mortgages in the CDOs prompted rating firms to downgrade CDOs to sub-investment-grade debt, causing their values to plunge.

DAUNTING TASK

Analyzing pools of CDOs to determine which are toxic and which aren't is a daunting task requiring computing power that simply wasn't available 10 years ago. Each CDO may consist of 1,000 loans. BlackRock technicians say they have to run 500,000 computer models, in many cases tracing a mortgage or a loan back to the homeowner or to the property's zip code.

"We can model every single item on a balance sheet and project cash flows," says Mark Wiedman, managing director of BlackRock Solutions' advisory group. After running the numbers, BlackRock assigns a "fair value" to each CDO, a value that's supposed to represent the up-to-date value of the loans.

That doesn't mean people will be willing to buy the assets at that price. "There is a big difference between the fair value of toxic assets and their market value," says Gregg Berman, co-head of New York-based RiskMetrics Group Inc.'s Risk Management unit.

HARD TO VALUE

To determine a fair-value price, analysts look at the underlying collateral and the various tranches and their interest rates. They prepare mathematical models to determine default rates, percentages of prepayments and interest-rate changes. Different models produce different valuations, Berman says.

The value of a toxic asset largely hinges on the default rates of the underlying loans, a figure that can't be precisely predicted, even with the most sophisticated of models, he says.

"It's almost impossible to figure out the prices of these things," says Marshall Blume, a professor of finance at the University of Pennsylvania's Wharton School.

Investors who bought into Fink's vision for BlackRock early have been rewarded. Fink took the firm public on Oct. 1, 1999, at $14 a share. BlackRock's shares climbed an average of 38 percent a year to a high of $230.75 on Aug. 11, 2008, before tumbling to $90.57 on March 3, hit by the drubbing financial stocks have received in the credit crisis. The stock has since staged a rally of 60 percent, closing at $144.48 on May 7.

Fink now finds himself with a new major shareholder: Bank of America Corp. It wasn't an alliance he'd planned.

LOOKING TO EXPAND

Fink, seeking to expand his firm, began hunting for a partner in 2005. In January 2006, after weeks of merger talks with Morgan Stanley deadlocked when the two firms couldn't come to terms, Stanley O'Neal, then Merrill Lynch's CEO, came calling on Fink to talk about a deal.

By February, Fink had snapped up Merrill Lynch Investment Managers, Merrill's asset management business, for $9.5 billion—the largest asset management deal ever. In return, Merrill ended up with 49.8 percent of BlackRock. (PNC reduced its stake to 34 percent.) The deal doubled BlackRock's assets under management to $1 trillion, Fink says.

In October 2007, Merrill's mounting subprime troubles forced it to take an unprecedented $8 billion write-off and prompted the board to push out O'Neal.

MERRILL CONTENDER

Fink emerged as one of a handful of front-runners for the job. Fink wanted a look at Merrill's books before deciding but never got a chance; the board appointed John Thain. In September 2008, having reported a $19.2 billion loss, Merrill was sold for about $50 billion in stock to Bank of America. Thain, O'Neal's replacement, would himself soon be fired by Bank of America CEO Kenneth Lewis. That leaves Bank of America holding Merrill's 47 percent stake in BlackRock, a position the company says it plans to keep. BlackRock on May 6 emerged as one of the bidders to make a preliminary offer to buy Bank of America's mutual-fund unit, according to people familiar with the situation.

Fink hasn't been bashful about using his BlackRock platform to offer advice on fixing the financial crisis. Toward the end of U.S. President George W. Bush's administration, Fink counseled then Treasury Secretary Henry Paulson on the original rollout of the $700 billion Troubled Asset Relief Program, suggesting Paulson use TARP funds to buy banks' toxic assets, Fink says.

Paulson opted instead to acquire equity stakes in banks, and Fink, on Dec. 11, publicly called the decision a "mistake," a position he says is unchanged.

'MAJOR MISTAKE'

"The major mistake was not putting money in assets," Fink says. "You can not stabilize equity until you stabilize balance sheets."

Fink has since made the same appeal to the administration of Barack Obama, talking up the purchase option to both Geithner and Bernanke before Geithner made his March announcement. Fink says he's known both men for several years, though only through the professional circles they all travel in. Politically, Fink is a registered Democrat and says he voted for Obama and raised $30,800 at a fundraiser for the Democratic Party.

BlackRock Solutions looks like a terrific investment for Fink. Besides its government contracts, the company says that in the last four months of 2008 it ran analytics on $1.5 trillion of new assets for its private clients. "The phone was kinda ringing off the hook," Wiedman says. "Great for business. Not so good for weekends."

[From the New York Times, May 18, 2009]

WALL ST. FIRM DRAWS SCRUTINY AS U.S. ADVISER

By ERIC LIPTON and MICHAEL J. DE LA MERCED

The financial crisis has ravaged many a Wall Street giant, but it has also produced a handful of winners. BlackRock, a money manager that is much admired but little known outside financial circles, is fast emerging as one of the nation's financial powerhouses.

BlackRock, which started in a one-room office 21 years ago, now manages $1.3 trillion in assets for big private clients, including hedge funds and foreign governments.

But it is the company's highly prized role as a government adviser and contractor that is now drawing attention.

By dint of its expertise and track record, it has won contracts to help the government manage the complex rescues of Bear Stearns, the American International Group and Citigroup.

It also won a bid to carry out a Federal Reserve program to stimulate the moribund housing market, and it has been hired to help evaluate Fannie Mae and Freddie Mac, the government-created mortgage finance giants.

Other firms have been hired by the government to assist with the bailout, illustrating the increasingly symbiotic relationship between Washington and Wall Street.

It makes sense for the government to turn to financial experts for help, but BlackRock has become so ubiquitous that some lawmakers, federal auditors and watchdog groups are now asking if the firm does too much, and if its roles as government adviser, giant federal contractor and private money manager will inevitably collide.

Can a company that is being paid to price and sell troubled assets for the government buy the same kinds of assets for private clients without showing preference? And should the government seek counsel from a company whose clients stand to make or lose billions if those policies are enacted?

"They have access to information when the Federal Reserve will try to sell securities, and what price they will accept. And they have intricate financial relations with people across the globe," Senator Charles E. Grassley, Republican of Iowa, said. "The potential for a conflict of interest is great and it is just very difficult to police."

Without naming BlackRock, federal auditors have warned that any private parties that purchase distressed assets on the government's behalf could use generous federal subsidies to overpay, artificially pushing up the price of similar assets that they manage for their own portfolios.

"In other words, the conflict results in an enormous profit for the fund manager at the expense of the taxpayer," Neil M. Barofsky, the special inspector general for the Troubled Asset Relief Program, wrote in a report last month.

Some of BlackRock's advice to the government has in fact helped the company. For example, in its role as an informal adviser, it urged the Fed to intervene in the markets in a way that made investors feel it was safe to put money back into money market funds, including BlackRock's.

The Federal Reserve will not reveal what it is paying BlackRock, disclosing only that on one of its five contracts, it will pay at least $71 million over three years to BlackRock and other firms to manage a portfolio of mortgage assets once owned by Bear Stearns. BlackRock says that rate is discounted and that the fees it collects on bailout-related work are only a tiny portion of its overall revenue.

BlackRock has many admirers for the range and the quality of services it has provided to the federal government. James R. Wilkinson, who served until January as the chief of staff to the former Treasury secretary, Henry M. Paulson Jr., described BlackRock's co-founder and chief executive, Laurence D. Fink, as a "patriot."

He added, "He is willing to help our country when we need it most."

Mr. Fink said he was proud that his company was helping pull the economy back from the brink, and he bristled at the suggestion of impropriety.

Treasury and Fed officials have begun to take precautions. BlackRock's dominance has prompted the Fed to seek an alternative partner as it prepares to expand its rescue efforts, a government official close to the situation said, requesting anonymity because the actions could affect the market.

And Treasury is holding off announcing the winning bidders for perhaps the most anticipated of all the bailout programs—the $1 trillion federally subsidized plan to purchase troubled assets from banks—in part to make sure the bidders cannot game the system. BlackRock is widely expected to win one of the contracts, in which the government would be a partner with private firms.

Andrew Williams, a Treasury Department spokesman, said that BlackRock had no special status and was among a large group of industry players consulted about bailout programs.

"We take this very seriously," Mr. Williams said. "We talk to a lot of people—as we should."

Now 47 percent owned by Bank of America, BlackRock offers traditional services like managing other people's money. But the unit that has grabbed most of the attention lately is BlackRock Solutions, whose sophisticated software, fine-tuned over many years, can take apart the thousands of loans in a mortgage-backed security to estimate what it is now worth and what it will most likely be worth in the future, helping investors decide whether to hold or sell the asset.

During one frantic weekend in March 2008, when Bear Stearns was collapsing, BlackRock's omnipresence became evident.

On a Saturday, the firm was hired by JPMorgan Chase—which was considering buying Bear Stearns—to value one type of Bear Stearns security.

The next day the Federal Reserve hired BlackRock, through a no-bid contract, to analyze and eventually sell off a $30 billion pool of risky mortgage securities that JPMorgan did not want.

Those multiple roles created the potential for conflict, BlackRock's own executives acknowledge. The company would be trying to sell assets on behalf of the government that were similar to assets it buys and sells for thousands of other private investors.

For example, if BlackRock Solutions signaled to BlackRock's asset managers the timing of a planned sale, that could benefit BlackRock's investors, but harm taxpayers and the Federal Reserve.

"We were very sensitive to it," said Mark Wiedman, a managing director at BlackRock Solutions.

To avoid this, BlackRock Solutions and BlackRock asset management employees are housed in separate buildings, working on separate computer networks. The firm also sells the Bear Stearns securities only through an independent broker, meaning BlackRock does not know who the buyers are. The Fed, in addition, has prohibited BlackRock from knowingly buying any of the Fed-controlled assets.

But some remain skeptical that such firewalls really protect taxpayers.

"How can one company have so much control over the process?" said Scott Amey, general counsel at the Project on Government Oversight, a Washington-based nonprofit group. "Isn't there somebody else they can turn to?"

The concerns about BlackRock also extend to its role as an informal adviser. Mr. Fink has been known to call Treasury officials several times a day, Bush and Obama administration officials said, between occasional visits.

Last fall Mr. Fink urged the Fed to take action to unlock the frozen market for short-term lending to companies—a business that BlackRock's money market mutual funds played a major role in. Investors had withdrawn $48 billion from those BlackRock funds, but once the Fed adopted the policy Mr. Fink was advocating, the money came pouring back.

Mr. Fink said his advice was for the good of the economy, and that his was one of many industry voices calling for such a move.

Still, Mr. Fink has not been shy in boasting about his access. "I mean it is a great seal of approval," Mr. Fink told Wall Street analysts in December, as he simultaneously coached the Bush administration and the incoming Obama team. "We are asked to help navigate new policy. I'm running out of here to go meet with Treasury to talk about plans later this afternoon."

But it is clear that the income from fees is a lesser benefit than the buffing of its global reputation, a point Mr. Fink has made. "It gives comfort to our clients that we are being involved in some of the solutions of our economy, and it allows us to show our clients that we are being asked in these difficult situations to provide advice," he said at the same event.

BlackRock has not been immune to market turmoil, but its stock over the last year has held up better than its peers'. While BlackRock's share price tumbled 33 percent, Federated Investors shares have lost 34 percent and Legg Mason, 65 percent. BlackRock ended 2008, a disastrous year for Wall Street, with $786 million in profit on $5 billion in revenue.

Some lawmakers remain wary, even though they cannot cite any specific impropriety. "The very nature of what we are asking them to do almost guarantees that it is going to be to the benefit of BlackRock," said Representative Darrell Issa of California, the ranking Republican on the House Committee on Oversight and Government Reform. "You can have separate pews, but if you go to the same church, it will cross over."

Edmund L. Andrews contributed reporting, and Kitty Bennett contributed research.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

○