

Testimony

Chairman Ben S. Bernanke

Economic outlook

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Chairman Schumer, Vice Chair Maloney, Representative Saxton, and other members of the committee, I appreciate this opportunity to discuss recent developments in financial markets and to present an update on the economic situation. As you know, the U.S. economy continues to confront substantial challenges, including a weakening labor market and elevated inflation. Notably, stresses in financial markets have been high and have recently intensified significantly. If financial conditions fail to improve for a protracted period, the implications for the broader economy could be quite adverse.

The downturn in the housing market has been a key factor underlying both the strained condition of financial markets and the slowdown of the broader economy. In the financial sphere, falling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital. Investor concerns about financial institutions increased over the summer, as mortgage-related assets deteriorated further and economic activity weakened. Among the firms under the greatest pressure were Fannie Mae and Freddie Mac, Lehman Brothers, and, more recently, American International Group (AIG). As investors lost confidence in them, these companies saw their access to liquidity and capital markets increasingly impaired and their stock prices drop sharply.

The Federal Reserve believes that, whenever possible, such difficulties should be addressed through private-sector arrangements--for example, by raising new equity capital, by negotiations leading to a merger or acquisition, or by an orderly wind-down. Government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. In the cases of Fannie Mae and Freddie Mac, however, capital raises of sufficient size appeared infeasible and the size and government-sponsored status of the two companies precluded a merger with or acquisition by another company. To avoid unacceptably large dislocations in the financial sector, the housing market, and the economy as a whole, the Federal Housing Finance Agency (FHFA) placed

Fannie Mae and Freddie Mac into conservatorship, and the Treasury used its authority, granted by the Congress in July, to make available financial support to the two firms. The Federal Reserve, with which FHFA consulted on the conservatorship decision as specified in the July legislation, supported these steps as necessary and appropriate. We have seen benefits of this action in the form of lower mortgage rates, which should help the housing market.

The Federal Reserve and the Treasury attempted to identify private-sector solutions for AIG and Lehman Brothers, but none was forthcoming. In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy. To mitigate concerns that this action would exacerbate moral hazard and encourage inappropriate risk-taking in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors. The chief executive officer has been replaced. The collateral for the loan is the company itself, together with its subsidiaries.¹ (Insurance policyholders and holders of AIG investment products are, however, fully protected.) Interest will accrue on the outstanding balance of the loan at a rate of three-month Libor plus 850 basis points, implying a current interest rate over 11 percent. In addition, the U.S. government will receive equity participation rights corresponding to a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders, among other things.

In the case of Lehman Brothers, a major investment bank, the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized--as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps--that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.

While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit--where available--to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth.

The Federal Reserve took a number of actions to increase liquidity and stabilize markets. Notably, to address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks, including an approximate doubling of the existing swap lines with the European Central Bank and the Swiss National Bank and the authorization of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada, among others. We will continue to work closely with colleagues at other central

banks to address ongoing liquidity pressures. The Federal Reserve also announced initiatives to assist money market mutual funds facing heavy redemptions and to increase liquidity in short-term credit markets.

Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy. In this regard, the Federal Reserve supports the Treasury's proposal to buy illiquid assets from financial institutions. Purchasing impaired assets will create liquidity and promote price discovery in the markets for these assets, while reducing investor uncertainty about the current value and prospects of financial institutions. More generally, removing these assets from institutions' balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.

I will now turn to a brief update on the economic situation.

Ongoing developments in financial markets are directly affecting the broader economy through several channels, most notably by restricting the availability of credit. Mortgage credit terms have tightened significantly and fees have risen, especially for potential borrowers who lack substantial down payments or who have blemished credit histories. Mortgages that are ineligible for credit guarantees by Fannie Mae or Freddie Mac--for example, nonconforming jumbo mortgages--cannot be securitized and thus carry much higher interest rates than conforming mortgages. Some lenders have reduced borrowing limits on home equity lines of credit. Households also appear to be having more difficulty of late in obtaining nonmortgage credit. For example, the Federal Reserve's Senior Loan Officer Opinion Survey reported that as of July an increasing proportion of banks had tightened standards for credit card and other consumer loans. In the business sector, through August, the financially strongest firms remained able to issue bonds but bond issuance by speculative-grade firms remained very light. More recently, however, deteriorating financial market conditions have disrupted the commercial paper market and other forms of financing for a wide range of firms, including investment-grade firms. Financing for commercial real estate projects has also tightened very significantly.

When worried lenders tighten credit, then spending, production, and job creation slow. Real economic activity in the second quarter appears to have been surprisingly resilient, but, more recently, economic activity appears to have decelerated broadly. In the labor market, private payrolls shed another 100,000 jobs in August, bringing the cumulative drop since November to 770,000. New claims for unemployment insurance are at elevated levels and the civilian unemployment rate rose to 6.1 percent in August. Households' real disposable income was boosted significantly in the spring by the tax rebate payments, but, excluding those payments, real after-tax income has fallen this year, which partly reflects increases in the prices of energy and food.

In recent months, the weakness in real income together with the restraining effects of reduced credit flows and declining financial and housing wealth have begun to show through more clearly to consumer spending. Real personal consumption expenditures for goods and services

declined in June and July, and the retail sales report for August suggests that outlays for consumer goods fell noticeably further last month. Although the retrenchment in household spending has been widespread, purchases of motor vehicles have dropped off particularly sharply. On a more positive note, oil and gasoline prices--while still at high levels, in part reflecting the effects of Hurricane Ike--have come down substantially from the peaks they reached earlier this summer, contributing to a recent improvement in consumer confidence. However, the weakness in the fundamentals underlying consumer spending suggest that household expenditures will be sluggish, at best, in the near term.

The recent indicators of the demand for new and existing homes hint at some stabilization of sales, and lower mortgage rates are likely to provide some support for demand in coming months. Moreover, although expectations that house prices will continue to fall have probably dissuaded some potential buyers from entering the market, lower house prices and mortgage interest rates are making housing increasingly affordable over time. Still, homebuilders retain large backlogs of unsold homes, which should continue to restrain the pace of new home construction. Indeed, single-family housing starts and new permit issuance dropped further in August. At the same time, the continuing decline in house prices reduces homeowners' equity and puts continuing pressure on the balance sheets of financial institutions, as I have already noted.

As of midyear, business investment was holding up reasonably well, with investment in nonresidential structures particularly robust. However, a range of factors, including weakening fundamentals and constraints on credit, are likely to result in a considerable slowdown in the construction of commercial and office buildings in coming quarters. Business outlays for equipment and software also appear poised to slow in the second half of this year, assuming that production and sales slow as anticipated.

International trade provided considerable support for the U.S. economy over the first half of the year. Economic activity has been buoyed by strong foreign demand for a wide range of U.S. exports, including agricultural products, capital goods, and industrial supplies, even as imports declined. However, in recent months, the outlook for foreign economic activity has deteriorated amid unsettled conditions in financial markets, troubled housing sectors, and softening sentiment. As a consequence, in coming quarters, the contribution of net exports to U.S. production is not likely to be as sizable as it was in the first half of the year.

All told, real gross domestic product is likely to expand at a pace appreciably below its potential rate in the second half of this year and then to gradually pick up as financial markets return to more-normal functioning and the housing contraction runs its course. Given the extraordinary circumstances, greater-than-normal uncertainty surrounds any forecast of the pace of activity. In particular, the intensification of financial stress in recent weeks, which will make lenders still more cautious about extending credit to households and business, could prove a significant further drag on growth. The downside risks to the outlook thus remain a significant concern.

Inflation rose sharply over the period from May to July, reflecting rapid increases in energy and food prices. During the same period, price inflation for goods and services other than food and energy also moved up from the low rates seen in the spring, as the higher costs of energy, other

commodities, and imported goods were partially passed through to consumers. Recently, however, the news on inflation has been more favorable. The prices of oil and other commodities, while remaining quite volatile, have fallen, on net, from their recent peaks, and the dollar is up from its mid-summer lows. The declines in energy prices have also led to some easing of inflation expectations, as measured, for example, by consumer surveys and the pricing of inflation-indexed Treasury securities.

If not reversed, these developments, together with a pace of growth that is likely to fall short of potential for a time, should lead inflation to moderate later this year and next year. Nevertheless, the inflation outlook remains highly uncertain. Indeed, the fluctuations in oil prices in the past few days illustrate the difficulty of predicting the future course of commodity prices.

Consequently, the upside risks to inflation remain a significant concern as well.

Over time, a number of factors should promote the return of our economy to higher levels of employment and sustainable growth with price stability, including the stimulus being provided by monetary policy, lower oil and commodity prices, increasing stability in the mortgage and housing markets, and the natural recuperative powers of our economy. However, stabilization of our financial system is an essential precondition for economic recovery. I urge the Congress to act quickly to address the grave threats to financial stability that we currently face. For its part, the Federal Open Market Committee will monitor economic and financial developments carefully and will act as needed to promote sustainable economic growth and price stability.

Footnotes

1. Specifically, the loan is collateralized by all of the assets of the company and its primary non-regulated subsidiaries. These assets include the equity of substantially all of AIG's regulated subsidiaries. [Return to text](#)

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