

S. HRG. 111-1098

**ECONOMIC AND BUDGET CHALLENGES
FOR THE SHORT AND LONG TERM**

HEARING
BEFORE THE
COMMITTEE ON THE BUDGET
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION

**March 3, 2009-ECONOMIC AND BUDGET CHALLENGES FOR THE
SHORT AND LONG TERM**



Printed for the use of the Committee on the Budget

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ECONOMIC AND BUDGET CHALLENGES FOR THE SHORT AND LONG TERM

TUESDAY, MARCH 3, 2009

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The Committee met, pursuant to notice, at 10:03 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Ron Wyden, presiding.

Present: Senators Wyden, Murray, Nelson, Cardin, Sanders, Whitehouse, Warner, Gregg, Grassley, Bunning, Crapo, Cornyn, Graham, and Alexander.

Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

OPENING STATEMENT OF SENATOR WYDEN

Senator WYDEN. The Budget Committee will come to order this morning. Our Chairman, Senator Conrad, who unquestionably knows more about the budget and the fiscal matters than anybody in my view in the Senate, is not able to be here today, Chairman Bernanke. But he did want me to convey that he is looking forward to talking with you in detail about the issues that we are going to explore this morning on another occasion.

Mr. Chairman, we thank you very much for coming. The public always pays attention to what you have to say, and I think it is right to begin this morning by asking what do the American people want to hear from you at this critical time. I believe the American people want you to be brutally honest about the true extent of our economic challenges and confident that the solutions to these challenges are being put in place. I think it is fair to say they are not tuning in for more bad news. Americans are not glued to their televisions hoping to learn about something else that has gone wrong. CNBC does not have record ratings because anybody wants to see the market continue to go down. Rather, I suspect they are all watching for the opposite. They are looking for hope. They want to be confident. They want to believe that there are solutions being put in place that are going to work.

Americans certainly have confidence in the American dream, the dream of a land with opportunity for each according to ability and achievement. But right now, as Warren Buffett said recently, "it is much better to be a financial cripple with a Government guarantee than a Gibraltar without one."

Just yesterday, after it was reported that AIG lost \$62 billion last quarter, an estimated \$460,000 per minute, the Federal Gov-

ernment offered AIG yet another check. How is this rewarding ability and achievement? Right now, small businesses across the country who have played by the rules and paid their bills on time cannot get a line of credit while AIG seems to have an open spigot for taxpayer money.

Now, Mr. Chairman, I share your view that stabilizing the financial sector is a necessary component of a sustainable recovery. But so is confidence. And to earn the confidence of the American people, in my view there needs to be an injection of openness, accountability, and, most of all, a sense of fairness.

You are in charge of the program that is supposed to get consumer and small business lending going again on Main Street. It seems to be slow getting off the ground while AIG, as we have just learned in the last day or so, seems to be getting pledges of money almost overnight. Nothing can increase confidence like rewarding hard work and know-how on Main Street. Giving those who have earned the opportunity to get credit to grow again, which is what Main Street is all about, is critical.

The Federal budget is an opportunity to provide more honesty about the economic challenges ahead and set in place policies that will generate the confidence needed to get investors back in the marketplace. We are looking forward to working with you on crafting just such a budget.

Let me now recognize our friend, the Ranking Minority Member, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Senator Wyden, and thank you, Mr. Chairman, for attending this hearing today.

I think Senator Wyden as Acting Chairman has touched at the core of one of the primary issues I am interested in, which is the question of confidence. Whether or not the economy recovers depends in large part on confidence of the American people in the value of their homes and in the fact that they will keep a job, confidence of those people who buy our instruments that our debt is solid and sound, confidence that our currency is strong. And I think there are questions out there that have been raised by the budget that has been presented to us by the administration relative to the ability to build on that confidence. I am going to be interested in hearing your reaction to that.

The budget as it is proposed essentially nationalizes all income over \$250,000, nationalizes health care, nationalizes student loans. We are in the process of nationalizing our banking system. And, in addition, it creates a national sales tax on the production of energy. While creating this massive expansion in the size of Government, it proposes that we have a debt as a percentage of GDP which will go to almost historic levels during any time in the post-World War II period—67 percent of GDP.

In the short run, one can accept the fact that debt is going to go up significantly because of the need to address this economy with liquidity that only the Government can put into it. But in the long run, one has to ask: How can this country sustain a debt-to-GDP ratio of 67 percent, deficits of over 3 percent, or as far as the eye

can see, and expect to maintain the value of the dollar or the ability of people to come and buy our debt?

There are two core issues here: The first is how we get the economy out of the hole that it is in, and that means stabilizing the markets, that means stabilizing the financial industry, and at the bottom of that is stabilizing real estate and also stabilizing the loan structure around general consumer activity. You set up the TALF proposal, which is a prospective attempt to do that. My question remains for you: How are we going to do it for the bad debt that is still on the books?

Second, there is the issue of the long-term debt of the United States. The fact that we are moving into a period where the baby-boom generation is retiring and will be close to full retirement at the end of this Presidency, should this President be re-elected. There is a tsunami of debt headed at us—\$66 trillion of unfunded liability. It will essentially overwhelm the capacity of our children to pay it and the ability of this Nation to sustain it. And unless we move forward on addressing it, I suspect it will cause the international community to question the value of our currency and the ability of us to sell them our debt. And I am interested in knowing your thoughts on that.

So I appreciate your coming here today. We are obviously in a period of extreme distress as a Nation from a fiscal standpoint, and our people are suffering. They are losing jobs, losing homes, wondering where they are going to be next week, next year, relative to their financial house. And we really look to the Fed as our rock in this exercise, and you have done very well so far in very trying times. But we need your advice and counsel as we go forward.

Thank you, Mr. Chairman.

Senator WYDEN. Thank you, Senator Gregg.

Mr. Chairman, we welcome your statement. We will make your prepared statement a part of the record in its entirety, and after your statement, we are going to have a vote at 11:30, so I think we are going to have 5-minute rounds of questioning from Senators.

Mr. Chairman, welcome.

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

Mr. BERNANKE. Thank you, Senator Wyden, Senator Gregg, and members of the Committee. I am pleased to be here today to offer my views on current economic and financial conditions, the Federal budget, and related issues.

Over the past 18 months, the global economy has experienced a period of extraordinary turbulence. The collapse of a global credit boom, triggered by the end of housing booms in the United States and other countries, and the associated problems in mortgage markets, had led to a deterioration of asset values and credit conditions and taken a heavy toll on consumer and business confidence.

The financial crisis intensified considerably in the fall. In the United States, the Government-sponsored enterprises Fannie Mae and Freddie Mac were placed into conservatorship, and Lehman Brothers Holdings and several other large financial institutions either failed, nearly failed, or were acquired by competitors under

distressed circumstances. Losses at money market mutual funds led to large withdrawals by their investors, and those outflows undermined both the stability of short-term funding markets, particularly the commercial paper market, and confidence in wholesale banking markets.

In early October, the loss of investor confidence in financial institutions around the world raised the prospect of an international financial collapse, an event that would have been devastating for global economic prospects. Using authorities granted by the Emergency Economic Stabilization Act, on October 14th the Treasury announced a plan to inject \$250 billion in capital into U.S. financial institutions. The Treasury's actions were complemented by the Federal Deposit Insurance Corporation's expansion of bank liability guarantees and by the expansive provision of liquidity by the Federal Reserve. Together with similar measures in other countries, these steps averted a collapse and restored a degree of stability to the financial system. Nevertheless, the cumulative effect of the financial stress was to precipitate a sharp downturn in economic activities around the world.

The Federal Reserve responded forcefully to the significant deterioration in financial market conditions and the substantial worsening of the economic outlook by continuing to ease monetary policy aggressively late last year. By December, the Federal Open Market Committee had brought its target for the Federal funds rate to a historically low range of 0 to 1/4 percent, where it remains today. The FOMC anticipates that economic conditions are likely to warrant exceptionally low levels of the Federal funds rate for some time.

With the Federal funds rate close to zero, the Federal Reserve has focused on alternative tools to ease conditions in credit markets. We have established new lending facilities and expanded existing facilities that aim to enhance the flow of credit to businesses and households. We increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers. We expanded our network of swap lines with foreign central banks to help ease conditions in global dollar markets that were spilling over into our own funding markets.

We established facilities to promote the functioning of money market mutual funds and the commercial paper market, and we introduced—in fact, today a new announcement—the Term Asset-backed Securities Loan Facility, or TALF, which is designed to facilitate the renewed issuance of consumer and small business asset-backed securities.

In addition, to improve the functioning of the mortgage market and to support housing markets and economic activity more broadly, the Federal Reserve has begun to purchase large amounts of agency debt and agency mortgage-backed securities.

The measures taken since September by the Federal Reserve, other U.S. Government entities, and foreign governments have helped improve conditions in some financial markets. In particular, strains in short-term funding markets have eased notably since last fall, and the London Inter-Bank Offered Rate, or LIBOR, which influences the interest rates faced by many U.S. households

and businesses, has decreased sharply. Conditions in the commercial paper market also have improved, even for lower-rated borrowers, and the sharp outflows from money market mutual funds in September have been replaced by modest inflows.

In the market for conforming mortgages, interest rates have fallen nearly 1 percentage point since the announcement of our intention to purchase agency debt and agency mortgage-backed securities.

Corporate risk spreads have also declined somewhat from extraordinarily high levels, although bond spreads remain elevated by historical standards. Likely spurred by the improvements in pricing and liquidity, issuance of investment grade corporate bonds has been strong, and speculative grade issuance, which was near zero in the fourth quarter, has picked up somewhat more recently. Nevertheless, significant stresses persist in many markets. For example, most securitization markets remain closed, and some financial institutions remain under pressure.

As I noted, the ongoing stresses in the financial markets have been accompanied by a sharp contraction in economic activity. After edging down during the summer, real GDP is reported by the Commerce Department to have declined at an annual rate of 6.2 percent in the fourth quarter of last year, with nearly every major category of final sales contributing to the drop.

The recent near-term indicators show little sign of improvement. Businesses shed 600,000 jobs in January, about the same pace of job loss as in November and December, and the unemployment rate jumped to 7.6 percent. Moreover, the number of claims for unemployment insurance has moved higher since mid-January, suggesting that labor market conditions may have worsened further in recent weeks. In reaction to the deteriorating job market, the sizable losses of equity, and housing wealth and the tightening of credit conditions, households have continued to rein in their spending. Home sales and new construction have continued to decline despite lower mortgage rates, reflecting the uncertain economic environment and the expectation of many potential buyers that home prices have further to fall.

The manufacturing sector has also deteriorated further so far this year. Manufacturing output fell sharply again in January, bringing the rate of capacity utilization to its lowest level in the post-World War II period. Orders and shipments of durable goods, which dropped in the fourth quarter, fell markedly further in January, and most survey-based measures of business conditions are at or near record low levels.

Given the weak economic environment, many businesses have apparently cut back their plans for capital expenditures significantly. Moreover, exports, which had provided a welcome offset to the weakness in domestic demand through the middle of 2008, fell sharply in the final months of last year, and the incoming news suggests a widespread contraction in activity abroad.

Despite the considerable decline in final demand in the United States, businesses have managed to trim their inventories in recent quarters. Still, with sales anticipated to remain poor for a while longer, many businesses are carrying more inventories than they

desire and consequently are likely to cut production further in the months ahead.

Meanwhile, overall consumer price inflation has slowed considerably, primarily because of the steep drop in energy prices in the second half of last year. The PCE price index was up just 0.7 percent in January from its year earlier level, after having risen 3.5 percent over the preceding 12-month period. Core PCE price inflation, which excludes the direct effects of food and energy prices, has also slowed, decreasing to 1-1/2 percent for the 12 months ending in January, from 2-1/4 percent in the year earlier period. Wide margins of economic slack and reduced cost pressures suggest that inflation is likely to remain quite low over the next couple of years.

Although the near-term outlook for the economy is weak, over time a number of factors should promote the return of solid gains in economic activity in the context of low and stable inflation. The effectiveness of the policy actions taken by the Federal Reserve, the Treasury, and other Government entities in restoring a reasonable degree of financial stability will be critical determinants of the timing and strength of the recovery.

If financial conditions improve, the economy will be increasingly supported by fiscal and monetary stimulus, the beneficial effects of the steep decline in energy prices since last summer, and the better alignment of business inventories and final sales, as well as the increased availability of credit.

As you are well aware, the Congress recently passed a major fiscal package which is aimed at strengthening near-term economic activity. The package includes personal tax cuts and increases in transfer payments intended to stimulate household spending, incentives for business investment, Federal grants for State and local governments to reduce their need to cut services or cancel building projects, and increases in Federal purchases. By supporting public and private spending, the fiscal package should provide a boost to demand and production over the next two years, as well as mitigate the overall loss of employment and income that would otherwise occur.

That said, the timing and magnitude of the macroeconomic effects of the fiscal program are subject to considerable uncertainty, reflecting both the state of economic knowledge and 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 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 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, the effect of the stimulus package on the level of real GDP at the end of 2010 could range from about 1 percent to a little more than 3 percent relative to a baseline forecast that does not include a stimulus. They estimate that these effects on output would leave the corresponding

unemployment rate between one-half percentage point and 2 percentage points lower at the end of next year than in the baseline forecast.

The goal of the fiscal package is not just to provide a one-time boost to the economy, but to lay the groundwork for a self-sustaining, broad-based recovery. Historical experience strongly suggests that without a reasonable degree of financial stability, a sustainable recovery will not occur. Although progress has been made on the financial front since last fall, more needs to be done.

As you know, in response to ongoing concerns about the health of financial institutions, the Treasury recently announced plans for further steps to ensure the strength and soundness of the financial system and to promote a more smooth flow of credit to households and businesses. The plan would use the remaining resources appropriated to the Treasury under the Emergency Economic Stabilization Act, approximately \$350 billion, and also involve additional spending to support the activities of Fannie Mae and Freddie Mac. Whether further funds will be needed depends on the results of the current supervisory assessment of banks, the evolution of the economy, and other factors. The administration has included a placeholder in its budget for more funding for financial stabilization should it be necessary.

Unfortunately, the spending for financial stabilization, the increases in spending and reductions in taxes associated with the fiscal package, and the losses in revenues and increases in income support payments associated with the weak economy will widen the Federal budget deficit substantially this year. Taking into account these factors, the administration recently submitted a proposed budget that projects the Federal deficit to increase to about \$1.8 trillion this fiscal year and to remain around \$1 trillion in 2010 and 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 more than 60 percent over the next several years—its highest level since the early 1950s in the years following the massive debt build-up during World War II.

Of course, all else equal, this is a development that all of us would have preferred to avoid, but our economy and financial markets face extraordinary challenges, and a failure by policymakers to address these challenges in a timely way would likely be more costly in the end. We are better off moving aggressively today to solve our economic problems. The alternative could be a prolonged episode of economic stagnation that would not only contribute to further deterioration in the fiscal situation, but would also imply lower output, employment, and incomes for an extended period.

With such large near-term deficits, it may seem too early to be contemplating the necessary return to fiscal sustainability. To the contrary, maintaining the confidence of financial markets requires that we begin planning now for the restoration of fiscal balance. As the economy recovers and resources become more fully employed, we will need to withdraw the temporary components of the fiscal stimulus. Spending on financial stabilization also must wind down. If all goes well, the disposition of assets acquired by the Treasury

in the process of stabilization will be a source of added revenue for the Treasury in the out-years. Determining the pace of fiscal normalization will entail some difficult judgments. In particular, the Congress will need to weigh the costs of running large budget deficits for a time against the possibility of a premature removal of fiscal stimulus that could blunt the recovery. We at the Federal Reserve will face similar difficult judgment calls regarding monetary policy.

As I mentioned earlier, the President has recently submitted a budget, and it proposes an ambitious agenda, including new initiatives for energy, health care, education, and tax policy. These are all complex policy issues in which the specific design of each program is as important as the budgetary amount allocated to it. The Congress will have considerable work in evaluating how to proceed in each of these areas.

As part of that evaluation, it will be critical to consider the formidable challenges and tradeoffs needed to simultaneously achieve an economic and financial recovery, fiscal responsibility, and program reforms that accomplish their desired goals effectively and efficiently. In particular, policymakers must remain prepared to take the actions necessary in the near term to restore stability to the financial system and to put the economy on a sustainable path to recovery. But the near-term imperative of achieving economic recovery and the longer-run desire to achieve programmatic objectives should not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Without fiscal sustainability, in the longer term we will neither have financial stability nor healthy economic growth.

Thank you for your attention. I am happy to take your questions.
[The prepared statement of Mr. Bernanke follows:]

For release on delivery
10:00 a.m. EST
March 3, 2009

Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

U.S. Senate

March 3, 2009

Chairman Conrad, Senator Gregg, and members of the Committee, I am pleased to be here today to offer my views on current economic and financial conditions, the federal budget, and related issues.

Recent Financial and Economic Developments and the Policy Responses

Over the past 18 months, the global economy has experienced a period of extraordinary turbulence. The collapse of a global credit boom, triggered by the end of housing booms in the United States and other countries and the associated problems in mortgage markets, has led to a deterioration of asset values and credit conditions and taken a heavy toll on business and consumer confidence.

The financial crisis intensified considerably in the fall. In the United States, the government-sponsored enterprises, Fannie Mae and Freddie Mac, were placed into conservatorship, and Lehman Brothers Holdings and several other large financial institutions either failed, nearly failed, or were acquired by competitors under distressed circumstances. Losses at money market mutual funds led to large withdrawals by their investors, and those outflows undermined both the stability of short-term funding markets, particularly the commercial paper market, and confidence in wholesale bank funding markets.

In early October, the loss of investor confidence in financial institutions around the world raised the prospect of an international financial collapse, an event that would have been devastating for global economic prospects. Using authorities granted by the Emergency Economic Stabilization Act, on October 14, the Treasury announced a plan to inject \$250 billion in capital into U.S. financial institutions. The Treasury's actions were complemented by the Federal Deposit Insurance Corporation's expansion of bank liability guarantees and by the

expansive provision of liquidity by the Federal Reserve. Together with similar measures in other countries, these steps averted a collapse and restored a degree of stability to the financial system. Nevertheless, the cumulative effect of the financial stress was to precipitate a sharp downturn in economic activity around the world.

The Federal Reserve responded forcefully to the significant deterioration in financial market conditions and the substantial worsening of the economic outlook by continuing to ease monetary policy aggressively late last year. By December, the Federal Open Market Committee (FOMC) had brought its target for the federal funds rate to a historically low range of 0 to 1/4 percent, where it remains today. The FOMC anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

With the federal funds rate close to zero, the Federal Reserve has focused on alternative tools to ease conditions in credit markets. We have established new lending facilities and expanded existing facilities that aim to enhance the flow of credit to businesses and households: We increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers; we expanded our network of swap lines with foreign central banks to help ease conditions in global dollar markets that were spilling over into our own funding markets; we established facilities to promote the functioning of money market mutual funds and the commercial paper market; and we introduced the Term Asset-Backed Securities Loan Facility, or TALF, which is designed to facilitate the renewed issuance of consumer and small business asset-backed securities. In addition, to improve the functioning of the mortgage market and to support housing markets and economic activity more broadly, the Federal Reserve has begun to purchase large amounts of agency debt and agency mortgage-backed securities.

The measures taken since September by the Federal Reserve, other U.S. government entities, and foreign governments have helped improve conditions in some financial markets. In particular, strains in short-term funding markets have eased notably since last fall, and London interbank offered rates, or Libor--which influence the interest rates faced by many U.S. households and businesses--have decreased sharply. Conditions in the commercial paper market also have improved, even for lower-rated borrowers, and the sharp outflows from money market mutual funds in September have been replaced by modest inflows. In the market for conforming mortgages, interest rates have fallen nearly 1 percentage point since the announcement of our intention to purchase agency debt and agency mortgage-backed securities. Corporate risk spreads have also declined somewhat from extraordinarily high levels, although bond spreads remain elevated by historical standards. Likely spurred by the improvements in pricing and liquidity, issuance of investment-grade corporate bonds has been strong, and speculative-grade issuance, which was near zero in the fourth quarter, has picked up somewhat more recently. Nevertheless, significant stresses persist in many markets. For example, most securitization markets remain closed, and some financial institutions remain under pressure.

As I noted, the ongoing stresses in the financial markets have been accompanied by a sharp contraction in economic activity. After edging down during the summer, real gross domestic product (GDP) is reported by the Commerce Department to have declined at an annual rate of 6.2 percent in the fourth quarter of last year, with nearly every major category of final sales contributing to the drop.

The recent near-term indicators show little sign of improvement. Businesses shed 600,000 jobs in January, about the same pace of job loss as in November and December, and the unemployment rate jumped to 7.6 percent. Moreover, the number of claims for unemployment

insurance has moved higher since mid-January, suggesting that labor market conditions may have worsened further in recent weeks. In reaction to the deteriorating job market, the sizable losses of equity and housing wealth, and the tightening of credit conditions, households have continued to rein in their spending. Home sales and new construction have continued to decline despite lower mortgage rates, reflecting the uncertain economic environment and the expectation of many potential buyers that home prices have further to fall.

The manufacturing sector has also deteriorated further so far this year. Manufacturing output fell sharply again in January, bringing the rate of capacity utilization to its lowest level in the post-World War II period. Orders and shipments of durable goods, which dropped in the fourth quarter, fell markedly further in January, and most survey-based measures of business conditions are at or near record low levels. Given the weak economic environment, many businesses have apparently cut back their plans for capital expenditures significantly. Moreover, exports, which had provided a welcome offset to the weakness in domestic demand through the middle of 2008, fell sharply in the final months of last year, and the incoming news suggests a widespread contraction in activity abroad.

Despite the considerable decline in final demand in the United States, businesses have managed to trim inventories in recent quarters. Still, with sales anticipated to remain poor for a while longer, many businesses are carrying more inventories than they desire and, consequently, are likely to cut production further in the months ahead.

Meanwhile, overall consumer price inflation has slowed considerably, primarily because of the steep drop in energy prices in the second half of last year. The PCE price index was up just 0.7 percent in January from its year-earlier level, after having risen 3-1/2 percent over the preceding 12-month period. Core PCE price inflation, which excludes the direct effects of food

and energy prices, has also slowed, decreasing to 1-1/2 percent for the 12 months ending in January from 2-1/4 percent in the year-earlier period. Wide margins of economic slack and reduced cost pressures suggest that inflation is likely to remain quite low over the next couple of years.

Although the near-term outlook for the economy is weak, over time, a number of factors should promote the return of solid gains in economic activity in the context of low and stable inflation. The effectiveness of the policy actions taken by the Federal Reserve, the Treasury, and other government entities in restoring a reasonable degree of financial stability will be critical determinants of the timing and strength of the recovery. If financial conditions improve, the economy will be increasingly supported by fiscal and monetary stimulus, the beneficial effects of the steep decline in energy prices since last summer, and the better alignment of business inventories and final sales, as well as the increased availability of credit.

Fiscal Policy in the Current Economic and Financial Environment

As you are well aware, the Congress recently passed a major fiscal package, which is aimed at strengthening near-term economic activity. The package includes personal tax cuts and increases in transfer payments intended to stimulate household spending, incentives for business investment, federal grants for state and local governments to reduce their need to cut services or cancel building projects, and increases in federal purchases. By supporting public and private spending, the fiscal package should provide a boost to demand and production over the next two years as well as mitigate the overall loss of employment and income that would otherwise occur.

That said, the timing and the magnitude of the macroeconomic effects of the fiscal program are subject to considerable uncertainty, reflecting both the state of economic knowledge and 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, the effect of the stimulus package on the level of real GDP at the end of 2010 could range from about 1 percent to a little more than 3 percent, relative to a baseline forecast that does not include the stimulus. They estimate that these effects on output would leave the corresponding unemployment rate between 1/2 percentage point and 2 percentage points lower at the end of next year than in the baseline forecast.

The goal of the fiscal package is not just to provide a one-time boost to the economy, but to lay the groundwork for a self-sustaining, broad-based recovery. Historical experience strongly suggests that without a reasonable degree of financial stability, a sustainable recovery will not occur. Although progress has been made on the financial front since last fall, more needs to be done. As you know, in response to ongoing concerns about the health of financial institutions, the Treasury recently announced plans for further steps to ensure the strength and soundness of the financial system and to promote a more smooth flow of credit to households and businesses. The plan would use the remaining resources appropriated to the Treasury under the Emergency Economic Stabilization Act--approximately \$350 billion--and also involve additional spending to support the activities of Fannie Mae and Freddie Mac. Whether further funds will be needed depends on the results of the current supervisory assessment of banks, the evolution of the

economy, and other factors. The Administration has included a placeholder in its budget for more funding for financial stabilization, should it be necessary.

Unfortunately, the spending for financial stabilization, the increases in spending and reductions in taxes associated with the fiscal package, and the losses in revenues and increases in income-support payments associated with the weak economy will widen the federal budget deficit substantially this year. Taking into account these factors, the Administration recently submitted a proposed budget that projects the federal deficit to increase to about \$1.8 trillion this fiscal year and to remain around \$1 trillion in 2010 and 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 more than 60 percent over the next several years--its highest level since the early 1950s, in the years following the massive debt buildup during World War II.

Of course, all else equal, this is a development that all of us would have preferred to avoid. But our economy and financial markets face extraordinary challenges, and a failure by policymakers to address these challenges in a timely way would likely be more costly in the end. We are better off moving aggressively today to solve our economic problems; the alternative could be a prolonged episode of economic stagnation that would not only contribute to further deterioration in the fiscal situation, but would also imply lower output, employment, and incomes for an extended period.

With such large near-term deficits, it may seem too early to be contemplating the necessary return to fiscal sustainability. To the contrary, maintaining the confidence of the financial markets requires that we begin planning now for the restoration of fiscal balance. As the economy recovers and resources become more fully employed, we will need to withdraw the

temporary components of the fiscal stimulus. Spending on financial stabilization also must wind down; if all goes well, the disposition of assets acquired by the Treasury in the process of stabilization will be a source of added revenue for the Treasury in the out years. Determining the pace of fiscal normalization will entail some difficult judgments. In particular, the Congress will need to weigh the costs of running large budget deficits for a time against the possibility of a premature removal of fiscal stimulus that could blunt the recovery. We at the Federal Reserve will face similar difficult judgment calls regarding monetary policy.

As I mentioned earlier, the President has recently submitted a budget, and it proposes an ambitious agenda, including new initiatives for energy, health care, education, and tax policy. These are all complex policy issues in which the specific design of each program is as important as the budgetary amount allocated to it. The Congress will have considerable work in evaluating how to proceed in each of these areas.

As part of that evaluation, it will be critical to consider the formidable challenges and tradeoffs needed to simultaneously achieve an economic and financial recovery, fiscal responsibility, and program reforms that accomplish their desired goals effectively and efficiently. In particular, policymakers must remain prepared to take the actions necessary in the near term to restore stability to the financial system and to put the economy on a sustainable path to recovery. But the near-term imperative of achieving economic recovery and the longer-run desire to achieve programmatic objectives should not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Without fiscal sustainability, in the longer term we will have neither financial stability nor healthy economic growth.

Senator WYDEN. Mr. Chairman, thank you.

Colleagues, if we all stick to five minutes, we will have a chance to get everybody's questions in, and we are going to adhere to that.

Mr. Chairman, at what point will the taxpayer no longer be on the hook for the massive AIG failure? What is the end game for American taxpayers?

Mr. BERNANKE. Well, Senator, first of all, the AIG situation is obviously a very uncomfortable one for me as well as for you. We took those actions because we felt that, first of all, the failure of the world's largest insurance company with millions of policy holders, thousands of derivatives and credit insurance counterparties, and a huge number of other interactions with other financial firms would be devastating to the stability of the world financial system. And if there has been any doubt about the power of financial stress to affect the real economy, I hope that it has been removed at this point. And so an important consideration in our actions certainly was to try to preserve financial stability.

Second, of course, we now have, of necessity and regrettably, a significant public investment in the company. Our belief was that to allow the company to fail at this juncture, putting aside its huge adverse effects on the financial system and on the economy, would have greatly also impaired the ability of the Government to recover the investments that have already been made in the company.

The actions we have taken will help to stabilize the company, will maintain its credit rating, will allow it to continue its process of spinning off and selling its constituent non-core companies, will allow it to continue to strengthen its core companies within the United States.

We do not know for sure what the future will bring. We do not know how the financial system will evolve or how the economy will evolve. But I do think that this does give us the best chance both to achieve financial stability and as well to ultimately recover most or all of the investments that the public has made in AIG.

Senator WYDEN. AIG has given the counterparties \$20 billion. Those people could be just about anybody in the world. Why won't the Fed disclose who those are?

Mr. BERNANKE. Well, first, in terms of disclosures, I think it is very important that we be as open and as transparent as possible, and as I have indicated last week in my testimony, Humphrey-Hawkins testimony, the Fed has set up a committee, headed by Vice Chairman Kohn, that is going to review all of our disclosure policies and try and ascertain what types of information we can disclose without adversely affecting policy effectiveness, for example.

The fact is, though, that the counterparties of AIG, life insurance owners, purchased financial insurance. They made legal, legitimate financial transactions. They have normally—under normal conditions they would have a presumption to privacy about their commercial decisions. So that is a consideration we have to take into account.

But we understand your concern, and we want to make sure that we provide all the information that is needed to make good public policy judgments.

Senator WYDEN. Mr. Chairman, essentially taxpayers have been kept in the dark on this AIG issue. They are looking at this massive infusion of money. They cannot figure out who is being rescued and why they are being rescued, and there has been virtually no accountability with respect to where the money is going.

I have asked you what the end game is. You said the situation is evolving. I have asked you why we cannot disclose the counterparties. It could be anybody, as far as I can tell, in the world, and you say you are studying it.

I just hope that in the days ahead the Fed is going to come clean as to why this is so essential. I think this is setting a precedent. AIG is not an investment company. It is an insurance company. Insurance companies in Oregon do not take these kinds of risks, and people want to know how we got into this situation and specifically what is being done to turn it around.

Mr. BERNANKE. I would like to address that. May I, Senator?

Senator WYDEN. Sure.

Mr. BERNANKE. I think if there is a single episode in this entire 18 months that has made me more angry, I cannot think of one than AIG. AIG exploited a huge gap in the regulatory system. There was no oversight of the Financial Products Division. This was a hedge fund, basically, that was attached a large and stable insurance company, made huge numbers of irresponsible debts, took huge losses. There was no regulatory oversight because there was a gap in the system.

We were then forced—we had no choice but to try to stabilize the system because of the implications that the failure would have had for the broad economic system. We know that failure of major financial firms in a financial crisis can be disastrous for the economy. We really had no choice. And I share your concern, I share your anger. It is a terrible situation. But we are not doing this to bail out AIG or their shareholders, certainly. We are doing this to protect our financial system and to avoid a much more severe crisis in our global economy.

Senator WYDEN. My time has expired. I have got more questions on this point.

Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman.

I accept and I suspect most of my colleagues accept the fact that we have to significantly expand the size of the Government as we try to get out of this hole that we are in, and that is why some of us have been tolerant and have not even in any way expressed any sort of negative view of the fact that there is going to be a budget deficit this year which is staggering, because it is an acceptable event—not an acceptable event. It is an event which we are going to have to tolerate due to the fact that we are trying to use the Government liquidity to basically float the economy.

But what really concerns me is that as I look at this budget proposal, beyond the initiatives which are aimed at trying to get the economy stabilized—TARP; your TALF, which is obviously Fed funds mostly; the stimulus package, which I did not agree with its direction, but I agreed with the concept—there is in this budget a massive movement of the Government to the left; in other words,

a massive expansion of the size of the Government, along with a massive expansion of the tax burden of the Government.

After that is all said and done, four years from now when one certainly hopes, presumes, and expects that we will be beyond these dire economic situations, we will be looking at a Government which is taking up 22 percent of the gross national product, has a 67-percent ratio of publicly held debt to GDP, and no end in sight. And, in fact, it continues to work its way up, with deficits running at 3 to 4 percent minimum, from 2013 to 2019, which is the end of the window for this budget.

Can we tolerate that size Government in the face of the fact that we know we still have not paid for and we still have coming on top of that the cost of the baby-boom generation, which will drive the cost of Government up to probably 30 percent of GDP if it is allowed to go forward without any restraint? What is the effect of that type of explosion in the size of the Government on the ability of us to sell our debt and the value of our currency?

Mr. BERNANKE. Well, Senator, first you are absolutely correct that the near-term deficit is primarily due to the current emergency. For the current year, most of it is due to the financial stabilization costs, the fiscal stimulus package, and the losses of revenues, which is very important, because of the weakness of the economy.

Going forward, the President has proposed a number of ambitious programs, as I mentioned, in a wide variety of areas. I think it is going to be up to Congress to figure out in terms of the substance of those programs whether they are achieving the social and other objectives that Congress wants to achieve. That is really not my place to—

Senator GREGG. But your place is to protect the value of the dollar and protect the ability of—

Mr. BERNANKE. I was about to—my concern here, as I expressed, was that there needs to be fiscal sustainability. If Government spending is higher, it needs to be recognized that that will involve higher taxes in order to maintain a close, reasonable balance between revenues and outlays. That does have some implications for efficiency of the economy.

I think those things and trying to restore sustainability in the near term need to be taken into account as part of the number of issues that you look at as you consider the whole range of ramifications of these policies.

I would add that I agree with you that we have to recognize that coming down the pike here are the implications of the graying population and increased costs of health care, which in turn will affect entitlement spending and will lead to a very large longer-term burden in the budget. And as I have said on numerous occasions, I think addressing those entitlement issues in an effective way is an incredibly important issue for this Committee.

Senator GREGG. Well, let me ask it a different way. If we do not act as a Government on the issue of the long-term fiscal tsunami, as I and Chairman Conrad have described it, which is the retirement of the baby-boom generation and the massive explosion in costs that they will put on the burden of our children, are we going to be able to say to the international community who is buying our

debt and financing our house that our dollar is strong and our debt is saleable with the resilience it has had over the last few—say over the last 10 years?

Mr. BERNANKE. Well, Senator, the CBO, for example, has done simulations which show that in 2030 under current laws, Medicare, Medicaid, and Social Security alone would take up about 16 percent of GDP, which is pretty close to non-interest spending—it is pretty close to the entire Federal non-interest budget. So it is clear that in order to get control of the overall budget situation, we are going to need to look at entitlements. If we do not get a sustainable fiscal situation and deficits continue in large amounts for a long period, then it will become more difficult to sell our debt, and interest rates will rise, and they will be counterproductive.

So I think we need to think about what programs we want to introduce and how we want to go forward, but there is unfortunately the necessary corollary that we have to find ways to pay for what we are spending.

Senator GREGG. Thank you, Mr. Chairman.

Senator WYDEN. I thank my colleague.

Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

Let me go back to the question of AIG, because we were all very troubled by the announcement of \$61 billion or more in losses last quarter and yesterday \$30 billion in additional assistance. The justification for that, I am hearing, is the systemic risk AIG continues to pose and the fragility of markets today and the cost to the taxpayer of Government inaction, and that is a quote. I am really troubled by the manner in which we are dealing with AIG because of the risk exposure to the taxpayer, which is growing dramatically. And I wanted to ask you a couple of questions.

How does the Federal Reserve work with the Treasury to identify those firms that do pose a “systemic risk”? How do we say that? What is the definition?

Mr. BERNANKE. Well, there are several criteria. One is firms that are very large and interconnected in the system. Second, a lot has to do with counterparty positions. This was something where AIG was, as I said, particularly egregious. They took all these large bets where they were effectively “insuring the credit positions” of many, many banks and other financial institutions. Their failure would have caused all of those losses to be transmitted throughout the banking system and would have had very adverse effects on the banking system as well as on other insurance companies.

So we looked at the interactions with other financial firms, potential for contagion, the size of the company relative to the overall system. In this case, we are dealing with the largest insurance company in the world. Its failure would have sent shock waves through the entire insurance industry.

I would like to raise yet another deficiency in our system. I mentioned before the failure of oversight with respect to the financial products of AIG. Another problem which I called attention to on a number of occasions is that, unlike, say, the FDICIA program, which allows the FDIC to resolve a failing bank, we have no structure, no legal and regulatory structure that allows us to resolve in a safe and sound way a large financial international conglomerate.

And we are much better off, frankly, trying to resolve it within the context of continued operation than to allow it to fail and all the chaos that would occur following a bankruptcy.

Senator MURRAY. So you are saying there would be a real risk to just everyday average families? How would you define that? What would we see?

Mr. BERNANKE. Well, we have already seen the stresses we saw in September. In September, we saw AIG and Lehman and other financial firms under great pressure. That pressure, together with a buildup of credit contraction in the previous months, is the main reason why the last quarter has been one of the worst in many, many years and why the recession, which was mostly focused in the United States, has now become global. So the direct effects on jobs, on income, on asset values, stock values are direct and immediate and very, very powerful.

Senator MURRAY. Well, it is hard to understand for a lot of families when they keep seeing things get worse and we are still pouring money there, but I appreciate that response.

Let me go to something you mentioned in your testimony, and that is the TALF. I am hearing from a lot of businesses on a daily basis in my home State who are really struggling to get credit, and it is causing, you know, a bigger problem all the way across the board.

You mentioned the TALF. Can you describe for us what the current status of this is and how it is going to help just small businesses in our home States?

Mr. BERNANKE. Yes. Although there has been a lot of talk about banks and their ability to lend, in fact, for many types of credit, non-banks, securitization markets, are the main source of funding, and those markets have largely closed down. And so by restoring and restimulating activity in securitization markets, we hope to get credit flowing for a number of different critical areas.

So the TALF, we put out an announcement this morning which gives the first dates, and there will be money lent under the TALF in March. The first \$200 billion of the program is aimed at consumer, small business, and student type credit. It will allow money to flow into those areas, and we hope it will be successful not only in directly providing credit for those crucial areas, but stimulating other activity and other people to come into the market and to increase lending in those critical areas.

Going forward, in conjunction with the Treasury's plan, we are prepared to go up to \$1 trillion of new credit, with the next area we are going to look at being commercial mortgage-backed securities. We know right now there is a looming crisis in commercial real estate whereby owners of shopping malls, hotels, rental properties, and many other types of buildings are unable to refinance or to pay for new construction because the CMVS, the securitization market, is completely shut down. By using the TALF to provide credit and to stimulate the reopening of that market, we hope to do a lot to—

Senator MURRAY. So will our businesses or students who are getting financial aid begin to see that immediately?

Mr. BERNANKE. They should begin to—in fact, when we announced the TALF, even before we put out a dollar, the spreads on

the asset-backed securities came in, suggesting that interest rates were already coming down and that liquidity and availability was already improving. So we should see immediate benefits to students, to credit cards, to small businesses, to consumer loans.

Senator MURRAY. Within days.

Mr. BERNANKE. I think we have already seen some benefits, and we will be putting out money this month.

Senator MURRAY. OK.

Senator WYDEN. The time of the gentlelady has expired.

Senator Bunning.

Senator BUNNING. Thank you. I am going to followup the temporary Chairman's attack on AIG.

Mr. Chairman, AIG is approximately about 78 percent owned by the Federal Government presently. What has changed? What has changed from when we—did you examine when you went in all the aspects of what could happen before you put in the first tranche of money? And you and the Treasury and the New York Fed and others were sitting at the table when this decision was made. How could you have put in the first money knowing full well that you were going to wind up with approximately a 78-percent equity stake in the company? You could not possibly have put the first penny in if you knew, in fact, it would be over almost \$200 billion—it is not \$200 billion. It is a little less. But \$200 billion, and we are not at the end.

So how are the American people going to have any confidence in the people running the ship?

Mr. BERNANKE. Well, in terms of the decision to put the money in, as I said, I am very angry about the situation. I am sorry that there were these gaps in regulation and in the financial resolution regime. I remain—

Senator BUNNING. But there is—excuse me. I am going to interrupt you because I have got 5 minutes. There is an entity that was in charge of running and overseeing AIG, and that is the New York State Insurance Commissioner. Are you telling us that they did not do their job?

Mr. BERNANKE. I am telling you they did not have the capacity to deal with a global insurance company whose failure would have devastated the financial system.

Senator BUNNING. But isn't that the regulator of AIG?

Mr. BERNANKE. No. They regulate the insurance companies, not the conglomerate. There is a difference. They did not have any authority over the Financial Products Division, as far as I know.

Senator BUNNING. Well, the Financial Products Division is one of the real problems. That is why we went in in the first place.

Mr. BERNANKE. That is right.

Senator BUNNING. Go ahead.

Mr. BERNANKE. And so as I said, again, with great regret and trepidation, we made the decision because we felt there was no alternative. Throughout the restructuring, we have tried to do everything we can to make sure that the main focus of the company—we are not trying to make this company profitable again for the benefit of shareholders. Every objective we have is to make the company viable enough that it can sell itself off, sell off its non-core

businesses, and repay the taxpayers as soon as possible. And that has been our objective.

Senator BUNNING. But when you went in there, you did not touch their casualty and property insurance—I mean, that is the only profit center in AIG presently.

Mr. BERNANKE. No. We took an 80-percent ownership share, and the loan the Fed made was a senior lien on the entire value of the entire company, including all—

Senator BUNNING. In other words, casualty and property are included.

Mr. BERNANKE. Yes.

Senator BUNNING. OK. Just in a reply to Senator Murray's statement, in this morning's announcement you said that the TALF would only accept ratings from three of the largest rating agencies—the three agencies that have been wrong so many times during the last decade. Why do you refuse to take ratings from other agencies? And why do you keep rewarding failure?

Mr. BERNANKE. Well, Senator, we have been very attentive to the idea here of making sure that the Fed does not take any credit losses, and so we have taken five or six different steps. I do not want to take all your time. One of them is to work with the credit rating agencies. These are relatively simple assets. These are not complex CDOs or anything like that. And we have worked with them and looked at their models, and we are comfortable that they can rate these ABS in an appropriate way. And we have many other protections as well, including haircuts and so on.

We are willing to look at other agencies, but we just want to make sure that there is wide agreement among the credit raters that these are safe assets.

Senator BUNNING. But aren't they the same three rating agencies that got us in—that caused problems?

Mr. BERNANKE. There have certainly been major problems and failures in the credit rating agencies, and the regulators and the industry have been working hard to try and improve that performance. But you are absolutely right. That was a serious issue.

Senator BUNNING. And continues to be one. And my only final statement on AIG is that we are no better off now. You may think we are. Your agencies, the Fed and New York Federal Reserve Bank, and the Treasury may think we are better off. But the bottom line is that the Fed and the Treasury will leave the door open for more bailouts in the future.

Senator WYDEN. The time of the gentleman has expired.

Senator BUNNING. Thank you.

Senator WYDEN. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

Let me first agree with our Ranking Republican member about the concern on the long-term deficits and where are we when we get out of this recession and what type of a burden will this country have and what type of investments have we made to prevent a reoccurrence of this type of economic disaster.

Where I disagree with the Ranking Republican is that the President's budget deals with two of the major concerns that this Nation should have addressed many years ago: one, energy independence and dealing with our energy in a way that we can control our own

economy and energy; and the other with health care, with the 40-some million Americans who have no health insurance and the burden they are to our system. It seems to me it is going to be very difficult for us to figure out a way to reform the Medicare system if we do not reform the health care system. And the President at least has presented a budget that deals with both energy and health care and, unlike the previous administration, has put forward the way in which it is budget neutral so it is not adding to the budget deficit, but in a way helps us deal with the budget in the future.

And, yes, I am sure it is going to be controversial, and a lot of us will have differences of view as to how we should do this. But our President at least has put these issues on the table, which I think would make us a stronger Nation economically if we deal with both energy and health care at this time.

Our Ranking Republican then mentioned the word “nationalization” several times, so let me talk a little bit about nationalization. I am against nationalizing our financial institutions. I hope we do not have to do that. I do not think we should do that. But some believe we de facto have already done that with the type of investments that the Government has made in major financial institutions, taking basically equity positions, imposing significant restrictions on their operations. But the concern is have we done this in a way that is more costly to the taxpayer and less effective in getting the results that we want.

So have we really—how do we explain the fact that there is so much Government involvement, and yet the credit markets are still in many cases frozen? Has the Government really used its leverage appropriately, or has it gone too far?

Mr. BERNANKE. Well, there are many dimensions to the Government involvement, and as I mentioned, in many of the credit markets activities by the Fed and others have shown some benefits.

With respect to the banking system, clearly we have not stabilized that situation. The Treasury has a plan which it intends to execute. It is a comprehensive plan in that it includes supervisory assessment; it includes new capital; it includes taking bad assets off the balance sheet; it includes foreclosure mitigation and other steps as well. So it is a more broad-based, comprehensive plan, but it has not yet been executed.

The Federal Reserve is working closely with the Treasury to try and get that done. We also do not think that nationalization is either warranted or necessary. But we are prepared, even as—and I think the American people have a right to expect that as public money goes into institutions, particularly where there is a substantial ownership share, that there will be very close supervisory oversight to make sure that: a) the banks are not taking excessive risks; b) that they are taking steps necessary to restructure themselves and to restore themselves to viability and health; and, c) that they make appropriate credit decisions and are lending to help support the economy. And so those are the things that we plan to do.

Senator CARDIN. You have indicated that the current tools may not be enough and referred to the President’s budget as having a place holder for additional resources if they become necessary. Give

us your realistic assessment as to what we should be planning on. We have not seen the results, I think, that we had anticipated when the TARP legislation was passed last year.

Should we be planning that we are going to have to infuse additional Federal credit beyond that which is already authorized? And do we need to consider additional tax cuts or spending in order to stimulate the economy?

Mr. BERNANKE. Senator, I just do not have a number for that. It is going to depend on our assessments. It is going to depend on the evolution of the financial system and the economy. And I think it is more appropriate for the administration to make their judgment about how much more they want to do and in what form. And I am sure they will be coming forward with whatever request they might have. But I cannot really give you a number at this juncture.

Senator CARDIN. Well, you know, I respect your caution there, but we need the best advice. Clearly, if we go back and look at the advice that was given to us last fall, the results are not where we thought we would be. And I think some of us are concerned that the influx of money to AIG and elsewhere, will we get the results that we anticipate?

Mr. BERNANKE. I think we will eventually get results. I think that continued attention to these issues, a more comprehensive approach, we will eventually stabilize the system. When we stabilize the financial system, I think we will see marked improvement in the economy, and it will illustrate the point I have been trying to make, that the financial stability issues—which I realize are remote to many people on Main Street—are really intimately tied to the overall success of the economy.

Senator CARDIN. Thank you.

Senator WYDEN. I thank my colleague.

Senator Graham is next?

Senator GRAHAM. Thank you, Mr. Chairman.

I am trying to ask Senator Gregg's question a little bit differently. Is there any outer limit on the Federal Government's ability to borrow money?

Mr. BERNANKE. Certainly there are outer limits.

Senator GRAHAM. What are they? And how close are we to them?

Mr. BERNANKE. Well, it is hard to judge in any kind of explicit way since we do not know. I mean, countries have clearly—for short periods of time have clearly had very high levels of debt. The United States had more than 100 percent debt-to-GDP ratio during World War II. The Japanese during their financial crisis raised the debt-to-GDP ratio above 100 percent. But clearly that is not a healthy situation. It is one in which interest payments can become a very important part of the Government's outlays.

We have been over the years bringing our debt-to-GDP ratio down to about 40 percent. Now we are going to see a jump to 60 or 65 percent. We need to be, I think, looking for what is called a "primary deficit"—that is, the deficit excluding interest payments—at somewhere close to balance. That would be sufficient to stabilize our debt-to-GDP ratio. I think that would be a good objective.

It is very hard to know how much higher the debt-to-GDP ratio could be before the international financial markets begin to balk.

And so I think the prudent thing to do is to try and maintain stability of the debt-to-GDP ratio.

Senator GRAHAM. Has there always been a buffer zone between reality and this magical place? And is there a buffer zone today?

Mr. BERNANKE. Well, as I think the recent experience is showing, confidence and expectations are critical, and I think the markets will be quite able to absorb, for example, the large amount of issuance we are seeing in the next couple of years if there is a reasonable expectation and confidence in the same markets that the United States is serious about getting its budget position under control in the longer term.

Senator GRAHAM. There are some projections that exist that in 2050 the debt-to-GDP ratio will be 300 percent. What kind of effect would that have if that became a reality?

Mr. BERNANKE. Well, I do not think that is going to happen. It cannot happen because things would break down before then.

Senator GRAHAM. Something has to change for it not to change.

Mr. BERNANKE. That is right.

Senator GRAHAM. For it not to happen, right, something has to change?

Mr. BERNANKE. Something would change. Whether it was either change in policy or change in the willingness of the lenders to finance the debt.

Senator GRAHAM. What would a zombie institution be in your definition?

Mr. BERNANKE. The term "zombie institution" was used frequently in the context of the Japanese situation where there were banks that essentially kept their bankrupt customers on life support for long periods, did not insist on repayment or restructuring, were not making new loans, were not doing anything to make themselves healthy, raise new capital or to restructure themselves. That is what I would call a zombie institution.

I do not think that any major U.S. bank is currently a zombie institution. They are all lending, they are all active, and they are all viable.

Senator GRAHAM. Is AIG a zombie institution?

Mr. BERNANKE. AIG is in a very difficult place. It has lost a lot of money, and it was a good company, a strong insurance company that was ambushed by the Financial Products Division and other bad financial debts.

Senator GRAHAM. If AIG is not a zombie institution, who would be?

Mr. BERNANKE. I do not know of any large zombie institutions in the U.S. financial system, and our idea with AIG is, in fact, to allow it to stabilize and to become profitable enough to repay the obligations it has to the United States.

Senator GRAHAM. And the reason we are continuing to stabilize is because the downside of it failing is so enormous. Is that correct?

Mr. BERNANKE. Yes, Senator. Unfortunately, that is the case.

Senator GRAHAM. Would it be worth \$1 trillion to avoid failure?

Mr. BERNANKE. I do not think we are going to come remotely close to that, but I think that the costs of the financial crisis in mid-September—

Senator GRAHAM. Would it be worth half a trillion dollars?

Mr. BERNANKE. In the mid-September crisis, which included AIG, Lehman, and other things, I would put the costs of that to the U.S. and world economies in the multiple trillions.

Senator GRAHAM. So literally it would be cheaper to put \$2 trillion in and then let it fail?

Mr. BERNANKE. No. I think what is happening here is that we are—over time we have been doing what we can to break the company up, to get it into a saleable position, and to try to de-fang it. We have done a lot, for example, to take off some of these dangerous counterparty positions that would create the contagion. So we are doing all we can to make it, you know, a safer institution as well as trying to get it to stabilize.

Senator GRAHAM. Once we administer the stress test to the major banks, will we have more information as to whether or not future capitalization is warranted?

Mr. BERNANKE. What we will learn from that, Senator, what we are learning from those assessments will be how much, if any, additional capital is needed—

Senator GRAHAM. I have only got 15 seconds. My question basically is: Will we ever know in this country whether or not we are repeating the Japanese mistake? Do you have any test out there to let us in Congress know that we are throwing good money after bad when it comes to certain institutions?

Mr. BERNANKE. The Japanese mistake was not acting quickly enough or aggressively enough, and I think that is not our problem.

Senator GRAHAM. OK.

Senator WYDEN. The time of the gentleman has expired.

Senator SANDERS.

Senator SANDERS. Thank you, Mr. Chairman. Welcome, Mr. Chairman.

We have spent a lot of time in Congress talking about the \$700 billion TARP bailout, which I voted against, as it so happens. Not a whole lot has been talked about with regard to the \$2.2 trillion that the Fed has lent out. Now, I find it absolutely extraordinary that—I wrote you a letter and I said: Hey, who did you lend the money to? What were the terms of those loans? How can my constituents in Vermont get some of that money? Who makes the decisions? Do you guys sit around in a room? Do you make it? Are there conflicts of interest?

So my question to you is: Will you tell the American people to whom you lent \$2.2 trillion of their dollars? Will you tell us who got that money and what the terms are of those agreements?

Mr. BERNANKE. We explained each of programs. In terms of the terms, we explained the terms exactly. We explained what the collateral requirements are. We explained what the—

Senator SANDERS. To whom did you explain that?

Mr. BERNANKE. It is on our website.

Senator SANDERS. OK.

Mr. BERNANKE. So all that information is available and our commercial paper program—

Senator SANDERS. And who got the money?

Mr. BERNANKE. Hundreds and hundreds of banks, any bank that has access to the U.S. Federal Reserve's discount—

Senator SANDERS. Can you tell us who they are?

Mr. BERNANKE. No, because the reason that is counterproductive and will destroy the value of the program is that banks will not come to the—

Senator SANDERS. Isn't that too bad?

Mr. BERNANKE. Sorry?

Senator SANDERS. In other words, isn't that too bad, they took the money but they do not want to be public about the fact that they received it. We heard a whole lot about AIG. They are on the front pages.

Mr. BERNANKE. These are very—

Senator SANDERS. Now, I have got banks and I have businesses in the State of Vermont who are in a lot of trouble—not banks. Our banks, by the way, are doing pretty well. Now, how do these guys who are honest business people get it? Do you have to be a large, greedy, reckless financial institution to apply for these moneys?

Mr. BERNANKE. There is no subsidy. There is no capital involved. There is no gift involved. It is a collateralized, short-term liquid loan that is both over-collateralized and is recourse to the company itself. We have never lost a penny doing it.

Senator SANDERS. And how can other institutions get those loans as well?

Mr. BERNANKE. According to the law, we are supposed to be lending to depository institutions. We—

Senator SANDERS. Well, let me just say this, Mr. Chairman. I have a hard time understanding how you have put \$2.2 trillion at risk without making those names available, those institutions public. And we are going to introduce legislation—today, by the way—to demand that you do that. It is unacceptable to me that that goes on.

Mr. Chairman, one of the issues that bothers me very much is that for many, many years, some of us were concerned about deregulation. Some of us were very concerned about where the economy was going. We did not hear much coming from the Bush administration who told us over and over again that the fundamentals of the economy were sound. We did not hear much from the Fed.

Now, looking back, do you think that maybe there was a problem there that you did not raise some alarms out there and say we have got a problem when trillions of dollars are being floated around the world in a deregulated, non-transparent way? When you heard people talking about the fundamentals of the economy being sound, how come you did not raise an alarm?

Mr. BERNANKE. Well, there was a massive credit crisis, and it has been true that our regulatory system and our financial supervisory system did not succeed in preventing those impacts. And I think it is very important that we—

Senator SANDERS. Did not succeed in preventing them. Let's take it another way. Do you think that the repeal of Glass-Steagall was a tragic mistake?

Mr. BERNANKE. No, I do not think so. But I do think we need to have much more effective holding company and oversight supervision, and I strongly support a strong program of regulatory reform going forward.

Senator SANDERS. Mr. Chairman, in my State people ask me how it could be that you are providing loans at almost zero interest rates to large financial institutions who are then charging consumers 25 or 30 percent interest rates on their credit cards. Do you think that that is acceptable? Or do you think that those institutions that are receiving help from the Fed should substantially cut those interest rates?

Mr. BERNANKE. With respect to credit cards, we have been working actively in that area in a couple dimensions. One is that credit availability will be enhanced by our TALF program, which I have just announced—

Senator SANDERS. No, but you are not answering my question. Should a financial institution that is being bailed out by taxpayers charge those taxpayers 25 or 30 percent interest rates when they are receiving—

Mr. BERNANKE. Well, you need to address that to the Treasury, because it is the TARP that is providing help to failing or damaged firms. The Federal Reserve lends to healthy firms on a collateralized basis—

Senator SANDERS. Last question—

Mr. BERNANKE [continuing]. With high liquidity.

Senator SANDERS. Last question. Many, again, of my constituents—and I think people all over this country—are wondering why the CEOs of these large financial institutions who have been extremely greedy, reckless, and maybe have engaged in illegal behavior have not been fired so that we can work with people that want to really reform the system. Should the CEOs of the financial institutions that have led us into this deep, deep recession be fired?

Mr. BERNANKE. Well, pay and job tenure should depend on performance, and those which have performed poorly should lose their jobs.

Senator SANDERS. Are any of them—

Mr. BERNANKE. Many have lost their jobs.

Senator SANDERS. Most of the major guys are still holding their positions.

Senator WYDEN. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman. Thank you for being here today.

The Federal Reserve Board's balance sheet is something we talk about, and maybe do not understand very well. The Fed has committed since October more than \$2 trillion, as I understand it, in its various enterprises, which is collateralized, and you expect to recover the \$2 trillion or so, and you just said you have never lost a penny doing it. But the fact is that about 5 percent of it is Bear Stearns or AIG until yesterday, and now it must be a little higher—maybe it is not, but it was until yesterday. And we hear proposals to get bad assets out of banks with the Federal Government putting up \$100 billion and maybe the Fed leveraging \$1 trillion.

So my question is a little like Senator Graham's question about debt. What are the outer limits of our ability to use the Federal Reserve Board's balance sheet for these various activities? And what are the risks?

Mr. BERNANKE. Senator, that is a good question. Let me first say something about the balance sheet. It is a little under \$2 trillion.

About a quarter of it is treasuries that we hold, so that is not really lending except to the Government. About half of it is short-term liquid lending to banks. As we were discussing with Senator Sanders, that is done on a collateralized, short-term basis. There is some money in a commercial paper program that we have had that has had a good bit of success in reducing commercial paper rates in that market. And there is some money for the GSE purchases we have done, which have brought down mortgage rates. So we have been working actively to try to improve general credit conditions.

As you point out, about 5 percent of our balance sheet is devoted to the Bear Stearns and AIG—

Senator ALEXANDER. If I may interrupt just a minute to specify, the first risk is that you do not get your money back. You think you will. The second risk would be that the more money you print, the more likely we have inflation down the road.

Mr. BERNANKE. Senator, that is absolutely correct. So you are absolutely right that in order for us to begin to raise interest rates and begin to stabilize the economy, at that time when the economy begins to grow again, we are going to have to shrink the balance sheet. And we are very comfortable—we are watching that very, very carefully. It is very important. We spend about half of our time at FOMC meetings looking at the balance sheet and trying to make that evaluation. But as I mentioned, about half the balance sheet, about \$1 trillion alone, is in very short-term lending. And then we have several hundred billion dollars of commercial paper, which is no longer than three months. So a lot of this can be just run off and allow the balance sheet to shrink back down.

Senator ALEXANDER. So you have got some room in terms of—well, I guess as I am hearing you, you plan to get your money back by heavy collateralization, and you are watching inflation over a long time. The reason I ask, I was Governor in the early 1980s when in Tennessee unemployment was 11 percent, inflation was 14 percent, and interest rates reached 20 percent because of different circumstances.

But let me take that in my remaining time to ask you another question. We had very good testimony here in this Committee from a panel that basically said there might be \$2 trillion in toxic assets that need to be taken off the financial institutions' books. I sense, although I do not think the Senator from Vermont is part of this consensus, that there is a growing consensus that we need to fix the banks. Eisenhower said, "I will go to Korea." I would like to hear President Obama say, "I will fix the banks."

What does he need to do to fix the banks? And how much are we going to have to cough up to help him do that? And if it takes \$2 trillion, how much do we have to capitalize that effort? How much leverage can the Federal Reserve Board lend to it? Are we going to have to, as testimony was said here, if it is \$2 trillion, that we need to capitalize it, in their words, "as much as you can," and they then said three, four, five, six hundred billion more dollars in order to get the toxic assets out of the banks?

Mr. BERNANKE. Senator, the Treasury's plan has, I think, the three key elements for stabilizing the banks. That is supervisory review, making sure we know what is there and making sure that

the banks are strong enough; that is capital provision, which is what the Capital Assistance Program is about; and the third is taking bad assets off the balance sheets. And there are various ways of doing that. The Treasury has talked about some kind of public-private partnership where the private sector would help determine the prices. The question is: How do you leverage up the TARP money—

Senator ALEXANDER. Right, but my last—

Mr. BERNANKE [continuing]. Financing, and let me just quickly say that there are different ways to do that, and some of them do not involve the Fed. For example, the FDIC could guarantee liability—

Senator ALEXANDER. I understand, Mr. Chairman, but doesn't someone need to step forward and say, "I will fix the banks," and I will do A, B, and C, the same way President Eisenhower said, "I will go to Korea," to build the kind of confidence back in our financial system that Senator Gregg was talking about?

Mr. BERNANKE. I agree we need to fix the banks, and we need to fix the financial system. If we can do that, we will get a good recovery.

Senator ALEXANDER. Thank you, Mr. Chairman.

Senator WYDEN. I thank my colleague.

Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Chairman. Welcome, Mr. Bernanke.

On the long-term front, we are looking at \$50, \$60 trillion worth of unfunded liabilities; i.e., we see the obligation coming, we have not set aside a nickel to pay for them. Those seem to be the real, as the former Comptroller General said, "swamp the ship of state" problems. If we get through this financial problem with \$7 trillion spent, that is one-fifth of the \$35 trillion liability we own just for the Medicare slice of the health care tsunami that is bearing down on us.

You spoke about this at Chairman Baucus' Finance Committee event earlier, and I would like to sort of reprise those thoughts now.

There are two ways we can go about solving this problem. We can wait until it is really upon us, and then we can apply the traditional fiscal solutions of throwing people off of their coverage, thinning out the benefits, paying providers less, or raising taxes to bring the fiscal cost of the system into balance.

Before I ask you about that, there is a second way, which is actually intervene in what is an astonishingly overpriced, underperforming, complex, and wasteful health care system and design ways to actually bring down the cost, which, as many studies and experiments have shown, can be done while improving the quality of health care dramatically. And in this area, there are things like investing in health information infrastructure and investing in quality improvement in ways that save cost and investing in prevention in ways that save cost and in reforming the payment system so that it is sending appropriate signals for the kind of system that we want.

I see those as two very distinct choices. My worry is that the latter series, the more humane series, the reform series of options

take time to implement, and if we goof off and fiddle and let this moment pass, then we are left with that other set. We are left with throwing people off their coverage, thinning out the benefits, paying providers still less, and raising taxes.

Looking at that second group, what do you think is the actual long-term viability in terms of solving our problem of resort to that fiscal toolbox of throwing people off the coverage, thinning out the benefits, cutting provider payments, and raising taxes?

Mr. BERNANKE. Well, that is both very difficult to do and a very, you know, unattractive way to go, obviously.

Senator WHITEHOUSE. Even if we did it, would it last long?

Mr. BERNANKE. Well, just to give you a sense, you mentioned these very large, unfunded obligations for Medicare. Those obligations are calculated assuming that medical costs grow at a rate 1 percent faster than per capita income. In fact, historically that has been 2 to 2.5 percent. So even those projections assume a considerable improvement in the rate of cost control in the U.S.

So I think it is very important, both in order to get a rational system and to get one that people can get used to and we can learn by experience how to make it work better, I think it is very important that we address these issues now. And, frankly, in terms of the long-term entitlement issues, the medical issue, which has multiple dimensions—it involves cost. It also involves access. It involves quality. Those are very, very tough problems. I do think that—

Senator WHITEHOUSE. You said “now.” Can I ask you, in my remaining minute, to talk a little bit about how urgent that “now” is? Is that just we should do it now? Or is there real pressure on us to get—

Mr. BERNANKE. Well, I was asked this question at the Senate Finance Committee, and he asked me when we should start, and I said 10 years ago. So I think it is very urgent that we look at these issues and make some tough decisions, I mean, the general public policy decisions about choices that have to be made about what kind of health care system we want to have and how we want to structure it.

Senator WHITEHOUSE. Let me make just one observation and then close. I know what you are trying to do. I appreciate the efforts that you make to shore up the institutions that direct our financial system. You are concerned about the shock waves, as you have said, through the insurance industry from the AIG failure. You are concerned about devastation in the financial services industry from the credit collapse.

Just from Rhode Island’s perspective, I submit that the Rhode Island business community, the small business community in particular, is suffering shock waves itself, that our neighborhoods are suffering devastation themselves. And the more that what we are doing focuses on these big institutions, the more it looks as if the masters of the universe who made this mess are not truly being held accountable, and the less people at home see some real difference, the more challenging it is going to be for us as a democracy to not only solve this problem but to have the public good will necessary to solve the health care problem, necessary to solve the climate change problem stacked up behind that.

If you blow all of the public's good will solving this problem, we are in serious trouble on the health care and the climate change and other troubles. So I would urge you to bear that in mind.

Senator WYDEN. I thank my colleague.

Senator Grassley.

Senator GRASSLEY. Let me preface my question, before I read it, that sometimes the work of the Federal Reserve comes up at my town meetings, and, you know, you cannot go in depth into what you do, and I probably do not know everything you do. But I try to explain that you can have irresponsible Republican Congresses, you can have irresponsible Democratic Congresses, and if they overspend, eventually it is going to bring about inflation. And I see the work of the Federal Reserve as a counterweight to Congress to explain in a non-political way, maybe correcting mistakes that politicians ought to know more to do but do not do.

So my question is this: If Congress would adopt nearly the Obama budget, it would add trillions to the Federal debt. Because investors covet the relative security of Treasury's securities during times of crisis, the Treasury is able to attract all the money it needs while paying extremely low interest rates on newly borrowed money. However, the day will come when those securities will mature. To retire that debt, the Treasury will need to float new debt at what is almost certainly going to be a higher rate of interest.

Question: Is the Federal Government setting itself up for a new long-term crisis as the cost of maintaining the Federal debt explodes in the years to come?

Mr. BERNANKE. Well, Senator, I should start off by saying that it is not my place or my standing to evaluate the specific programs that Congress is looking at. They are going to have to make a lot of tough decisions about how you want to go with health care, how you want to go with global warming, education—all those very big issues that are very important to the American people.

My position here is simply to talk about the fiscal implications, and I think it is important. I realize that we have enormous deficits in the very short term. I am afraid that they are unavoidable given the need to get the economy back on a recovery path. But we do have to look forward. Even as we make plans to change our health care system or make other changes, we have to make sure that in the medium term we have a fiscal position that will allow—and I use as a rule of thumb, say, the debt-to-GDP ratio not to be growing so that when can assure ourselves that we will be able to finance those debts at a reasonable rate and not impose excessive burdens on our children and grandchildren.

Senator GRASSLEY. Well, do you have a benchmark that you throw out for percentage of national debt to GDP or annual deficit to GDP?

Mr. BERNANKE. Well, there is no magic number, but I would hope that given that we are going to be above 60 percent, I hope that we do not go higher than that. I would like to see us try to come back down gradually over time.

Senator GRASSLEY. Again, back to the budget issues, because I think what we do and how you react to what we do, particularly if the things we do are inflationary, I will ask this question: President Obama's fiscal year 2010 budget assumes the recession will be

shallower and the recovery will be stronger than most private economists forecast. The administration forecasts 3.2 percent growth for calendar year 2010. That seems to me to be a little optimistic. I hope, of course, the optimism matures. Some people say it is rosy.

How likely is it that the administration is right and most every private economist is wrong on this issue, what the growth is going to be next year?

Mr. BERNANKE. Well, it is true that the administration's forecast is a little bit more optimistic than, say, the Fed's projections or the CBO projections. Part of that might be the timing of when that forecast was made. The recent news has been on the negative side. But I think it is important to understand that these forecasts are not precise. There is a lot of uncertainty. So I think that their numbers, although they are on the more optimistic side of the forecast that have been made, are certainly within the range of uncertainty that all of us face in trying to forecast the economy.

Senator GRASSLEY. Would you say the same thing about the unemployment rate's peaking in the second quarter at 8.2 percent? Compared to private economists' forecasts that I have seen, this sounds surprisingly low. Do you share the administration's optimistic outlook for unemployment?

Mr. BERNANKE. Well, we have a projection for 2009 of between 8.5 and 8.75 percent. That is our estimate for the fourth quarter. So we have a somewhat higher estimate. As I said, these things are hard to predict with precision.

Senator GRASSLEY. Thank you, Mr. Chairman.

Senator WYDEN. Thank you, Senator Grassley.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Thank you, Mr. Bernanke. I have got lines of questioning.

One, you hear, obviously, a lot of concern from all of us about some of the excesses that have come out of the financial markets. I start with the premise that over the last decade, under the guise of financial innovation, the banks and financial institutions have tried a lot of new products that in theory were supposed to help us better price risk, but in reality ended up causing more systemic risk. And, you know, a classic case—and I know a number of my colleagues have raised this point—AIG, a pretty good insurance company, until you suddenly layer on an exotic Financial Products Division out of London selling products into Europe with slews of credit default obligations that were not even hedged, that we are having to pick up the fallout from.

I guess on a going-forward basis we are going to try to at least put some regulatory umbrella over all of these actions, but I have got a two-part question.

One, the normal theory, at least recent theory, I think, around regulation has been, well, put some regulations and at least give transparency. But will that be enough in a market that seems to be overly financially engineered? And at some point, do we actually need to look at the underlying value of some of these new devices and whether there is an actual societal value, whether they accomplish anything other than simply creating a fee structure for the banks or the financial institutions? And is oversight and trans-

parency enough? Or will we potentially need bright-line prohibitions about some of these products going forward? Point one.

And point two, question two is: Even if we get it right in this country—back to my colleague from Kentucky’s questions about the commissioner in New York. If the commissioner in New York did not have the ability to oversee the activities of AIG that were taking place in London, can we ever get to enough of a domestic-only regulatory scheme to get it right? And are we going to need to look at some type of international regulatory oversight that actually has got teeth?

So transparency and traditional regulation versus bright-line prohibition around some of these products and how we assess these products. And then even if we do get it right in this country, how do we take that on an international stage?

Mr. BERNANKE. Well, Senator, on new products, I think that there would be cases where safety and soundness and systemic stability would say that the regulators should prohibit a product, that it either is perhaps excessively difficult or deceptive from the perspective of a consumer, or it embodies risks that are not, you know, productive in terms of the overall system. So I think there would be situations in which you would want to prohibit certain products or at least insist on design changes and other protections for certain products.

Senator WARNER. And let me just interject there, because my concern is that even if we get it fixed, we are going to be chasing yesterday’s products while the financial engineering tools are going to continue to be creating the next generation of problems, and we have got to somehow find a regulatory framework to get ahead of that.

Mr. BERNANKE. I think that confidence in financial engineering has gone down quite a bit, and we need to be very—careful and make sure that the products that are being created are serving a real purpose and are not simply some kind of arbitrage for regulation or avoiding oversight.

With respect to international, we are working very hard—there is an international community involving the Basel Committee, the Financial Stability Forum, the IMF, and many other organizations that do work to try to harmonize and work together. As you know, the G-20 are meeting in London in about a month. So it is very important to have coordination among the major regulators.

I have not heard too much serious discussion of a transnational regulator because of the political and sovereignty issues that raises. But I do think that close cooperation—which we have had at the Federal Reserve for some time. We work very frequently with other national regulators, do simulation exercises and so on.

Senator WARNER. Cooperation that might extend at some level to at least common standards. I am not advocating some international regulator.

Mr. BERNANKE. There is a great deal of interest in common standards in capital regulation, in accounting, in a whole variety of other areas.

Senator WARNER. Let me just move from this macro to perhaps a smaller, much smaller piece of the problem, and I am very anxious to see the implementation of the TALF. I am concerned that

it has taken this long, and I think it has great potential. But the sooner we get it rolled out, the better.

You have talked about how it will have benefits to consumers, small businesses, and students. One area that I keep hoping that the Fed or Treasury will press on is the not total freezing up but the concerns in the municipal markets. You know, we see that in school-based systems that are trying to go out and get their school bonds floated, housing agencies trying to get their housing bonds floated, States in terms of transportation bonds. I would hope that you would continue to look at using TALF to try to free up a little bit and bring our municipal markets back into some kind of a traditional form as well.

Senator WYDEN. The time of the gentleman has expired, and we are going to see how many questions we can get in. I think I have Dr. Bernanke until noon, and the vote may be going a little later, so we are going to try and see if we can get a few more questions in.

Dr. Bernanke, in the budget and throughout the debate about how to strengthen our fragile economy, both sides of the aisle are now proposing to use the Tax Code to advance various social objectives. I believe that it is more pro-growth to start cleaning out the Tax Code, to go and clean out some of those loopholes that are being added at the rate of almost three for every working day, and use that money to hold down rates and keep progressivity.

We are going into the tax reform debate certainly next year. Isn't it more pro-growth to start cleaning out the tax loopholes and using that money to hold down rates?

Mr. BERNANKE. Senator, I think most tax economists would agree with what you said. There, first of all, is the issue of complexity. People spend something like 20 to 30 hours of their time just filling out their tax form. But beyond that, the general recommendation from tax economists is that you should limit deductions and keep the overall rate as low as possible.

It is certainly important that the Government have ways of stimulating certain types of activities, but often that can be done through an appropriation process rather than through a tax break.

Senator WYDEN. I am going to show you my fair flat tax, because it has got a one-page 1040 form. The people at Money Magazine filled out their taxes on it in something like 40 minutes. We are going to be asking for your counsel as we go to this tax reform debate on the Finance Committee, because I think if you look at this debate, both sides are essentially proposing adding a whole truckload of additional loopholes. And I personally think we ought to be going in the opposite direction, so I appreciate your comment.

The second area deals with another disclosure question. My sense is on the banking issue a big part of the solution is that you have got to dimension the problem. In other words, people today cannot get a sense about whether they ought to be sending investment dollars to the private banking system and the like because they do not know what the real troubled assets are on the books.

What is it going to take to flush out the scope of the problem of these troubled assets on the banks' books? It is a disclosure question. I want to be clear I am interested in the disclosure part of it. What is it going to take to get disclosure on this?

Mr. BERNANKE. Well, just very quickly, you know that we are doing the supervisory assessment, which is supposed to try to get a sense of how much capital these banks would need, how much hole they need to fill in order to be well capitalized even in an adverse environment.

It is a difficult problem, Senator, because many of these assets are very complex and, therefore, opaque. But, in addition, even simple assets are hard to value these days because they depend so much on the future movements of the economy. I mean, if you do not know what is going to happen to house prices, how do you value a mortgage? So it is very difficult.

So we are doing all we can to try and improve disclosure. That is part of the program that Secretary Geithner talked about. But it is also one of the reasons why you like to, if possible, get some of these assets off the balance sheets of the banks because that creates more transparency for the remaining portion of the bank. And that is better for attracting investment from the private sector.

Senator WYDEN. I know it is complicated. There is no question about it. I know it is opaque, and I have sat in the Finance Committee, and I have heard experts say that. But that is why we have you there. That is what we have you there to give us some sense of what the dimensions of this problem are. And so I hope we are going to see that quickly because I do not think we can go onto the other debates. I have never heard about anybody coming up with a solution for a problem if they cannot dimension the nature of the problem. We have got to get that addressed more quickly.

Mr. BERNANKE. We are working to dimension it. We are using GAAP accounting. A lot of this is an accounting issue. How do you account for complex assets which have uncertain cash-flows?

Senator WYDEN. I want to make my last question one that I think is a basis for optimism. I have told you, I think, that we want brutal honesty from you and we want a reason to be confident. And I think that the history of dealing with tough times—you look, for example, at the fact that Silicon Valley essentially was created in the middle of a recession in the 1970s. You had major tech companies come out of the 1980s. So innovators can prosper in tough times. And I think I would like you to close at least my questions—Senator Graham and others have questions—by telling us why you think that innovators can succeed in these kinds of tough times. I think there are opportunities for innovators. There have always been opportunities for innovators, and that is what the American dream has been all about.

So for purposes of my questions, close this on a positive note and tell us why innovators ought to feel that they can still go out in the marketplace and succeed like they have done again and again in tough time.

Mr. BERNANKE. Well, I think that is absolutely true, and confidence in the U.S. economy is one reason why the dollar has actually done relatively well compared to some other currencies.

Recently at the Federal Reserve, we had an organization of venture capitalists, and they said yes, there were some difficulties now raising money and so on, but they are still very active in starting new firms in the health sciences, in energy, and all number of different areas. They have a long-term perspective. They believe that

technological opportunities abound everywhere, and they have a lot of confidence that the U.S. is the place where entrepreneurship and technical innovation can lead to the profits that stimulate entrepreneurial activity.

So, you know, I believe that technological progress will continue, be very strong, and I think the American people—I realize people have raised a number of concerns people have, politically and otherwise. But I do think the American people in the past have shown an excellent ability to respond to adversity, and I believe that is going to happen this time and that we are going to see a much stronger economy not that far in the future.

Senator WYDEN. Senator Graham.

Senator BUNNING. Oops.

Senator WYDEN. Oh, excuse me.

Senator BUNNING. That is all right.

Senator WYDEN. My apologies to my colleague.

Senator BUNNING. My colleague that travels with me.

Senator WYDEN. I welcome the Senator from Kentucky asking questions next.

Senator BUNNING. Thank you.

Last week, you told the Banking Committee that you did not bail out Lehman Brothers because you did not have the authority. Yet you found a way to create a Commercial Paper Funding Facility which requires no real collateral. So how is it you can make loans from unsecured commercial paper to AIG at the same time it is getting TARP funds, yet you could not find a way to save Lehman Brothers?

Mr. BERNANKE. Well, with respect to the Commercial Paper Facility, after a lot of evaluation, the legal counsel determined that the charging of a higher interest rate as well as allowing for the option of collateralization satisfied the requirements. We lent only to AAA credits, and we had no difficulty in terms of credit in that facility.

With respect to Lehman Brothers, there was just no equivalent collateral. There was nothing to make a huge loan against that would allow us to get repaid. And we just did not have the legal authority to make that loan.

Senator BUNNING. You mentioned AAA credit. By whose ratings were they AAA?

Mr. BERNANKE. Well, by the credit rating agencies.

Senator BUNNING. The same people that have failed miserably in rating AAA, and we got into the big problem in the housing market because the collateralization of those loans are rated AAA by the same agencies?

Mr. BERNANKE. You are right, Senator, but—

Senator BUNNING. Thank you. This is not to be detrimental, but Richmond Fed President Lacker dissented from the most recent Fed statement because he thought buying long-term treasuries is a better way to expand the balance sheet than targeted facilities. In particular, he said targeted programs move credit away from other worthy borrowers, amount to fiscal policy, increase moral hazard, and might be hard to unwind.

You obviously did not agree with his views because you voted the other way. Why didn't you agree?

Mr. BERNANKE. Well, I think you have to solve the problem you have got, and the problem we have got is not lack of liquidity or lack of purchases of treasuries. The problem we have got is that so many of our critical credit markets are not functioning properly. The securitization market is not functioning, the mortgage market. If we want to help the economy grow again, we have got to get those markets working.

The programs we have done are not credit allocation because they are very broad based. The TALF is addressing a wide range of assets, and we are leaving to the private sector the decision to which assets to bring to the TALF.

The mortgage market is a very broad-based market, and it affects the whole economy, so I think—and as far as getting out of it is concerned, I already discussed earlier the unwinding process. I think we will be able to do that. So I think you have to solve the problem you have got, not the problem you have not got.

Senator BUNNING. OK. Then the problem we got is we have a problem with our banks, particularly our money market banks, which you say are not under stress; or if they are under stress, they are solvent. There are a lot of us who look at the same data that you look at and say most of those banks, particularly Citigroup and others—can you imagine Citigroup selling for \$1.50 a share? Now, does that mean that the market has miscalculated the value of that? Or is really Citigroup under more stress than the Fed realizes?

Mr. BERNANKE. Citigroup is certainly under stress, but our belief is that it has enough capital; it meets the criteria for being well capitalized; it has got a plan for restructuring. And we are going to work intensively with Citigroup to make sure that it is stable going forward. Not to say it does not need strengthening, not to say that other banks do not need strengthening. I did not mean to say that banks were not under stress. I do not think I said that. But—

Senator BUNNING. No, you said they were not being nationalized, is what you said.

Mr. BERNANKE. They are not being nationalized. But they certainly need—they received assistance, and that assistance, I hope, will be the start of a process that makes those banks able to raise private capital.

Senator BUNNING. Last question. When will you accept the money that they want to give back—some banks do—under TARP?

Mr. BERNANKE. Well, that is a Treasury decision, but as far as I know, they have no objection to taking money back if the banks want to give it back. But that is Treasury determination.

Senator BUNNING. That is a Treasury determination even though you were sitting in on the meetings when TARP was created?

Mr. BERNANKE. Well, I was sitting there, but TARP is a Treasury program, and the Treasury has authority over those sorts of issues.

Senator BUNNING. But isn't there an agreement that requires the regulators to agree to take the money back?

Mr. BERNANKE. Well, if a bank needs that capital to be safe and sound, then the regulators might not let them give it back. That is right. But I thought you were thinking about many small banks around the country that took that money—

Senator BUNNING. No. I was specifically thinking of JPMorgan Chase.

Mr. BERNANKE. Well, if a bank has taken a lot of capital and wants to return it, it needs to either replace it with private capital or show that it meets all the standards without that capital.

Senator BUNNING. Thank you.

Senator WYDEN. The time of the gentleman has expired.

Senator Whitehouse.

Senator WHITEHOUSE. Thanks again, Chairman.

Mr. Bernanke, during the course of this hearing, we have heard a number of my colleagues express real dismay about the amount of additional borrowing that is going to be required to address what I think all responsible economists concede is a fiscal emergency that the country is in, or certainly would be in without this.

As I recall, at the end of the Clinton administration, we had a budget in surplus, and we were headed by most estimates, including CBO's, to be a debt-free Nation. And then for 6 years before control in Congress changed, you had Republicans controlling the House, the Senate, and the White House. And during that time, according to our projections, if you take the difference between the CBO-projected budget on the day they took office and where things actually went, it is a \$7.7 trillion difference, a \$7.7 trillion hole that I refer to as the "Bush debt" and that many of my colleagues supported at the time. We had a Vice President who was at the time saying deficits do not matter. And now we hear these expressions of dismay about lending to solve this crisis from people who did not seem to mind when \$7.7 trillion in debt was being run up to finance tax cuts for the rich, to finance a war in Iraq, and other things.

Tell me, had we not gone that route, had we started—let's not even give credit for the projections that would have taken us into an actual national debt-free position. Let's just say we had zero national debt when we went into this crisis instead of the trillions and trillions of national debt that were run up, what would our position be in responding to this crisis had we started at zero instead of—what is it now, \$9 trillion?

Mr. BERNANKE. Well, I think it is evident that you start with lower debt, then you have more debt capacity, and it is easier to raise money from both domestic and foreign lenders. I think one of the features of the President's budget, which I think is interesting and constructive, is that it includes, for example, as I understand it, some general provision for disasters and things of that sort. It recognizes the uncertainties that we do face in a normal budgeting process.

So I can only agree with you that one of the benefits of keeping a low debt-to-GDP ratio and maintaining near balanced budgets under normal circumstances is that you have the flexibility to respond to a Katrina or to something like this, which is many times larger.

Senator WHITEHOUSE. Looking back, do you believe it was prudent as a Nation to have run up, as I calculate it, the \$7.7 trillion in debt during those 6 one-party years?

Mr. BERNANKE. It is a very complicated calculation, Senator, and I cannot do it all here, but I think the tax revenues in the late

1990s were partly not sustainable. They came from the stock market boom, and we know now that was not sustainable. So I think the idea that we would be debt free, I think that was somewhat exaggerated.

It is true that the revenue-to-GDP ratio did fall in the early part of the Bush Presidency. It did come back up to something closer to historical averages. So it is a complicated issue, but I do agree that in thinking about the future and recognizing that there are unanticipated emergencies that can occur, whether they be natural disasters or financial disasters or whatever, it is a good idea to have some fiscal capacity in reserve. We have got countries around the world now that really cannot do fiscal policy because they have not got the debt capacity to do it.

Senator WHITEHOUSE. Thank you.

Senator WYDEN. I thank the Senator.

Senator Graham.

Senator GRAHAM. Thank you.

Mr. Chairman, have you read the article—I think it was written yesterday—by James Baker, the former Treasury Secretary, “How Washington can prevent ‘zombie banks’”?

Mr. BERNANKE. Yes, sir.

Senator GRAHAM. What did you think of that?

Mr. BERNANKE. I understand the idea that going in and nationalizing the banks and just taking care of them once and for all is very attractive. I understand that.

Senator GRAHAM. I do not think he—well, let me put it in context. Here is where I am at. I want to do what is responsible. I want outcomes. I park my ideology here. I am a conservative Republican, and there are a lot of things that I think we should do that the administration is not doing. But we are all in this one literally together. So I voted for the TARP funds. And you are going to back to South Carolina to be honored this weekend—and congratulations, by the way. That is a big honor that they are bestowing upon you because you are a native of my State.

I am having to explain to people, you know, we are \$200 billion into AIG with no end in sight, and it would be helpful—I think I can take away from your testimony that the consequences of letting AIG just collapse uncontrolled would be a lot more to the country and to the public than \$200 billion. Is that a fair statement?

Mr. BERNANKE. Absolutely.

Senator GRAHAM. This idea that you are too big to fail, that does not set well with me, and I do not think it sets well with a lot of people. How do you feel about the term “too big to fail”?

Mr. BERNANKE. I think it is an enormous problem. I think we have learned it is a bigger problem than we thought it was, and I would say that dealing with the “too big to fail” problem should be a top priority as we go forward and do reforms.

Senator GRAHAM. Well, I believe that once we administer the stress test with these banks, we are going to know more than we know now. And my concern is: When do we throw good money after bad? I have supported the capitalization programs, but I at least would like to keep on the table—we own 36 percent of Citibank now. Is that correct?

Mr. BERNANKE. Yes, sir.

Senator GRAHAM. OK. Why did we convert preferred shares to common stock?

Mr. BERNANKE. Well, that decision was made for a variety of reasons, but among them is that the markets seem to believe—and with some reason—that common equity is better quality capital than preferred stock.

Senator GRAHAM. Well, Citibank is at \$1.22 today. It has not had much of an effect, has it?

Mr. BERNANKE. It certainly has not caused the stock price to go up.

Senator GRAHAM. From a South Carolina taxpayer point of view, and any other State, Virginia included, has the taxpayer been disadvantaged by losing the preferred status, potentially?

Mr. BERNANKE. I do not think necessarily that is the case, because it depends on the terms of conversion.

Senator GRAHAM. Or we have given up interest, right?

Mr. BERNANKE. Right, but it depends on the terms of conversion between the preferred and the common. May I—Senator, if I ask your indulgence, I would like to challenge the Congress to give us a framework where we can resolve a multinational, complicated financial conglomerate like Citigroup, like AIG, or others, if that became necessary. We do not have that framework, and, therefore, we have to work within the constraints of what we have.

Senator GRAHAM. Right. I understand. Now, when it comes to a big organization like—we are into this thing 36 percent the Federal Government owns. I do not know where nationalization, socialism, and capitalism begins or ends anymore. I mean, I think that is—I mean, obviously we are doing things that no one likes, whether you be a moderate, conservative Democrat, whatever you would like to call yourself, Senator Warner—you seem to be a good guy—or a conservative Republican from South Carolina. We seem to be in uncharted territory. Do you agree with that?

Mr. BERNANKE. I certainly agree, but I also want to emphasize that even though we are not formerly nationalizing any bank or institution, we are exerting plenty of control to make sure that they take the steps necessary to become viable?

Senator GRAHAM. That is my point. Call it what you like, and, you know, I got a lot of pushback when I mentioned leaving that option on the table, because when you look at the amount of money we are putting into the banks and the amount of control we have over how much you get paid and what decisions you make, we are pretty much running the damn thing, for lack of a better word. And there may come a time, at least in my mind, where it would be better to take them over quickly, sell off the good parts, and better manage the bad parts than it would be to continually capitalize. Does that make sense to you as a limited option in the future if this continued path does not work?

Mr. BERNANKE. As a possible option in the future, as an abstract option. But I reiterate that we do not have the tools to do that.

Senator GRAHAM. Right. I understand. But the choice that all of us have is to sit on the sidelines and watch all this money go into these systems, and nothing seems to be changing. And the one thing I want you to understand—you are so much brighter than I am about this, but I do have some common sense. The public has

just about had it with this continuous capitalization. And I think they would tolerate, if the bank is never going to perform after hundreds of billions of dollars, just to take it over, find a way to break it up, sell off the good parts and better manage the bad parts, like we did with the RTC a long time ago.

I just want to let you know that as a conservative Republican, I am parking my ideology, but we have a political problem, both of us, both sides of the aisle. Do not underestimate how hard it is going to be for you and others to continue to print money to solve this problem.

Senator WYDEN. Point well taken, from my judgment.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I want to add that I think Senator Graham has put his finger on part of the problem. A lot of this is around semantics of what words we use, not the practical outcome. And I think the Senator from South Carolina raises a very good point.

I want to come back to my two lines, and I know I am the last on the line, but back on our AIG situation, I understand why you all had to act last year. And I understand all the ramifications, I believe, of the total failure and an unstructured failure of AIG.

But what still kind of makes me concerned is I believe that a lot of these counterparties that bought these CDOs and CDSs were coming out of the London operation, in effect renting AIG's AAA status to take their less than AAA instruments and elevate them.

At some point in this process, they should have been doing some level of credit analysis as well about what AIG was doing and the fact, for example, that they were not even hedging—AIG was not even putting any kind of conservative downside hedges on these sales that they made. And I guess it just irks me a bit that we, the American taxpayers, are still basically asked to continue to totally bail out all these counterparties when at some point I just—and I understand the structural concerns, but there ought to be some haircut taken by these folks at some point in this process. And I would just like to hear your reaction to that.

Mr. BERNANKE. Well, I think, you know, the ramifications are just so complex that there are so many counterparties and so many different types, we have tried to de-fang the thing by taking some of the CDOs and other things off the balance sheet. But beyond the counterparties, you have got millions of insurance contracts. You have got millions of stable value wraps on 401(k)'s and all kinds of other financial instruments. So are you going to begin to—are you going to haircut everybody who has a life insurance policy?

Senator WARNER. Well, the insurance policy holder, though, did not make the determination that they were going to go out and purchase the CDO to try to improve their credit rating. At some point here, some marginal haircut on some of these counterparties.

Mr. BERNANKE. Once again, we are back into this legal question, which is unless the company is in bankruptcy, we cannot default to counterparties. We do not have a way of safely putting the company into bankruptcy.

To respond to Senator Graham, AIG is effectively under our control. We are breaking it up. We are doing it to repay. But we are doing it within the legal context of an ongoing firm because bank-

ruptcy is just not a good option given how complex and international this company is.

Senator WARNER. But, in effect, what we are saying is consequently folks who bought these instruments should have been doing some level of credit analysis of what AIG was selling who did not do that credit analysis and are going to still come out whole for their lack of appropriate due diligence or responsible behavior.

Mr. BERNANKE. I am as unhappy as you are about that, Senator. I just do not know what to do about it.

Senator WARNER. Let me just in my remaining one moment come back again. I got my pitch in about the muni markets. My time ran out, and I have yet to hear, though, from you or Secretary Geithner there is recognition of the problem, and the fact that, again, from a job creation standpoint and a creditworthiness standpoint, the fact that these are public entities, they are creditworthy, they are projects that have been scrubbed, they are ready to go to market, the fact that the spreads are still at unreasonably high levels. I just would again encourage you, and I would ask you to please make some comment on whether you think the TALF or any other instrument could be used, either from a backstop standpoint or from going into the markets and starting to purchase some of these muni bonds to jump-start the area.

Mr. BERNANKE. I could not really give you a full assessment without doing the analysis. Let me tell you why we have not put that ahead of CMBS and some of the other private sector instruments. Part of it is just that we know that the fiscal program, the Congress does have substantial help for States and localities, and it seems more natural for the Congress to be providing that kind of support. And our 13(3) authority, which has been talked about so much, in fact excludes lending to municipalities and States.

Senator WARNER. I understand.

Mr. BERNANKE. And, therefore, it is a bit beyond, I think, the intent of Congress. So we are certainly aware of those situations. We think there has been some improvement in the muni market. It is very important. We agree it is very important.

Senator WARNER. But do you believe the TALF falls out—your 13(3) does not extend to TALF since TALF seems to be a hybrid?

Mr. BERNANKE. I do not want to say categorically because there might be some way to—particularly since there are certain categories. We are allowed, for example, to buy very short-term municipal debt even without 13(3) as part of our regular open market operations.

Senator WARNER. Well, just as I have asked Secretary Geithner, and I would ask and would love to hear back, perhaps offline, what tools are available out there to jump-start this market.

Mr. BERNANKE. OK.

Senator WARNER. Thank you, Mr. Chairman.

Senator WYDEN. Before we lost the Senator from Virginia, who does know something about markets because he has been successful in them, I want to note the nature of the exchange you just had with the Chairman on the counterparties issue.

The Senator from Virginia has said—and I am sure others are going to suggest this as well—that these counterparties ought to take a haircut, that they ought to, in effect, have some kind of con-

sequence. And, by the way, we do not even know who these counterparties are. They could be anybody in the world. The Chairman's response to the Senator from Virginia said, well, I do not really know what to do about it.

Well, I proposed something today. I think we ought to be disclosing at a minimum who these counterparties are. They are not being disclosed. The American people are in the dark on this issue, and I think it is time for some sunlight. And I very much want to work with you on this, Mr. Chairman, because I think that the public really wants to know why are these people so important. Why are they so important? Why do they play such a fundamental role in the American economy? And it is part of this debate. The reason that AIG has gotten this money is because they are "systemically important." I think the small businesses that Senator Warner and I represent, we think they are systemically important. These small businesses seem like collateral damage in all of this while AIG and the large powerful interests seem to get money very quickly.

So I thought that the exchange that you just had with the Senator from Virginia certainly highlighted this debate, he had an idea. He came in with a specific suggestion with respect to counterparties. You said you really did not know what ought to be done. And I want to leave this hearing with the comment that I think we know what needs to be done. I think these interests ought to be disclosed.

So let us give you the last word. You have been very patient, by the way, with your time this morning, taken a lot of questions, a lot of rounds. We will give you the last word.

Mr. BERNANKE. Yes, I would like to say something about the American public's reaction, and I understand why people are angry. And as I said, I have been very angry at a number of circumstances. I am generally a pretty even-tempered kind of person. It is not fair that money is going to big corporations. We are in a situation, though, where we need to stabilize the financial system. If we do not stabilize the financial system, we have no hope of getting the economy back to a normal state.

Once that fire is put out, then we need to think very hard as a country how we are going to make sure this does not happen again, and I will be the first person to work with the Congress to make sure we find strong measures to avoid this ever happening again. But right now, if we do not do what is necessary to stabilize the financial system, the consequences for people on Main Street will be quite adverse.

Senator WYDEN. Mr. Chairman, you have been very generous with your time, and the Senate Budget Committee is adjourned.

[Whereupon, at 11:55 a.m., the Committee was adjourned.]

Chairman Bernanke subsequently submitted the following in response to written questions received from Senator Lindsey Graham in connection with the March 3, 2009, hearing before the Senate Committee on the Budget:

Is it wise to raise taxes during a recession?

Most economists feel that raising *overall* taxes would be counterproductive to the necessary efforts to help achieve a financial and economic recovery during the current recession. Once the economy has been put onto a sustainable path to recovery, however, policymakers will need to make the difficult choices associated with addressing fiscal imbalances that might include raising taxes.

President Obama has proposed limiting itemized deductions for upper income taxpayers. What do you think will be the impact of this proposal on charitable contributions? What would be the impact of limiting the mortgage interest deduction on the housing market?

As you know, during my tenure as Chairman of the Federal Reserve Board I have avoided taking a position on explicit tax and spending issues. I believe that these are fundamental decisions that must be made by the Congress, the Administration, and the American people. Instead, I have attempted to articulate the principles that I believe most economists would agree are important for the long-term performance of the economy and for helping fiscal policy to contribute as much as possible to that performance. In that regard, a general economic principle of tax reform is that the economic efficiency of a tax system can usually be enhanced if tax rates can be kept as low as possible while at the same time broadening the tax base in order to raise the desired amount of revenue. However, reforming the tax structure is not easy as it involves not only setting tax rates but also the difficult decisions of how to broaden the tax base. Indeed, changes to the structure of the tax system that may improve its efficiency may not be judged to be equitable. Nevertheless, the choices that are made regarding both the size and structure of the federal tax system will affect a wide range of economic incentives that will be part of determining the future economic performance of our nation.

Congress is likely to take up legislation to allow bankruptcy judges to reduce the principal amount of mortgage loans for borrowers (known as “cram down”). Do you support this policy change? How do you think this proposal will impact mortgage rates?

Providing bankruptcy judges with the ability to adjust mortgage terms and reduce outstanding principal should result in more sustainable mortgage obligations for some borrowers and thus help reduce preventable foreclosures. Such an approach has several advantages. In particular, because of the costs and stigma of filing for bankruptcy, mortgage borrowers who do not need help may be unlikely to turn to the bankruptcy system for relief. Bankruptcy judges may also be able to assess the extent to which a borrower truly needs assistance. Because the bankruptcy system is already in place, this approach could be implemented very quickly, and these changes to the bankruptcy code would likely involve no financial outlay from the taxpayer.

These advantages, however, could come at the cost of restricting borrower access to mortgage credit. The academic literature has not reached a consensus as to whether these changes to the bankruptcy code would result in material limitations on the availability of mortgage credit. Studies of regulations in other lending markets, however, suggest that such a tradeoff may exist. As these changes to the bankruptcy code would be permanent, it is possible that these changes could have long-lasting effects on credit availability. Thus, while these modifications to the bankruptcy code would not impose direct costs on taxpayers, they could impose indirect costs through higher interest rates or more stringent lending standards.

In addition, some private-label mortgage-backed securities (MBS) contain so-called “bankruptcy carve-out” provisions requiring that losses stemming from bankruptcies be shared across the different tranches of the securities. The implication is that the investors holding the AAA-rated tranches would bear most of the losses from principal write-downs allowed by the legislation because they account for most of the outstanding deals. Large holders of AAA-rated MBS, including the housing GSEs, might thus face material losses if bankruptcy judges were permitted to reduce the principal amount of mortgages. Such an outcome might further destabilize conditions in financial markets.

As the Congress considers whether to enact modifications to the bankruptcy code, it will need to weigh these various factors.