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THE ECONOMIC OUTLOOK

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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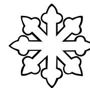

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THE ECONOMIC OUTLOOK

APRIL 27, 2006

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

The Committee met at 10:02 a.m., in room 216 of the Hart Senate Office Building, the Honorable Jim Saxton (Chairman of the Committee) presiding.

Representatives present: Saxton, Ryan, English, Paul, Brady, Maloney, Hinchey, and Cummings.

Senators present: Bennett, Sununu, Sessions, Reed, and Sarbanes.

Staff present: Chris Frenze, Robert Keleher, Brian Higginbotham, Colleen Healy, Katie Jones, Jeff Schlagenhauf, Jeff Wrase, Chad Stone, Matt Salomon, and Pamela Wilson.

OPENING STATEMENT OF HON. JIM SAXTON, CHAIRMAN, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Good morning. Chairman Bernanke, it's a pleasure to welcome you here this morning. We appreciate your appearance today and we look forward to hearing your views on the economic outlook.

According to the official data, a healthy economic expansion has been underway for several years. The U.S. economy advanced 4.2 percent in 2004, and 3.5 percent in 2005.

As I have noted many times, the pickup in economic growth since the middle of 2003 is mostly due to a rebound in investment activity, which had been weak prior to that. This rebound was fostered by a mix of Federal monetary policy and the 2003 tax legislation and its incentives for investment.

The continued economic expansion has created 5.2 million payroll jobs since 2003. The unemployment rate, at 4.7 percent, is below the averages of the 1970s, the 1980s, and the 1990s.

The Federal Reserve and private economists forecast that business investment and the overall economy will continue to grow this year.

As the Fed noted in a policy report last February, "The U.S. delivered a solid performance in 2005." The Fed also stated that "the U.S. economy should continue to perform well in 2006 and 2007."

Recent data indicate that the economic growth rate for the first quarter of this year will be quite robust when it is released tomorrow.

According to a broad array of economic data, the outlook remains positive. Consumer spending is expected to be solid in 2006; home

ownership has reached record highs; household net worth is also at record levels; the trend in productivity growth remains strong.

Although oil prices have raised business costs and imposed hardships on many consumers, these prices have not derailed the expansion.

Meanwhile, long-term inflation pressures are contained. As a result, long-term interest rates such as mortgage rates, are still relatively low, although these rates have edged up in recent weeks.

According to the Fed's preferred price index, inflation is well under control.

One point that I would like to mention, however, is that it's important to examine the price of energy, the causes for increased prices, the relationship between supply and demand, the relationship between the pump price of gasoline and oil companies' profits, and the effect of these items on the economy as we go forward.

In sum, current economic conditions are strong. While economic growth is expected to exceed 3 percent this year, the economic outlook remains positive.

Mr. Chairman, at this point, we would normally hear from the Ranking Member, Senator Reed, however, he's tied up on the floor, and so we're going to turn to you now for your testimony, and then we'll get into questions.

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

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

Chairman Bernanke. Thank you. Mr. Chairman and Members of the Committee, I am pleased to appear before the Joint Economic Committee to offer my views on the outlook for the U.S. economy, and on some of the major economic challenges that the Nation faces.

Partly because of last year's devastating hurricanes and partly because of some temporary or special factors, economic activity decelerated noticeably late last year. The growth of the real gross domestic product, or GDP, slowed from an annual average rate of nearly 4 percent over the first three quarters of 2005, to less than 2 percent in the fourth quarter.

Since then, however, with some rebound in activity underway in the Gulf Coast region and continuing expansion in most other parts of the country, the national economy appears to have grown briskly. Among the key economic indicators, growth in non-farm payroll employment picked up in November and December, and job gains averaged about 200,000 per month between January and March. Consumer spending and business investment, as inferred from data on motor vehicle sales, retail sales, and shipments of capital goods, are also on track to post sizable first-quarter increases.

In light of these signs of strength, most private sector forecasters such as those included in the latest Blue Chip survey, estimate that real GDP grew between 4 and 5 percent at an annual rate in the first quarter.

If we smooth through the recent quarter-to-quarter variations, we see that the pace of economic growth has been strong for the

past 3 years, averaging nearly 4 percent at an annual rate since the middle of 2003.

Much of this growth can be attributed to a substantial expansion in the productive capacity of the U.S. economy, which, in turn, is largely the result of impressive gains in productivity, that is, in output-per-hour-worked.

However, a portion of the recent growth reflects the taking up of economic slack that had developed during the period of economic weakness earlier in the decade. Over the past year, for example, the unemployment rate has fallen nearly one-half percentage point, the number of people working part-time for economic reasons, has declined to its lowest level since August of 2001, and the rate of capacity utilization in the industrial sector has moved up 1.5 percentage points.

As the utilization rates of labor and capital approach their maximum sustainable levels, continued growth in output, if it is to be sustainable and non-inflationary, should be at a rate consistent with the growth in the productive capacity of the economy.

Admittedly, determining the rates of capital and labor utilization consistent with stable long-term growth is fraught with difficulty, not least because they tend to vary with economic circumstances.

Nevertheless, to allow the expansion to continue in a healthy fashion and to avoid the risk of higher inflation, policymakers must do their best to help to ensure that the aggregate demand for goods and services does not persistently exceed the economy's underlying productive capacity.

Based on the information in hand, it seems reasonable to expect that economic growth will moderate toward a more sustainable pace as the year progresses. In particular, one sector that is showing signs of softening is the residential housing market. Both new and existing home sales have dropped back, on net, from their peaks of last Summer and early Fall, and while unusually mild weather gave a lift to new housing starts earlier this year, the reading for March points to a slowing in the pace of homebuilding as well.

House prices, which have increased rapidly during the past several years, appear to be in the process of decelerating, which will imply slower additions to household wealth, and, thereby, less impetus to consumer spending.

At this point, the available data on the housing market, together with ongoing support for housing demand from factors such as strong job creation and still-low mortgage rates, suggests that this sector will most likely experience a gradual cooling, rather than a sharp slowdown. However, significant uncertainty attends the outlook for housing, and the risk exists that a slowdown more pronounced than we currently expect could prove a drag on growth this year and next. The Federal Reserve will continue monitoring housing markets closely.

More broadly, the prospects for maintaining economic growth at solid pace in the period ahead, appear good, although growth rates may well vary, quarter-to-quarter, as the economy downshifts from the first-quarter spurt.

Productivity growth, job creation, and capital spending are all strong, and continued expansion on the economies of our trading partners, seems likely to boost our export sector.

That said, energy prices remain a concern. The nominal price of crude oil has risen recently to new highs, and gasoline prices are also up sharply. Rising energy prices pose a risk to both economic activity and inflation. If energy prices stabilize this year, even at a high level, their adverse effects on both growth and inflation should diminish somewhat over time. However, as the world has little spare oil production capacity, periodic spikes in oil prices remain a possibility.

The outlook for inflation is reasonably favorable, but carries some risks. Increases in energy prices have pushed up overall consumer price inflation over the past year or so. However, inflation in core price indexes, which, in the past has been a better indicator of long-term inflation trends, has remained roughly stable over the past year.

Among the factors restraining core inflation, are ongoing gains in productivity, which have helped to hold unit labor costs in check, and strong domestic and international competition in product markets, which have restrained the ability of firms to pass cost increases on to consumers.

The stability of core inflation is also enhanced by the fact that long-term inflation expectations, as measured by surveys and by comparing yields on nominal and indexed Treasury securities, appear to remain well anchored.

Inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability. As to inflation risks, I have already noted that continuing growth in aggregate demand in excess of increases in the economy's underlying productive capacity would likely lead to increased inflationary pressures. In addition, although pass-through from energy and commodity price increases to core inflation has thus far been limited, the risk exists that strengthening demand for final products could allow firms to pass on a greater portion of their cost increases in the future.

With regard to monetary policy, the Federal Open Market Committee, or FOMC, has raised the Federal Funds rate in increments of 25 basis points at each of its past 15 meetings, bringing it to its current level to 4.75 percent.

This sequence of rate increases was necessary to remove the unusual monetary accommodation put in place in response to the soft economic conditions earlier in this decade. Future policy actions will be increasingly dependent on the evolution of the economic outlook, as reflected in the incoming data. Specifically, policy will respond to arriving information that affects the Committee's assessment of the medium-term risk to its objectives of price stability and maximum sustainable employment. Focusing on the medium-term forecast horizon is necessary because of the lags with which monetary policy affects the economy.

In the statement issued after its March meeting, the FOMC noted that economic growth had rebounded strongly in the first quarter, but appeared likely to moderate to a more sustainable

pace. It further noted that a number of factors have contributed to the stability in core inflation.

However, the Committee also viewed the possibility that core inflation might rise as a risk to the achievement of its mandated objectives, and it judged that some further policy firming may be needed to keep the risk of attainment of both sustainable economic growth and price stability, roughly in balance.

In my view, data arriving since the meeting, have not materially changed that assessment of the risks. To support continued healthy growth of the economy, vigilance in regards to inflation, is essential. The FOMC will continue to monitor the incoming data closely, to assess the prospects for both growth and inflation. In particular, even if, in the Committee's judgment, the risks to its objectives are not entirely balanced, at some point in the future, the Committee may decide to take no action at one or more meetings, in the interest of allowing more time to receive information relevant to the outlook. Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings, and the Committee will not hesitate to act when it determines that doing so is needed to foster the achievement of the Federal Reserve's mandated objectives.

Mr. Chairman, the remainder of my testimony, which I submit for the record, discusses two longer-term challenges to the U.S. economy: The first is the long-run sustainability of the Federal budget deficit. Given the aging of our population, we're going to see increasing stress on transfer programs as a share of GDP, and I argue that Congress needs to make difficult choices about what share of the GDP is to be devoted to Federal programs, and to set taxes accordingly to match that share of GDP.

The second issue that I discuss—and I'm simply summarizing—is the U.S. current account deficit, which is now at about 6.5 percent of GDP, and which cannot be sustained indefinitely at that level.

Recent discussions with the G7 have made the important point that the U.S. current account deficit is not a U.S. problem alone, but is a global problem, and one which requires action and response, not only by the United States, but by our trading partners, as well. There are a number of steps that both we and our trading partners can take to improve the current account situation over a period of time. On our side, again, improved fiscal balance would be helpful, but, in addition, other countries need to take action, as well.

In conclusion, Mr. Chairman, the economy is performing well, and the near-term prospects look good, although, as always, there are risk to the outlook. Monetary policy will continue to pursue its objectives of helping the economy to grow at a strong, sustainable pace, while keeping inflation firmly under control.

And while many of the fundamental factors that determine long-term economic growth appear favorable, actions to move the Federal budget toward a more sustainable position will do a great deal to help ensure the future prosperity of our economy.

Thank you, and I'd be happy to take any questions you might have.

[The prepared statement of Hon. Ben Bernanke appears in the Submissions for the Record on page 37.]

Representative Saxton. Mr. Chairman, normally we would begin our questions at this point, but let me just ask Senator Reed, who was tied up on the floor previously, if he has an opening statement.

OPENING STATEMENT OF HON. JACK REED, RANKING MINORITY, A U.S. SENATOR FROM RHODE ISLAND

Senator Reed. Well, thank you very much, Chairman Saxton, and welcome, Chairman Bernanke, and thank you for your testimony today and for your service.

All eyes are on you as you embark on a very delicate balance in terms of allowing the economy to grow and employment to reach its full potential, while you remain mindful of the risks of inflation.

For some time, the Fed's job has been easier. It had room to raise interest rates from very low levels, with little risk of derailing the economic recovery, while inflation and other lurking economic problems were at bay.

Today, soaring energy prices, record budget and trade deficits, negative household savings rates, and a disappointing labor market recovery, all pose tremendous challenges to setting monetary policy.

The Fed has raised its target for the Federal Funds rate by 25 basis points at each of the last 15 FOMC meetings, and, according to the minutes of the March meeting, most members of the FOMC thought that the end of the tightening process was near. The question on everyone's mind is, are we there yet?

The phrase we are hearing is that interest rate changes will now be data-driven, so I hope that means, Chairman Bernanke, that the Fed will look hard at the full range of data on economic growth, employment, and inflation, to determine the best course for monetary policy.

GDP is growing, but the typical American worker has been left out of the economic gains of this recovery. Strong productivity growth has shown up in the bottom lines of shareholders, but not in the paychecks of workers.

Too many Americans are being squeezed by stagnant incomes and rising costs for gasoline, healthcare, and education. It seems to me that there is still room for real wages to catch up with productivity, before the Fed needs to worry about inflationary pressures from the labor market.

However, there are many other downside risks to the economy on the horizon. You have mentioned some of them.

Energy prices have been pushing up overall inflation for some time, but last month, we saw an uptick in core inflation, which might be an early sign that businesses are starting to pass on their higher energy costs to customers.

Rising oil prices and interest rates, coupled with a weakening housing sector, could take their toll on consumers and businesses alike, and slow down the economy.

Your task in setting the right course for monetary policy is complicated by fiscal policy and international imbalances, which you

discuss in the bulk of your statement, which you put into the record.

We no longer have the fiscal discipline that we had in the 1990s, which allowed for monetary policy that encouraged investment and long-term growth. The President's large and persistent budget deficits have led to an ever-widening trade deficit that forces us to borrow vast amounts from abroad, and puts us at risk of a major financial collapse if foreign lenders suddenly stop accepting our IOUs.

Even assuming we can avoid an international financial crisis, continued budget and trade deficits will be a drag on the growth of our standard of living, and leave us ill prepared to deal with the effects of the retirement of the Baby Boom generation.

Strong investment financed by our own national saving, not foreign borrowing, is the foundation for strong, sustained economic growth and rising living standards.

There is final issue that I'd like to raise, and that is the growing inequality of income, earnings, and wealth in the U.S. economy. Your predecessor, Chairman Greenspan, regularly raised that issue as one of the concerns for our political economy. It is not good for a democracy to have widening inequality.

I know you share those concerns. Recently the Federal Reserve published the results of the 2004 Survey of Consumer Finances. They show that the growth in median income and wealth have slowed substantially, and the top 1 percent of families hold more wealth than the bottom 90 percent of families.

Mr. Chairman, I hope you can concentrate on that issue as you continue to develop policy, and, I again encourage and welcome your presentation here today. Thank you, Mr. Chairman.

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

Representative Saxton. Thank you very much, Senator Reed.

Mr. Chairman, let me begin with a question that I think is central to the subject that we're discussing here, and that is the Fed's role in managing our Nation's monetary policy.

In both your statement and in Senator Reed's statement, the subject of inflation was mentioned prominently. As a matter of fact, the Fed's monetary policy for many years has focused on price stability and trying to control inflation.

Under such policy, inflation and interest rates are kept low. As this low inflation persists, the central bank's policy becomes increasingly credible in the eyes of investors, as well as in the eyes of savers.

As a consequence, inflationary expectations recede and interest rates decline. These movements, in turn, encourage economic growth and lower unemployment, and just better economic outcomes for everyone.

My question is this: If the United States were to move toward explicit inflation targeting, would this be largely a movement for greater transparency, or mostly a significant change in the substance of Fed monetary policy?

Chairman Bernanke. Thank you, Mr. Chairman. Let me first address the point on inflation. The Federal Reserve has a three-

part mandate: Price stability; moderate long-term interest rates; and maximum employment.

Clearly, keeping inflation low and stable addresses directly the first two of those, in particular, since long-term interest rates can only be low if investors expect inflation to remain low. I would argue, in addition, that there's very strong evidence that low and stable inflation and well-anchored inflation expectations also contribute mightily to the third objective, which is strong and stable employment growth.

For example, we have seen since the mid-1980s, what economists refer to as the great moderation, the fact that recessions have been somewhat less frequent and milder, that quarter-to-quarter variation in output and employment has been lower. Many scholars attribute that to the fact that inflation in that last 20-year period, has been low and stable.

Therefore, it is very much in the interest of all of the objectives, including the employment objectives of the Federal Reserve, to keep inflation low and stable. So, then, the question is, how to do that?

The Federal Reserve already has established strong credibility for keeping inflation low and stable, and I anticipate we will retain that credibility.

I have discussed, and will be discussing with the Federal Open Market Committee, ways in which we can continue Chairman Greenspan's movement toward greater transparency and better communication, to further anchor inflation expectations and reduce uncertainty in financial markets.

One of the ideas that's been discussed in that context, is the idea of defining, quantitatively, what the optimal long-term inflation rate might be. In doing so, the hope would be to reduce uncertainty and to help anchor inflation expectations more tightly.

Clearly—and I'd like to emphasize this point—taking this step would in no way repudiate the employment part of the dual mandate; to the contrary, it would provide the Fed with a stronger tool and better ability to meet this very important objective.

So, to answer your question most directly, I don't see, and I don't desire, any change in the basic operating procedures of the Fed, nor in its objectives; rather, I think that we need to work on our communication, broadly speaking, to make sure that inflation expectations remain low and stable, as a tool for meeting all three of the Federal Reserve's mandated objectives.

Representative Saxton. Mr. Chairman, thank you. Some worry about Fed policy, which has focused on price stability over the last couple of decades. Recently, under this policy we have seen a relatively long period of Fed tightening, which resulted in higher overnight interest rates.

Some would worry that this translates into higher interest rates in the economy, particularly in long-term interest rates, and, most recently, that has not happened. As a matter of fact, we have seen stable long-term interest rates, in spite of the fact that short-term rates have increased rather significantly.

Why is it that long-term rates have remained stable and even come down during this period of time, on occasions, when Fed pol-

icy has been to tighten and the net result of that is short-term rate increases?

Chairman Bernanke. Mr. Chairman, first I'd like to reiterate the point that increasing short-term rates to control inflation has the effect actually, in the long run certainly, of keeping long-term rates lower, rather than higher.

I can only draw the contrast between the 1970s and the early 1980s when people paid 18 percent for mortgages, vis-à-vis today where they are paying 6 percent-plus, in an environment where inflation is low and stable and under control, and in that respect, meeting our objective of low to moderate long-term interest rates is best achieved by keeping inflation low and stable.

With respect to the recent behavior of long-term interest rates, it's useful to think about the long-term interest rate as consisting of a series of short-term rates, the rates for the next few years and then the rates that investors expect to be maintained further out into the future.

Over the last almost 2 years, as the Fed has been tightening, the short-term component of that has been rising, as the policy rate has risen, but the further-out short-term rates, at the far end of the yield curve, have been declining and offsetting that effect and leaving the overall 10-year rate more or less stable.

The declines in the far-out yields, further out in the term structure, seem to result from both an increase of saving in the global economy, which has been looking for returns—and some of that has come to the United States and to other industrial countries, driving down returns—and also some reduction in term premiums, reflecting the reduced sense of risk that investors feel about the general economy, about inflation, and about the bond market, specifically.

Now, recently, we have seen a turnaround, in that the far-out short-term rates, the rates that investors expect to be maintained, 5 or 10 years from now, have risen fairly significantly, leading to an overall increase in long-term interest rates.

I think there are basically two reasons for that: First, there has been some return of the term premium back to more normal levels, after a period of unusually low levels.

But, second, and, I think, importantly for our economy, it appears that the world economy is growing this year at a very healthy pace. We're seeing strength in Japan; we're seeing some incipient strength in Europe; China continues very strong, as well as Southeast Asia; emerging markets are doing well, so general strength in the world economy is providing some increased upward pressure on long-term interest rates, and that, I think, explains what's been happening in the last couple of months.

Representative Saxton. Thank you. Let me just change the subject for just a moment.

The price of oil has reached a price in excess of $70 a barrel. Just let me ask quickly before we turn to the next Member, how does the oil price increase affect your outlook on the economy? Are you worried or extremely worried? What is your general outlook on this subject?

Chairman Bernanke. Yes, Mr. Chairman, higher oil prices do create problems for monetary policy. On the one hand, they directly affect the cost of living, inflation, on the other hand, by taking pur-

chasing power away from consumers, they tend to slow economic activity, and so they do produce a difficult problem.

For the Federal Reserve, one issue we will be looking at very carefully is whether the increases in energy prices that we have already seen and that we may see in the future pass through into core inflation—that is, whether they go beyond the energy sector itself and begin to be seen in higher prices for other goods and services. If that were to happen and if expectations of inflation were thereby to rise, that would be very deleterious to the long-term growth of the economy.

By contrast, if inflation expectations remain stable and core inflation is not infected, so to speak, by high energy prices, that gives the Fed considerably more leeway to respond to any changes that may happen in the real economy related to the higher oil prices.

In particular, we do expect to see a slight slowing in growth, perhaps a couple of tenths, this year and next associated with the higher oil prices and their effects on consumer spending. And we are very aware of that and are paying attention to those developments.

Representative Saxton. Thank you, Mr. Chairman.

Senator Reed.

Senator Reed. Thank you, Mr. Chairman. Because Senator Sarbanes has to leave, I would yield him 5 minutes for questions.

Senator Sarbanes. Thank you very much, Senator Reed. I will be very brief and I apologize to Chairman Bernanke that I cannot stay. I have been looking forward to this hearing, but I have another commitment.

I am drawn to the sentence at the bottom of page 3 of your statement: "Of course, inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability." And the question I want to raise to you is that in order for the Federal Reserve to demonstrate its commitment to price stability, is it necessary for the Open Market Committee to raise interest rates 25 basis points every time they meet?

Chairman Bernanke. No, Senator.

Senator Sarbanes. Well that is fine. All I need is an answer, just so I——

Chairman Bernanke. If that satisfies——

Senator Sarbanes [continuing]. Just so I know that we are not on an irreversible treadmill here, since we have seen 15 meetings in a row in which the Open Market Committee has taken the interest rates up. But it has not built itself in so that you have to do that at every meeting in order to show that you're inflation fighters, is that correct?

Chairman Bernanke. Yes, Senator. Our assessment currently is that the risks to inflation are perhaps the most significant at the moment and we need to address that. But as I emphasized in my statement—I make two points: first is that now that we have taken away most of the extraordinary accommodation that we had in the system back from 2003, we are much more data-driven, we need to continually reevaluate our forecasts and think about the prospects for the economy and make our decisions based on the information that is coming into our hands.

And second, as I noted in my written testimony, there is always the possibility that if there is sufficient uncertainty that we may choose to pause simply to gain more information to learn better what the true risks are and how the economy is actually evolving.

Senator Sarbanes. Well, I see that the minutes of your most recent meeting on March 28th did say, "Most members thought that the end of the tightening process was likely to be near and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy." I very much share that concern, and so I welcome that statement and I hope the Open Market Committee will, in effect, act off of that statement in the upcoming meetings.

The other point I would like to raise to you is I want to again urge you, as we did when we held your confirmation hearing, on the issue of Federal statistics and the importance of having appropriate and accurate Federal statistics. A number of us in the Congress—71 Members, 29 Senators and 42 House Members—have written to the President about the elimination of the Survey of Income and Program Participation series, and we urge the Administration to try to find money with which to continue that particular program.

I think if the Chairman of the Fed would take a keen interest in Federal statistics, it would be very helpful in assuring ourselves that we have accurate and reliable data upon which to make some of these decisions. Major decisions are being made that have vast economic implications, and yet the amount of money going into the methodologies is very, very limited. We were never able to get Chairman Greenspan to agree to any spending program except Federal statistics. He did on one occasion say that he thought we ought to do more. So I would just leave that idea with you. Thank you very much.

And thank you, Senator Reed.

Representative Saxton. Thank you very much, Senator Sarbanes.

Senator Bennett.

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

I would note your comment with respect to rate hikes. Everybody wants to read into what you are saying to get an advance understanding of what is going to happen tomorrow. My own sense is that the economic information tomorrow is going to be very strong with respect to GDP growth in the first quarter; you indicated your assumption that that will be the case. My market watchers say that could be really bad for the market, because when the GDP numbers come out very strong, that means the Fed is going to raise interest rates and they are all going to sell off in anticipation of that.

I recognize that there is no way you or I can anticipate what you are going to do at the next FOMC meeting but, following up on Senator Sarbanes, I would just reassure the people who were concerned about this, Chairman Bernanke has said that even if in the Committee's judgment the risk to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook.

That is a very Greenspan-type statement, sufficiently tipped in both directions, but I take it as a signal that what you have said to Senator Sarbanes here is correct, that we are getting to the point where this almost automatic increase is not going to occur. And Chairman Greenspan made it very clear in his statements that there was going to be an automatic increase every single time they met when the rate was 1 percent. And he tried to be as clear as he ever could be that that was going to happen, and I welcome this statement and I think in this conversation we have had, we ought to highlight it one more time, as I have done.

Now, let's talk about the global savings glut. You have made mention of that, suggesting that one of the explanations for the persistence of relatively low long-term interest rates has come from a global savings glut. And as long as we are looking into crystal balls and trying to predict what is going to happen, let's get out of the FOMC crystal ball and look around the world. Do you think there is still a global savings glut and what is your sense as to how long it is going to continue? Because that has a great deal to do with the current account deficit and people investing in the United States and so on.

Chairman Bernanke. Thank you, Senator. Just to provide a little bit of background, I have argued in the past that there is an excess of saving over investment in our trading partners around the world and that extra saving has come to the United States, has driven down world real interest rates, and has been part of the reason for our current account deficit. And I do believe that is part of the explanation for why the current account deficit of the United States has risen and part of the reason why, as I argued earlier, it is really a global issue and not just a United States issue to deal with this deficit.

In terms of whether the savings glut still exists, there is a short-term and a long-term answer to that question. Relevant to my earlier comment, I think we are seeing a bit of a decline in that glut in that interest rates—global interest rates, not just those in the United States—long-term rates have risen in the last couple of months, suggesting some reduction in the excess of savings over investment outside of the United States, and I think that is perhaps a small step in the direction toward the moderation of the savings glut.

Longer-term, though, I think there is still a long way to go. And, in particular, what is needed is for our trading partners, including those in southeast Asia, and also oil producers, emerging markets generally, to rely more heavily on their own domestic demand as a source of growth rather than on exports to the United States.

To take one example, I do see some encouragement that the Chinese are at least talking about these issues, that they have recognized that it is not in their interest to run their economy as an export-led economy indefinitely, and that they are at least discussing some approaches to increase domestic consumption in order to reduce the amount of saving that they put into the world capital markets.

So these are steps that are promising. It is still very early; there is not much to be seen from it yet. But that is the kind of development that, over a number of years, will help rebalance the world

economy so that the U.S. is not importing goods and capital at such a high rate and other countries are growing more from their domestic demand and less from exports.

Senator Bennett. So if I can summarize without putting words into your mouth, the solution to the current account deficit given the scenario you have outlined, could very well come in slowly over time rather than dropping off a cliff, and we could see this thing resolve itself in the next, say, within the next decade or so.

Chairman Bernanke. I would not expect it to resolve in a short period. It is going to take quite a few years for these balances to readjust internationally.

Senator Bennett. But you do not see it dropping off a cliff.

Chairman Bernanke. I do not expect any such change.

Senator Bennett. Good. Thank you.

Representative Saxton. Thank you very much, Senator.

We are going to go now to Mrs. Maloney, the gentle lady from New York.

Representative Maloney. Thank you.

Welcome, Mr. Bernanke, and thank you for your testimony. Democrats are concerned not only about price stability and maintaining and controlling inflation, but also jobs, wages, and continuing to grow our economy. We are very concerned that in the recovery the economic positive impact has not shown up in the wages of the average worker and there has been a decline in the past 2 years, and we hope you will take that into consideration as you develop monetary policy.

My constituents are very concerned, I would say even nervous about this continued clip or pace in the increase in interest rates—it has been raised 15 times since June of 2004, and there is a feeling that maybe we should step back a few steps and just assess where we are. And there is a deep concern about it and I wanted to relay that to you. My question is can we continue to increase interest rates without having a negative impact on our economic growth?

Chairman Bernanke. Thank you for the question. Let me just address a few parts of it, if I might.

On wages, real wages have not grown at the pace we would like to see. There are a number of reasons: energy prices have clearly sapped consumer buying power. There has been a spread between real wages and compensation reflecting increased health costs, health insurance costs, for example, and, most puzzling, real wages have not apparently caught up with the productivity boom that we have seen going on in the economy.

My suspicion is that as the economy continues to strengthen and labor markets continue to strengthen, we will see further increases in real wages and that will be very desirable. I would also add that I do not believe that higher real wages are inflationary. Higher real wages can be offset by higher productivity and they can be offset by lower margins between costs and selling prices. And so I do hope to see higher real wages going forward.

With respect to the Fed's mission, as I argued before, it is like the seventies when inflation was out of control and those were not good times for workers either. I think we all benefit from price stability. The Fed has a very important objective in maintaining price

stability and credibility that is going to keep prices at a stable point. And I believe that doing so supports strong and stable employment growth, and that is the other part of our mandate, to which we are going to pay very serious attention.

Representative Maloney. Do you believe we can continue to raise interest rates without having a negative impact on our economy?

Chairman Bernanke. I think we will try to raise rates, if we do, in a way that maximizes the attainment of our objectives, which are price stability and maximum sustainable employment growth. Employment growth that is not sustainable and which leads to——

Representative Maloney. Mr. Chairman, are we not near full employment now, so——

Chairman Bernanke. But the underlying growth of the economy, which is being determined by a very robust productivity increases, is still going to be quite healthy, and so my anticipation is that for example, in 2006 we are still going to see growth in the range between 3 and 4 percent, a very healthy pace of growth, and I believe that would be consistent with our attempts to keep inflation well anchored.

Representative Maloney. In your testimony you said our accounts deficit, our trade deficit, was 6–6½ percent of GDP and that this was unsustainable and that our world partners, our global partners, are saying the same thing. Right now we have very low national savings and also this large trade deficit. What role does fiscal discipline have in addressing these problems and, second, what will happen if we do not get control of the Federal budget? What will happen?

Chairman Bernanke. Well first of all, it is very important that we get control of the fiscal situation, particularly over the longer term. As my testimony elaborates, in particular as our society ages, the share of GDP going to the three major transfer programs is going to go from about 8 percent of GDP today to about 16 percent in 2040. And if that were to transpire as forecast, we would be faced either with essentially cutting all other types of spending or raising taxes quite substantially. So there are some very hard choices to be made if our Federal budget is going to be sustainable into the next few decades. That is very important, and we need to be thinking about that soon. The sooner we make these hard choices, the better the economy will be able to adjust whatever changes we make.

With respect to the current account, there is a link, a somewhat weak link, between fiscal and current account deficits. To the extent that fiscal deficits reduce national saving, that in turn contributes to the need to borrow abroad, which a part of what the current account deficit is about. Unfortunately, most of the research suggests that fiscal consolidation by the United States on its own will only have modest impacts on the current account deficit. Every dollar or so by which the fiscal deficit is reduced by most estimates would only reduce the current account deficit by 20 or 30 cents for various reasons that I could get into.

But the implication is that the United States really cannot solve the current account deficit problem by itself. It is a global issue.

We need the cooperation of our trading partners. And all together, by taking actions which are in our own individual interest, we can also help create a better balance in terms of trade flows as well.

Representative Maloney. My time is up. I did want to ask what we could do about this growing inequality, but maybe the next round.

Chairman Bernanke. Sure.

Representative Saxton. We are going to go to Mr. Ryan next, but I cannot help but talk a little bit here just for a minute about a real-life experience that I had relative to interest rates and inflation expectations. In 1965, I graduated from college and in 1966, I became a real estate salesman. And I remember for quite a few years whether I went to Bank A, B, or C, the interest rate on home mortgages was 6 percent. And as we got to the late 1970s all of a sudden inflation became an issue. And by the end of the seventies, 1978, 1979, inflation had reached double digits. And when we went to the bank with the person who wanted to buy the house, they were told the interest rate was 18, 19 or 20 percent. And when I asked the bankers why that was, they said because we don't know what inflation is going to be next year. Our expectation is that we don't know, and therefore we have to hedge against even higher inflation than 10 or 11 percent.

Today's interest rates are back where they were essentially in 1966, when I was a young guy and a real estate salesman. And today home mortgage interest rates are at 6 percent because the expectations of inflation going forward are that inflation is under control. And I credit the policy of the Fed over the past couple of decades for bringing us back to 1966 levels of mortgage interest rates.

I wanted to note that because everyone in the public should have the opportunity to understand what it is that the Fed has been successful in doing over these years. And I don't know whether you would like to comment further on that, but this is an extremely important element going forward with respect to economic growth.

Chairman Bernanke. I would just add that it's often neglected that the third part of our legal mandate is to maintain low to moderate long-term interest rates and that is, of course, best achieved by keeping inflation not only low, but keeping a high degree of confidence among bond traders and the like that it will stay low.

Representative Saxton. We have a chart over here that shows the path of inflation during the decades of the 1980s and 1990s and into 2000. It very clearly shows that during the early 1990s inflation peaked out at a very moderate 4.5 to 5 percent and today we are down to a rate that appears to be under 2 percent. And so these are what creates the environment in which long-term rates are set. And so to the extent that we thank you and your predecessor for helping us to understand this, it has been a very, very healthy process.

[The chart entitled "Inflation" appears in the Submissions for the Record on page 41.]

Mr. Ryan.

Representative Ryan. Thank you, Chairman. We have belabored monetary policy so I am going to switch to fiscal policy, but I want to just make one point. Chairman Bernanke, I am very

pleased and encouraged with what you had to say about inflation targeting. To the extent that the Fed can institutionalize expectations and smooth out the investment horizons and remove further uncertainty by being more transparent with inflation targeting, I think that is a fantastic contribution you can bring to the Federal Reserve, so I am very encouraged with your statements on that.

On fiscal policy, we are in the midst of considering tax legislation right now as to whether or not to extend the tax cuts that passed in 2003. Many of us are concerned that large tax increases at this time, during our economic recovery, would be a bad idea. I just want to go through a few statistics, because we have seen people make points to the contrary which don't necessarily add up.

Since the 2003 tax cuts—first of all, our unemployment rate was 6.3 percent at that time. Now it is at 4.7 percent. Since the 2003 tax cuts, we have gained net in the employment survey 5.2 million new jobs. Our economic growth rate, the 10 quarters preceding the tax cuts was 1.3 percent, the 9 quarters since then it has been 3.9 percent; so we have seen a remarkable turnaround I would say due in large part to the fiscal policy of our country. But now is the time to talk about whether or not to extend these things. And people have been talking about revenues.

When we passed it—I serve on the Ways and Means Committee, and we looked at these revenue projections quite a bit. And we thought, according to our estimates, that we would increase the deficit or that we would actually see a reduction in revenues. And what actually ended up turning out was that our revenue projections by the Joint Committee on Taxation didn't materialize; actually revenues increased at these lower tax rates. Economic revenues from the individual side in 2004 were up 1.9 percent at the lower tax rates and the corporate income tax receipts were up 43.7 percent in 1904. In 1905, revenues were up 14.6 percent on the individual side and 47 percent on the corporate side.

At this moment, we are debating tax legislation as to whether or not to extend the 2008 deadline on capital gains and dividends. And that is where some people are saying the dividends—the capital gains tax cuts cost us money.

The Joint Committee on Taxation at the time, in 2003, told us that we would lose $27 billion in revenue in lower receipts over the years 2004–2005. What actually materialized, the actual revenues were, realization surged and receipts went up. The receipts increased by $26 billion. So we went from a projection of a $27 billion loss over 2004 and 2005 to actually increasing tax receipts from capital gains at the lower tax rate by $26 billion over that, so an enormous difference.

The question I basically have is do you agree that the tax cuts have been helpful to economic growth, and do you see a benefit in providing predictability to investors on tax rates? I clearly can tell that you believe there is a benefit to providing certainty with respect to monetary policy, thus the discussion on inflation targeting. Do you believe that there is a benefit to the economy and to investors by providing certainty on tax rates given the fact that virtually every corner of the Tax Code is up for grabs in either 2008 or 2010?

Chairman Bernanke. Mr. Ryan, I highly value the nonpartisan nature of the Federal Reserve, and for that reason I have decided

that I will not be advising on specific individual tax and spending programs. I will make a couple of comments, though, which I hope will be useful.

One is that I do agree that fiscal policy, along with monetary policy, was an important factor in helping to restart the economic engine in this latest episode, and some of the statistics you quoted suggest that we did go from a very weak situation early in 2003 to a much stronger growth path after that.

The other comment I would make on your issues with respect to revenues I have addressed in a recent letter, and that concerns the issue of dynamic versus static scoring. To the extent that tax cuts, for example, promote economic activity, the loss in revenues arising from the tax cut will be less than implied by purely static analysis which holds economic activity constant.

There is currently an important and interesting debate going on to the extent to which so-called dynamic scoring should be used in the Congress. I don't want to come down with a definite recommendation. One issue is that any dynamic scoring model requires some assumptions about what theory, what model, you are going to use to make the assessment, and, therefore, you are going to have to look at different alternatives in coming up with an outcome. But I do think it is worth considering an alternative range of scoring mechanisms to give Congress a sense of what the possible outcomes would be on the revenue side from different tax changes.

Representative Saxton. And as to promoting certainty in the investment markets and in households and businesses to the tax climate in the future?

Chairman Bernanke. Well again, I don't want to make a definite recommendation. The specifics of the dividend tax extension, for example, would involve not only considerations of efficiency, but also considerations of equity and revenues. But looking strictly at the efficiency side, clearly more certainty about the tax code—and I think this applies to any tax regulation—when people know the tax rules are going to be stable, they are going to have stronger effects and more positive effects than if they are worried that they are going to be changing from year to year.

Representative Saxton. Thank you.

Senator Bennett. Senator Reed.

Senator Reed. Thank you, Mr. Chairman. Thank you for your testimony today. And just in line with the question about the effect of tax cuts, the former chairman of the Council of Economic Advisors, Greg Mankiw, wrote in his macroeconomic textbook that there is no credible evidence that tax cuts pay for themselves and that an economists who makes such a claim is—quote—"a snake oil salesman who is trying to sell a miracle cure." Do you agree with that?

Chairman Bernanke. I don't think that as a general rule tax cuts pay for themselves. What I have argued instead is that to the extent the tax cuts produce greater efficiency or greater growth, they will partially offset the losses in revenues. The degree to which that offset occurs depends on how well-designed the tax cut is.

Senator Reed. If you will let me—this goes out of the realm, I think, of macroeconomics to simple arithmetic. We are running a huge deficit, so over time if the tax cut doesn't pay for itself and we cut taxes again, we are not likely to help the deficit. Is that a fair judgment?

Chairman Bernanke. Well, the issue as always is whether the deficit should be adjusted on the spending side or on the tax side, and I have to leave that to Congress, those are very difficult value judgments.

Senator Reed. Well you are very clear in that statement, but I can assume that those tough choices that must be made include choices on the revenue side as well as the spending side, is that your view?

Chairman Bernanke. I would say that if you are one of those who supports low taxes that you also have to accept the implication that spending also has to be controlled in a commensurate way, whereas if you are in favor of a larger government, then you have to accept the corollary that taxes have to be higher. So, I think the specific law I am arguing for here is the law of arithmetic, which says——

Senator Reed. Well so am I, but right now the arithmetic is not running favorably in terms of those people who want fiscal discipline.

Chairman Bernanke. And I am agreeing that people need to be consistent in their choices.

Senator Reed. Thank you.

One of the issues that Congresswoman Maloney mentioned and I am concerned about also is this growing inequality.

Your recent survey of consumer finances has some very disturbing data. According to the statistics, the top 1 percent of families hold more wealth than the bottom 90 percent of families combined. And that is accurate, I presume?

Chairman Bernanke. Yes.

Senator Reed. It suggests that in most families wage is the main source of income. Is that true also?

Chairman Bernanke. Yes.

Senator Reed. These figures on wages are not encouraging. After accounting for inflation, the median usual weekly earnings of full-time wage and salary workers fell by 0.9 percent between the end of 2000 and the end of 2004, and the earnings at the 10th percentile fell by 2.1 percent. But meanwhile, earnings for the 90th percentile, the upscale workers, were up 4 percent.

We are seeing a divergence between low-income/moderate-income Americans, who are losing ground, and very wealthy Americans, who are gaining ground. And that has not only economic consequences, it has social and moral consequences in many respects.

What do we do about this? What policies can we adopt to, as you indicated in your statement, not only increase wages, but make sure that those benefits are more equally distributed?

Chairman Bernanke. Senator, first of all, I agree that the increasing inequality in wages is an important social problem, first, because we care about our fellow citizens and want to be sure that they are living in a decent way, but second, from a political point of view our society is based on opportunity, it is based on flexibility

in labor markets and product markets, it is based on open and fair trade, and all of those things are at risk if a growing portion of the population feels they are not sharing in the benefits from those changes.

So, I am very concerned about rising inequality. It is a very difficult problem. I think it should be made clear that the growing inequality in wages which we are seeing is not a new phenomenon. It has been going on for about 25 years or so. And indeed a good bit of it occurred in the early 1980s.

There are a number of arguments and analyses about why these increases are taking place. My own view, and I think that of most economists, is that the dominant factor is the increase in the return to skills; the fact that as our society becomes more technologically oriented, people who have not necessarily formal education, but other kinds of skills, on-the-job kinds of training, will get a higher return, get a higher wage.

So, for a given distribution of education, these changes, this skill-biased technical change, is going to cause the wage distribution to widen.

In addition, it has been pointed out in some recent research that there is a phenomenon at the very top, the so-called "super stars phenomenon," which suggests that, given the size of our markets and the interconnectedness of our world economy, those people who have extraordinary skills can command tremendous premiums for their work.

Consider what a star baseball player receives today versus 20 years ago, the fact that that player can now play before much larger markets and through an international market; that affects their wages, as well.

So again, my main explanation for this phenomenon is the higher return to education, the higher return to skills. What can we do about it?

Well first of all, the Federal Reserve will do what it can, which is primarily to try to maintain strong and stable employment growth, and that is going to keep providing opportunities for people and give them on-the-job experience that will allow them to have higher wages.

But more broadly, the only really sustainable response to this problem is to alleviate the skills deficit. Sometimes that is taken as a counsel of despair because it takes such a long time to improve our school system and to bring a whole new generation through the system, but I would like to point out that skills can be acquired through a whole variety of programs and mechanisms, including on-the-job occupational training, community colleges, technical schools, and all kinds of other vehicles which would allow people to upgrade their skills relatively quickly.

In our current labor market, people with skills like commercial drivers' licenses, or practical nursing degrees, are at a premium. They have sufficient skills that they are in high demand. So, I do think that it is feasible within a medium-run period of time to upgrade our skill base sufficiently to make a noticeable dent in this inequality.

I agree it is a very difficult problem, and I hope that we will address it because it does pose issues for our political economy, as well as for our society.

Senator Reed. Just a final point. Do you believe it should be the conscious policy, for all the reasons you espoused, of this Government to raise wages and distribute them more equally in terms of our economic performance?

Chairman Bernanke. Well, in the current Administration?

Senator Reed. Well, in any Administration.

Chairman Bernanke. Well, administration after administration have tackled the educational issues. This Administration has its own program. Others have had others. There is a significant amount of money being put into job training programs and there have been suggestions for reform about how to make that more effective and more efficient.

There has been a lot of support for community colleges. Your colleague, Senator Dole, for example, has often talked about the benefits of community colleges.

I make just one additional comment, which is that one area where we are quite deficient is in financial literacy. Many people who earn even a moderate income are not able to save and to build wealth in part because they may not understand enough about banking and financial markets to allow them to do that.

So, I am very much in favor of activities through the Congress, the Federal Reserve, and through the financial sector itself to help train people to understand better how to save, how to budget, and how to build wealth for themselves and for their children.

Senator Reed. Thank you.

Thank you, Mr. Chairman.

Senator Bennett. Thank you very much.

Senator Sununu.

Senator Sununu. Thank you.

Chairman Bernanke, a number of economists and regulators, including members of the Fed, have testified to Congress on a number of occasions that the business models of Fannie Mae and Freddie Mac effectively amount to privatized profits coupled with socialized risk that stems from the implied guarantee behind their securities.

Your predecessor spoke clearly of the need for Congress to anchor the companies more firmly in their housing mission—which we all agree is very important but from which they have strayed at times—and he noted the danger and the risks that are presented to our financial system and the economy by Fannie and Freddie's very large, maybe more fairly put, massive investment portfolios.

I have a letter from Chairman Greenspan, Chairman Bennett, that I would like to be included in the record——

Senator Bennett. Without objection.

Senator Sununu. [continuing]. Which addresses the relationship between these portfolios and the housing mission.

[The letter from Chairman Alan Greenspan to Senator John Sununu appears in the Submissions for the Record on page 47.]

Senator Sununu. But in short, the research done by Fed economists has shown that their investment portfolios simply act as investment vehicles whereby they can arbitrage their low borrowing

rates against higher yields for mortgage-backed securities. As a result, they earn great profits, but they do so in a way that does not result in better accessibility for 30-year mortgages, and lower interest rates for consumers.

That is a very profitable arbitrage operation and, as a result, we should not be surprised that Fannie and Freddie do not support provisions in our GSE legislation that passed the Senate Banking Committee that would give a regulator power to set limits on those portfolios consistent with their mission.

Now in the coming months, as they square away the many financial and accounting irregularities that have delayed their issuing of financial statements, OFAO, their current regulator, will lift its requirement that they put aside additional capital.

For Fannie Mae, for example, that is going to result in a release of $5 to $6 billion. When that capital is leveraged by what is typical for these institutions 30 or 40 times, that means that they could potentially grow their portfolios dramatically—$250 billion or more.

This causes me great concern given the very significant systemic risks that exist, but I think, fortunately for the taxpayers, the Treasury does have some power to limit the size of the portfolios, and in particular the statutes governing Fannie and Freddie state that the corporation is authorized to issue, upon the approval of the Secretary of the Treasury, and have outstanding, at any one time, obligations having such maturities and bearing such rate or rates of interest as may be determined by the corporation—again, with the approval of the Secretary of the Treasury.

So obviously the Secretary has the power in statute to clearly limit the issuance of GSE debt.

My question is that, given the nature of the implied guarantee, is this power that has been given to the Secretary in statute an important power to have, given the structure of these corporations? And under what circumstances should the power be exercised?

Chairman Bernanke. Thank you, Senator.

I would like first just to comment on the S. 190 legislation on portfolios. There is a misperception, I believe, that the legislation calls for hard caps, or for specific numbers, and that is absolutely not the case, as you well know.

What the legislation tries to do is specifically to anchor the size of the portfolio in the housing mission so that it serves the mission and not other purposes.

In particular, the portfolio would be allowed to hold affordable housing mortgages that are not otherwise securitizable. They would be allowed to hold as much liquidity as they wished in order to intervene perhaps in the housing markets during periods of stress, but it would be limited in securitizable MBS which, beyond a moderate amount for inventory purposes and the like, is really not a direct or obvious affordable housing reason for those holdings.

You are correct, as far as I understand, that the Treasury does have the power to limit the debt issued by the GSEs, and perhaps some power even over the terms or maturities, as you suggested.

My preference, in terms of making sure that this is done right would be to ask the Congress to, or hope the Congress could, make clear to the regulator what the expectations of the Congress were

and what the powers of the regulator were. That would be, I think from a political economy point of view, the right first step.

If we were unable to achieve progress through Congress, I don't think Treasury should abandon that power. I think it should consider using it if it believes that the systemic risks being generated by the portfolios greatly outweigh the benefits that are mandated by the affordable housing mandate.

Senator Sununu. So in structuring the language in the legislation—and you have spoken about the legislation I think in past hearings—one, to reiterate, you would not recommend a hard cap, and we have no such hard cap in the legislation; are certainly comfortable with maintaining portfolios in the kinds of securities that you describe; and feel that the portfolio should be consistent with the housing mission, as everything that they do should be consistent with their mission as chartered by Congress.

One, is that a fair representation of the key elements that we consider in the legislation?

And is there anything else that you think would be important to maintaining an appropriate level of flexibility?

Chairman Bernanke. No, I think that is a fair characterization and I agree with that characterization. I would just add that the S. 190 bill also has some important provisions relating to capital and receivership which are part of making the GSE regulator more like a bank regulator with adequate supervisory powers.

Senator Sununu. Thank you.

Thank you, Mr. Chairman.

Senator Bennett. Thank you.

Mr. Hinchey.

Representative Hinchey. Thank you, Senator.

Thank you very much. Mr. Chairman. Thank you for your testimony here today and for your service. I very much appreciated listening to you. It has been very instructive.

We have heard a lot about the positive aspects of the economy, including things like low interest rates, and it may have been mentioned also that the productivity rate is now I think more than 3 percent. There are a lot of positive aspects to that.

But there are also a conflux of circumstances that need to be addressed, I think, as well. We live in a demand economy. I think every successful entrepreneur, at least since Henry Ford, has understood that. But we are not doing much to deal with that end of our economy.

As you pointed out just a few moments ago, for the last 25 years or so the median household income of American families has been stagnant or declining during that period of time. But it has dramatically dropped in the last few years.

In the last few years, that median household income has gone down by almost 4 percent.

So we are facing a number of circumstances that we are not really addressing. Rising income inequality has been mentioned on a number of occasions here. We also have very low and declining personal savings rates. We have a huge and growing debt. And the current account deficit, which you talked about a moment ago, is also placing a heavy burden on our economy.

These rising imbalances are seemingly at the moment peculiar to America. You have no other industrial country that has this conflux of circumstances in the way that we do. And it seems to me that they are essentially impracticable and unsustainable.

So I just would like to hear your opinion on what we ought to be doing to deal with these circumstances on the demand side. We have this huge tax cut, the benefits of which have flown to people who are already very secure, and these benefits have made them even more so.

The primary beneficiaries of that tax cut are the richest 1 percent and those just a few percentage points below that group. But it has little or no effect, obviously, based upon these statistics, on the average working family.

What should we be doing to deal with those economic circumstances?

Chairman Bernanke. Thank you, Congressman. The United States is unique in some respects and not in others. We do have an unusually large current account deficit. There are some smaller countries with large deficits, Japan and Germany have surpluses, and I have discussed some of the ways in which we can address that particular problem.

On the long-term issues of the fiscal deficit, one of the main drivers there is the aging of the population. In that regard, we are perhaps no worse off than some of the other major industrial countries which are aging quickly. Even China, surprisingly, because of their one-child policy, will become as old as the United States by the middle of this century.

So the aging and the demographic transition and the implications that that has for fiscal policy is a broader issue, a difficult one, but one that we share with others.

I have already addressed to some extent the inequality issue. We are not the most unequal country in the world by any means, but this trend is a disturbing one and it has I think unfortunate consequences for our political economy.

I am not quite sure what you mean by "demand policies." I think that if you mean fiscal and monetary policies to bring the economy to full employment, I think we have worked hard on that and the economy is approaching a sustainable growth path consistent with maximum sustainable employment.

But I do think that if we are going to address wages, and in particular inequality in wages, we have to to do that I would say on the supply side. That is, by addressing the skills gaps that exist among different groups of people in our society.

Senator Reed. Well if that is the case, then we are going in the opposite direction because we are cutting back on education and training, and we are cutting back on various ways in which we can enhance the skill sets of our personnel. We are doing that in the context of the Federal budget.

We are also seeing a decline in pensions as we move away from defined benefit to defined contribution benefit pension programs. These are going to reduce the economic circumstances of people who are working today and those who are about to retire.

So I think the point is that while the emphasis of this particular Government, this Congress and this Administration, has been on

tax cuts and enormous amounts of spending, it is not in ways that are going to enhance the economy.

We are not doing anything, for example, to increase the amount of goods that we produce that are marketable both here in America and around the world. In fact, the amount of goods that we produce that fall into both of those categories is declining, and that of course is a major contributor to the current account deficit that we are experiencing.

So are there not other things that we could be doing, and should be doing, to deal with those aspects of this economy?

And although you mentioned that there are other countries that have similar circumstances discretely in one or two of those categories, I do not think there is any other country in the industrial world—no other advanced country—that is confronting this confluence of circumstances. And I do not know how this economy is going to continue to prosper unless we begin to deal with those circumstances which are unique in the industrial world.

Chairman Bernanke. A point on which I am very much in agreement is that in thinking about the budget, it is not enough just to say what is the total amount that we are spending; it is really how well are we spending it?

The programs we are spending it on, are they effective? Are they delivering results? So I would urge Congress to look very hard at the mix of programs that you authorize to make sure that they are producing returns for the dollar.

So in particular looking at education, are there ways to increase accountability? To increase flexibility? To allow schools to do a better job?

With regard to job training programs: We spend on the order of $15 to $20 billion a year on job training programs. Is that money being well used? I think it is enormously important for us to review those programs on a regular basis to make sure that the benefits are flowing to the people who need them and not just being lost in the bureaucracy.

Senator Reed. Thank you.

Senator Bennett. Mr. English.

Representative English. Thank you, Mr. Chairman.

Mr. Chairman, your testimony here has been actually a source of not only interest to me today but also a source of great encouragement. But I would like to pursue a couple of the specific issues that you have brought up in your testimony.

I first of all found it refreshing that you focused as heavily in your printed remarks as you did on the challenge of the U.S. current account deficit.

On that point, you specifically mentioned that you think it is appropriate for some of our trading partners to pursue exchange rate flexibility.

In your view, given that China now has massive currency reserves, is China in a position to move seamlessly toward a position of exchange rate flexibility to benefit themselves, as well as presumably to stop dictating for their goods an artificial price advantage?

Chairman Bernanke. China certainly could and should do more toward increasing the flexibility of its foreign exchange re-

gime. A point I think that is worth emphasizing and that we have tried in our bilateral discussions to make with the Chinese, and Treasury of course takes the lead on this, is that increased currency flexibility is in China's interest.

It is a very large country. They need to have an independent monetary policy. They cannot really run an independent monetary policy without a flexible exchange rate.

Moreover, their current policies are distorting prices domestically as well as internationally. And in particular that means that their economy is becoming devoted toward export production and not toward the production of domestic goods and services.

Finally, as an emerging power in the world trading system, China has an interest in global stability, as do we, and by reducing its overall trade surplus, by increasing its focus on domestic demand, and by increasing the flexibility of its currency, it can help improve global stability.

So for all those reasons, I think they should move further. There are technical issues that they are trying to address, but they are quite conservative, let's say, in terms of their willingness to move further on this issue.

Representative English. And a remark that you made that I found particularly intriguing had to do with your comment about the fact that simply reducing the fiscal deficit will have a limited impact on the reduction of the current account deficit.

You know, I know there has been a great deal of political rhetoric linking the two deficits together. Could you explore for us why there is a limited interaction where a reduction in the budget deficit has only a limited impact on the trade deficit?

Chairman Bernanke. Yes, I would be glad to.

I would first point out that, just looking around the world, there is no obvious correlation between trade deficits and budget deficits.

Japan and Germany have budget deficits which are equal to or larger than ours and they have large trade surpluses. The U.S. trade deficit began to expand in the 1990s at a time when we had a budget surplus. And so there is not an obvious 1 to 1 correlation.

The issue in this case is: If the United States were to reduce its own deficit, if no other action is taken by any other country, that would tend to slow down economic activity by reducing aggregate demand. The Fed, following its mandate for full employment, would lower interest rates, stimulating investment spending in the United States.

And so the investment/savings imbalance would not be much changed if that were the only action being taken. And the estimates that have been made by not only the Federal Reserve, but by the OECD and others, are that a dollar reduction in the U.S. budget deficit only would by itself lead to about a 20 to 30 cent reduction in the current account deficit.

By contrast, if the U.S. budget deficit reduction were accompanied by increased demand abroad so that the Fed would not have to respond—that is, exports would take the place so to speak of Government spending—then you could get a much bigger pass-through from deficit reduction into current account deficit reduction.

Representative English. That is an excellent analysis.

Mr. Chairman, I had not planned to bring up this final point, but in response to some of the strawmen that have been brought up earlier in previous questions, I wanted to explore the issue of whether tax cuts can actually promote enough economic growth to pay for themselves.

I note that in 2003, before the reduced rates of tax on capital gains were passed, the CBO estimated the total capital gains liabilities in 2004 and 2005 would be $125 billion.

Following the passage of the new tax rates, CBO revised its estimates and at that point their estimate for capital gains tax liabilities in '04 and '05 had fallen to $98 billion, a drop of $27 billion.

Earlier this year, however, CBO reported on actual capital gains liabilities in '04 and '05. Rather than falling by the projected $27 billion, they actually rose by $26 billion to a total of $151 billion.

Mr. Chairman, I recognize that many factors influence capital gains realizations, including the strength of the economy, but as many experts have speculated the lower rates clearly are partially responsible for improving the economic outlook and rising stock prices.

You know, accordingly, can we look at these actual revenue numbers and not conclude that, at least at some level, these tax rate reductions have actually produced added revenue for the Treasury?

And, accordingly, slapping on a tax increase because it is a tax increase, that some on the other side have suggested in this area, might actually generate—might actually not generate the revenue that we need in order to deal with the deficit?

Chairman Bernanke. As you point out, Congressman, this is a complex issue. There are a lot of factors affecting both the increase in the stock market and realizations. And one of the issues here is the question whether or not some realization is taking place today which otherwise might have taken place in the future.

And so in that sense the increase in tax revenue is reflecting a one-time gain as opposed to a permanent gain. So that is one of the issues that you would have to address in analyzing the revenue effect.

But I go back to what I said before, which is that well-designed tax cuts which stimulate economic activity will at least partially offset the revenue losses by stimulating the tax base.

Representative English. Thank you, Mr. Chairman.

And thank you, Mr. Chairman.

Senator Bennett. Thank you.

Mr. Paul.

Representative Paul. Thank you, Mr. Chairman. I would ask for unanimous consent to submit some written questions, if I don't get through this.

Senator Bennett. Without objection.

Representative Paul. Thank you, and welcome. Mr. Chairman. I have a question dealing with inflation targeting, but I wanted to make a few assumptions first and have you comment on these assumptions, as well.

You state that inflation is under reasonable control at the moment. I have a lot of constituents that would disagree with you, and would disagree with the chart because if you look at energy

and medicine and education and taxes, there's a lot of price inflation out there that they are concerned about.

I think there is a discrepancy in who suffers the most from higher prices. Sometimes the wealthy suffer less than the poor and the middle class because of the way they spend their money. So, one index is not a perfect answer to how people respond to inflation.

One assumption I would have, I think it was Milton Friedman who said that inflation is first and foremost a monetary phenomenon, and I sort of ascribe to that. And many other economists, you know—there's a consensus among many economists that would go along with that.

Another assumption that I would make is that the role of the Fed in dealing with the money supply has to do with increasing or decreasing the money supply, and yet we mostly talk about interest rates, we're raising interest rates or we're lowering interest rates. But my assumption is that we're manipulating increases or decreases in the money supply in order to secondarily affect interest rates.

Assuming that we did not have an Open Market Committee and they ceased purchasing securities, my assumption would be that interest rates would go a lot higher, but we don't know exactly how high. So the Fed's job, generally speaking, is to keep interest rates lower than the market and that the point is there's only one way they can do that and that is increasing the money supply so, therefore, the money supply is the most direct measurement that we need to look at to find out what to anticipate with price increases, also recognizing that productivity obviously influences that.

Traditionally we've always measured our dollar in terms of gold. The dollar was worth $20—gold was worth $20 an ounce when the Fed came into existence. Today that dollar, pre-Fed dollar is worth 4 cents. We've had tremendous depreciation and devaluation and a lot higher prices since then.

We had major events throughout history that were monetary events. During the Roosevelt era, gold going from $20 to $35, and this was considered a devaluation. And then twice under Nixon, an 8 percent devaluation and then a 10 percent devaluation. And then of course when gold was put into the marketplace we had again a lot of devaluation. Gold settled down after that, around $250 an ounce, and that's what the price of gold was in the early—in 2001. Since that time, gold has gone from $250 up to $630, plus or minus. That represents more than a 60 percent devaluation of the currency.

Now in your job in looking at inflation and targeting inflation and looking at prices, how important is this? We do know that central banks around the world—and our central bank is still very much aware of the fact that gold is an important monetary element, it is not like we've thrown it away or sold it. We hold more gold than anybody else. So it is a monetary issue.

But how do you look at this price? Does this concern you? Is it meaningless? What if gold would go to a thousand dollars an ounce, how would that affect your thinking about what to do with interest rates and the money supply?

Chairman Bernanke. Thank you, Congressman. You raise a lot of interesting questions there. I can address a few of them.

It's true that we look at core inflation, which leaves out, for example, energy and food and the question, as you know, is whether that really is representative of the consumer basket that the average person is facing. The answer is no. And we are interested in maintaining stability of overall inflation.

Our focus on core inflation is mostly a technical thing, because generally speaking energy and food prices are more volatile and tend to stabilize more quickly than other parts of the inflation basket. That hasn't been true lately, as you know, and we really need to pay attention I think to the overall inflation rate as well as the core inflation rate.

You're also quite correct that our interest rate policy is closely linked to our control of the money supply, and during periods like the recent one where interest rates have been rising, you also expect to see slower money growth and that in fact has been generally the case, and those two things do go together.

I don't think it's really the case that we keep the interest rate lower than the market. If we were doing that, then financial conditions would be excessively easy and we would probably see more inflation. In fact, although we're obviously not perfect at controlling inflation, not only the Fed, but other central banks around the world have done a much better job in the last few decades at targeting and managing inflation and that at least is positive.

You raise the question of gold, and if your question is do I look at the gold price, it's on my screen, I look at it every day. I think there is information in gold prices, as there is in other commodity prices. But there are also other indicators of inflation. For example, there is the spread between indexed and nominal bonds—the so-called break even inflation compensation, which suggests that inflation expectations are relatively well controlled.

So the puzzle is why are gold prices rising so fast? There is probably some fear of inflation; there certainly is some speculation about commodity price increases in general, which is being driven by world economic growth. But clearly a factor in the gold price has got to be global geopolitical uncertainty and the view of some investors that, given what's going on in the world today, that gold is a safe haven investment and for that reason they purchase it.

So to summarize in trying to forecast inflation, I strongly believe that you need to look at lots of different things. The commodity and gold prices and oil prices, energy prices, are all part of the matrix of things that a good central banker has to pay attention to. But no single variable I think is going to be adequate for judging the inflation situation.

Representative Paul. Thank you.

Senator Bennett. Mr. Brady.

Representative Brady. Thank you, Chairman Bennett.

Mr. Chairman, I'm Kevin Brady, a five-term Member from the Texas area, east Texas and part of the Houston region. International trade is a big job creator for our State and obviously helps stretch families' budgets by giving them lower prices and more choices when they shop. As a Nation we are a fairly open market. How important is it economically that we continue to pursue more open markets overseas, more trade agreements that lower those

barriers and continue to offer more consumer choices here at home? How important is it that we continue to follow that policy?

Chairman Bernanke. Congressman, it's extremely important, and for more reasons than the textbook will tell you, I think. The textbook tells us about comparative advantage, the idea that some countries can produce some things cheaper than others and therefore it pays them to trade to take advantage of that. And that's certainly going on in the world today, we're getting specialization across different countries.

But I think also that an open trading system increases competition, it increases the flow of ideas, increases the flow of capital, and makes the world overall a more dynamic and effective economic environment. And so I think it's a terrible mistake to try to shut out the world, to embrace economic isolationism and, even though it's not always popular, economists and I hope Congress will try to keep trade open.

There is an issue which is an important one, not to be neglected, that while trade provides broad benefits to our society and to our economy, there are sometimes people who are made worse off by trade, workers who lose their jobs because a certain factory goes overseas or because the competition from imports is reducing their market. We need to pay attention to that concern.

But rather than attempting to freeze their jobs in place by preventing any change in the economy, we're much better off allowing the change to take place, but helping people retrain or otherwise provide for themselves so that they can join the global economy rather than be isolated by it. So I certainly agree with your proposition with the proviso that we need to pay attention to those who are adversely affected by trade as well as those who benefit.

Representative Brady. I agree. People oftentimes look at the trade deficit and proclaim it a failure of our trade policy, but your testimony, written testimony, makes the point it's much more complex than just how much we buy and how much we sell. America is a key investment target overseas. But, it is also our failure to save as a Nation is—a factor we can control as a solution on current accounts and the trade deficit. Is it your view that our best solution or approach is increase our savings and increase our sales abroad, which also requires other countries to boost their spending and lower their barriers? Is that the solution to how we approach this problem? It's not to stop free trade, it is to increase our savings and our sales.

Chairman Bernanke. Absolutely. And I think one of the reasons to be concerned about the current account deficit is that it may promote protectionist impulses which would be very counterproductive to our economy.

Representative Brady. Mr. Chairman, let me finish with this thought. I was not going to ask this question, but in the last week we've seen a spate of ideas on how to deal with current energy prices, from a windfall profits tax to today where I read about $100 rebates and gas tax holidays. I won't ask you if these are political gimmicks, but I will ask you are these substantive? Do these substantively, positively impact the fundamental drivers of our energy prices?

Chairman Bernanke. Congressman, unfortunately the high prices we're seeing are due to a multitude of factors, but they're driven primarily by supply and demand conditions in the world today. We have substantial economic growth which generates increased demand, and supply has been very insecure for a variety of reasons. And unfortunately there's nothing really that can be done that's going to affect energy prices or gasoline prices in the very short run. This situation has been building up for a long time.

And what we need to do is think about whether there are actions we can take that, over a number of years, will put us on a more secure footing and allow for either increased supply or reduced demand that will help keep prices down. Unfortunately, after many years of not really doing as much as we should on the energy front, this situation has arisen and I don't see any way to make a marked impact on it in the very short run.

Representative Brady. Does a windfall profits tax increase production or in any way lower our gas prices?

Chairman Bernanke. I don't think it would. Profits taxes have the adverse effect of removing one of the major incentives of our market system. If people think that their profits are going to be taxed away, that reduces their incentive to engage in certain activities.

So I would like to let the market system work as much as possible to generate new supplies, both of oil but also of alternatives, and for the prices, as painful as they may be, to help generate more conservation and alternative uses of energy on the demand side.

Representative Brady. Thank you, Chairman. Thank you, Chairman Bennett.

Senator Bennett. Thank you, Mr. Chairman. This has been a most illuminating morning.

Representative Hinchey. Mr. Chairman, are you concluding?

Senator Bennett. Did you want a second round?

Representative Hinchey. If you don't mind. It's not quite 20 of.

Senator Bennett. All right. Well, in that case, I'll use my prerogative to comment and then yield to you.

I'm on my way tonight to Brussels, where I will be addressing, with some other Members of both the House and the Senate, economic issues with members of the European Union. As your testimony makes clear, the United States would not trade its place economically with any other country in the world. If you look at the level of unemployment, if you look at the level of deficit computed as a percentage of GDP—rather than in total dollars—and if you look at the aging populations and the demographic projections in other developed countries of the world, and every other country would like to be where we are, which is not to say we don't have serious problems.

But I think we should put it in that perspective, and that's going to be, I think, some of the conversations we will have in Brussels.

With your predecessor, Chairman Greenspan and I used to have a kabuki dance that we went through every time he appeared before this Committee, and I had not planned to do it here, but it keeps coming up. I would always ask him, stroking my chin in a thoughtful fashion, as if it has just occurred to me, Mr. Chairman, what is the ideal capital gains rate?

And he would stroke his chin and say, Senator, the ideal capital gains rate is zero. And I would say, thank you, and, you know, we would do that every time he came, because capital gains means if there's a capital gains tax rate, it locks the capital to the degree that the rate is high, in its current investment.

And it may well be that the entrepreneur or the venture capitalist who has built, by his investment, Business A, now wants to sell Business A to the pension fund that's perfectly happy with the mature investment, and move that venture capital to Business B, that creates an opportunity for more entrepreneurial activity, and, thereby, more wealth.

But there is a barrier to making that movement from a mature business to an entrepreneurial activity, in the form of a tax. As we lower that tax barrier from 28 percent to 20 percent, we see more capital flowing over the wall, if you will.

And when we lowered it again to 15 percent, we saw more capital flowing over the wall, and I would like to see the barrier disappear altogether, because the two things that are essential to create wealth, are accumulated capital and risk-taking.

And if the accumulated capital is held in one place where the risk-taking—it can't join with the risk-taking in another place, the economy, as a whole, doesn't get the benefit of the growth.

Now, that's my non-professional economic analysis, and having done that dance with Chairman Greenspan, I now give you an opportunity to comment on it one way or the other, and disagree with your predecessor, if you will, but let's at least discuss that, because I think that is the major issue with respect to capital gains.

It has to do with the movement of capital to the place where it can produce within the economy, ultimately the most wealth.

And I would add this comment: When we asked Chairman Greenspan, during the great expansion of the late 1990s, who is benefiting the most, even though the statistics were showing the great growth at the top, he very instantly said, the people who benefited the most from this booming economy, is the bottom quintile, because they have jobs.

And the difference in lifestyle for Bill Gates, by this growth, is really nothing, but the difference in lifestyle by people who can't get jobs who now can, because there's a booming economy, is night and day.

So, regardless of the statistics, the people who benefit the most from a growing economy and the creation of wealth are the people at the bottom. And that's what we all need to be concerned about, so I'd be interested in your responses.

Chairman Bernanke. Well, Senator, I think most public finance economists would agree that, on an efficiency basis, the zero tax rate on capital gains is the optimal one. You can see that, for example, in the President's Tax Panel, which tried to push our system toward a consumption-based tax; that is, one which exempts from taxation returns to savings, including dividends and capital gains, the idea being that by exempting savings from taxation, you create more rapid capital accumulation and that does generate broader economic growth.

So, as a theoretical matter, I think that's correct. Again, I want to be very careful not to make an unambiguous recommendation,

and I would just point out that people may differ about the equity implications in terms of who benefits the most from a cut in capital gains taxes, and that to the extent that there are revenue effects—and we just had some discussion about how big they might be and whether they are temporary or permanent—issues of the deficit and funding and government spending, would also arise.

So, the final policy decision is a complex one, but I think that purely from an efficiency perspective, it's a fairly broad view among public finance economists, that capital income should be taxed at a low rate.

Senator Bennett. Thank you.

Mr. Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman, and, thank you, Mr. Chairman. I have a number—actually, I think, a large number of constituents who take the position that the optimum tax rate on wages should be zero percent. That's a slightly different point of view, from a different perspective.

I want to——

Senator Bennett. I'll be happy to join them——

(Laughter.)

Senator Bennett [continuing]. If we find another way to finance the government. I don't think wages is the most efficient way to do it.

Representative Hinchey. Let's talk, Mr. Chairman, let's talk.

I very much appreciate your solid and straight answers to the questions that were delivered today, including the one about the payback on tax cuts. Your predecessor said something very similar in testimony before the House Budget Committee. He said: "It's very rare and few economists believe that you can cut taxes and you will get an equal amount of revenues. When you cut taxes, you gain some revenue back. We don't know exactly what this amount is, but it's not small, but it's also not 70 percent or anything like that."

And we have similar statements from the Congressional Budget Office and the Congressional Research Service. The one that I liked the best was the one from the former Chairman of the Council of Economic Advisors, Greg Mankiw, who wrote in his macroeconomic textbook, and he says and I quote, "There is no credible evidence that tax cuts pay for themselves and an economist who makes such a claim, is a snake oil salesman who is trying to sell a miracle cure."

So we have some interesting points of view on this particular issue.

I wanted to just ask you about the dollar. We have a national debt now which is about $8.33 trillion. Congress just raised the debt ceiling a couple of weeks ago—3 weeks ago, to just below $9 trillion.

Projections are now that within the next 5 years, that the national debt is going to exceed $11 trillion, based upon the circumstances that are prevailing currently. This year, we're anticipating a budget deficit of $379 billion.

The circumstances here have got to be putting enormous pressure on the value of the dollar. We've seen the value of the dollar decline recently, and I'm wondering what you would say about the

potential for the strength of the dollar, given these economic circumstances of huge growing debt and these huge annual budget deficits that are fueling that growing debt, and the current accounts deficit, which—I'm not sure what that number is, but I think it's something in excess of, what—what is the current accounts deficit?

Chairman Bernanke. Eight hundred billion dollars.

Representative Hinchey. Eight hundred billion, yes, a little over $800 billion.

What does this mean for the value of the dollar? Is the value of the dollar going to go down?

We have the situation and an interesting report from the IMF. They report that the internal purchasing parody of the Chinese currency is more than five times its external value. Given the outcome of the recent visit of the President of China, there doesn't seem to be any indication that those circumstances are likely to change.

What do we have to anticipate with regard to the pressure on the value of our dollar?

Chairman Bernanke. Well, Congressman, I just wanted to say a word about the Federal debt, which you mentioned, first of all. There are different ways of measuring it, and you get somewhat different answers.

The debt limit includes a lot of debt with the government, like the Social Security Trust Fund, for example, and if you look at the debt held by the public, including the Federal Reserve, you find that it's something on the order of 40 percent of GDP, which is lower than a number of other industrial countries.

From that perspective our current deficit last year was 2.6 percent of GDP, so in a short-term sense, we are in a comparable situation with other industrial countries.

I think we have a much larger problem, if you take an unfunded liability approach and say, well, what is it that we really owe to our senior citizens, based on the promises we've made in Social Security and Medicare, and there you get a much larger number, so that that's an issue.

I don't think the Federal debt has a great deal to do with the dollar. The usual arguments have to do with the current account deficit and the dollar, and here, I'd like to, I guess, make a clarification.

There was some media report that the discussions of the G7 over the weekend, had discussed some kind of depreciation of the dollar or managed depreciation of the dollar as part of the strategy for addressing the U.S. current account.

That is not correct. The G7 supports a market-determined dollar, not a managed dollar.

In terms of making forecasts, as I think Chairman Greenspan often said in this context, you can forecast the dollar and half the time, you're going to be right.

The experience is that forecasting the dollar is very difficult, and we want to just leave it to market forces to determine where the dollar is going to be.

Representative Hinchey. Thank you.

Senator Bennett. Thank you very much, Mr. Chairman. We appreciate your being here, and look forward to continued meetings with you, with the JEC.

This Committee was created by the Humphrey-Hawkins Act, as Senator Humphrey wanted to increase the connection between the Fed and the Congress, and established these regular reports.

We know you have other things to do, but we're grateful for your willingness to come spend the morning with us on the Hill. The hearing is adjourned.

Chairman Bernanke. Thank you, Senator.

(Whereupon, at 11:55 a.m., the hearing was adjourned.)

Submissions for the Record

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Chairman Bernanke, it is my pleasure to welcome you this morning before the Joint Economic Committee (JEC). We appreciate your testimony on the economic outlook.

According to the official data, a healthy economic expansion has been underway for several years. The U.S. economy advanced 4.2 percent in 2004, and 3.5 percent in 2005. As I have noted many times, the pick-up in economic growth since the middle of 2003 is mostly due to a rebound in investment activity, which had been weak. This rebound was fostered by a mix of Fed monetary policy and the 2003 tax legislation and its incentives for investment.

The continued economic expansion has created 5.2 million payroll jobs since August of 2003. The unemployment rate, at 4.7 percent, is below its average levels of the 1970s, 1980s, and 1990s. Federal Reserve and private economists forecast that business investment and the overall economy will continue to grow this year.

As the Fed noted in a policy report last February, "the U.S. delivered a solid performance in 2005." The Fed also stated that the "U.S. economy should continue to perform well in 2006 and 2007." Recent data indicate that the economic growth rate for the first quarter of this year will be quite robust when it is released tomorrow.

According to a broad array of economic data, the outlook remains positive. Consumer spending is expected to be solid in 2006. Homeownership has reached record highs. Household net worth is also at a record level. The trend in productivity growth remains strong. Although high oil prices have raised business costs and imposed hardship on many consumers, these prices have not derailed the expansion.

Meanwhile, long-term inflation pressures are contained. As a result, long-term interest rates, such as mortgage rates, are still relatively low, although these rates have edged up in recent weeks. According to the Fed's preferred price index, inflation is well under control.

In sum, current economic conditions are strong. With economic growth expected to exceed 3 percent this year, the economic outlook remains positive.

PREPARED STATEMENT OF SENATOR ROBERT BENNETT, VICE CHAIRMAN

It is a pleasure to welcome the Honorable Ben Bernanke, Chairman of the Board of Governors of Federal Reserve System, before the Committee this morning. We view your testimony on the economic outlook as a continuation of the longstanding productive exchange between the Federal Reserve and the Joint Economic Committee.

A wide range of economic data confirms that the U.S. economic expansion remains on a solid foundation. Growth in the inflation-adjusted, or "real," gross domestic product increased 3.5% during 2005, on the heels of over–4% growth in 2004. Real GDP has now been growing for 17 consecutive quarters. Most private forecasters believe that growth for the first quarter of this year will be a sizeable acceleration from the temporary lull in the final quarter of 2005 and growth is then expected to return to more trend-like, yet still healthy, rates through the remainder of the year.

The unemployment rate has fallen to 4.7 percent, the lowest level in five years and stands below the averages of the 1960s, 1970s, 1980s, and 1990s. In 31 consecutive months of job creation, payroll employment in the Nation has expanded by over 5.1 million new jobs. Last year alone, 2 million new jobs were added to business payrolls.

While long-term interest rates, including mortgage rates, have edged up recently, they remain low by historical standards and financial conditions of households and

businesses seem to be in reasonably good shape. Activity in housing markets has recently been showing signs of cooling, but levels of activity remain strong.

Although headline consumer price inflation has been boosted by another round of increased energy prices, so-called "core" consumer price inflation remains relatively steady and measures of inflation expectations remain stable.

Nevertheless, last year was the third consecutive year of rising and volatile energy prices, and we all feel how energy price increases have cut into households' purchasing power and the profitability of non-energy producing businesses. The economy has remained resilient in the face of escalating energy prices, but further increases pose a risk to future growth and inflation.

As I mentioned, the economic expansion remains on a solid foundation. And I believe that one important ingredient that helped generate the robust economic growth over the past few years is the enactment of pro-growth tax relief in 2003.

We look forward to your review of recent economic developments and your outlook for the U.S. economy.

Welcome, again, Chairman Bernanke.

PREPARED STATEMENT OF SENATOR JACK REED, RANKING MINORITY

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

All eyes are on you, Chairman Bernanke, as you embark on a tricky high-wire act in which you allow the economy to grow and employment to reach its full potential, while you remain mindful of the risks of inflation. For some time, the Fed's job had been easier—it had room to raise interest rates from very low levels with little risk of derailing the economic recovery, while inflation and other lurking economic problems were at bay. Today, soaring energy prices, record budget and trade deficits, a negative household saving rate, and a disappointing labor market recovery all pose tremendous challenges to setting monetary policy.

The Fed has raised its target for the federal funds rate by 25 basis points at each of the last 15 FOMC meetings. According to the minutes of the March meeting, most members of the FOMC thought that the end of the tightening process was near. The question on everyone's mind is: are we there yet? The phrase we are hearing is that interest rate changes will now be "data driven." So I hope that means, Chairman Bernanke, that the Fed will look hard at the full range of data on economic growth, employment, and inflation to determine the best course for monetary policy.

GDP is growing, but the typical American worker has been left out of the economic gains of this recovery. Strong productivity growth has shown up in the bottom lines of shareholders but not in the paychecks of workers. Too many Americans are being squeezed by stagnant incomes and rising costs for gasoline, health care, and education. It seems to me that there is still room for real wages to catch up with productivity before the Fed needs to worry about inflationary pressures from the labor market.

However, there are many other downside risks to the economy on the horizon. Energy prices have been pushing up overall inflation for some time. But last month, we saw an uptick in core inflation, which might be an early sign that businesses are starting to pass on their higher energy costs to customers. Rising oil prices and interest rates coupled with a weakening housing sector could take their toll on consumers and businesses alike and slow down the economy too much.

Your task in setting the right course for monetary policy is complicated by fiscal policy and international imbalances. We no longer have the fiscal discipline that we had in the 1990s, which allowed for a monetary policy that encouraged investment and long-term growth. The President's large and persistent budget deficits have led to an ever-widening trade deficit that forces us to borrow vast amounts from abroad and puts us at risk of a major financial collapse if foreign lenders suddenly stop accepting our IOU's.

Even assuming we can avoid an international financial crisis, continued budget and trade deficits will be a drag on the growth of our standard of living and leave us ill-prepared to deal with the effects of the retirement of the baby-boom generation. Strong investment financed by our own national saving—not foreign borrowing—is the foundation for strong and sustained economic growth and rising living standards.

One final issue that I would like to raise is the growing inequality of income, earnings, and wealth in the U.S. economy. Your predecessor, Chairman Greenspan, regularly raised that issue as one of concern for our political economy—it is not good for democracy to have widening inequality. I know you share these concerns. Recently, the Federal Reserve published the results from the 2004 Survey of Consumer

Finances. They show that growth in median income and wealth have slowed substantially and the top 1 percent of families hold more wealth than the bottom 90 percent of families.

In this environment, it is hard to understand why the Administration is continuing to pursue policies that add to the budget deficit by providing tax breaks to those who are already well-off, including the permanent elimination of the estate tax. Meanwhile, they continue to propose budgets that cut programs for those who are struggling to make ends meet. Mr. Chairman, I know you don't want to get into the specifics of particular policies, but I hope you can offer us some insights about the kinds of policies that are likely to be effective in addressing the real challenges we face in this economy and offering real opportunities for growth that provides widespread benefits to the American people.

I look forward to your testimony on the economic outlook and to a discussion of these issues.

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

Mr. Chairman and members of the Committee, I am pleased to appear before the Joint Economic Committee to offer my views on the outlook for the U.S. economy and on some of the major economic challenges that the Nation faces.

Partly because of last year's devastating hurricanes, and partly because of some temporary or special factors, economic activity decelerated noticeably late last year. The growth of the real gross domestic product (GDP) slowed from an average annual rate of nearly 4 percent over the first three quarters of 2005 to less than 2 percent in the fourth quarter. Since then, however, with some rebound in activity under way in the Gulf Coast region and continuing expansion in most other parts of the country, the national economy appears to have grown briskly. Among the key economic indicators, growth in nonfarm payroll employment picked up in November and December, and job gains averaged about 200,000 per month between January and March. Consumer spending and business investment, as inferred from data on motor vehicle sales, retail sales, and shipments of capital goods, are also on track to post sizable first-quarter increases. In light of these signs of strength, most private-sector forecasters, such as those included in the latest Blue Chip survey, estimate that real GDP grew between 4 and 5 percent at an annual rate in the first quarter.

If we smooth through the recent quarter-to-quarter variations, we see that the pace of economic growth has been strong for the past 3 years, averaging nearly 4 percent at an annual rate since the middle of 2003. Much of this growth can be attributed to a substantial expansion in the productive capacity of the U.S. economy, which in turn is largely the result of impressive gains in productivity—that is, in output per hour worked. However, a portion of the recent growth reflects the taking up of economic slack that had developed during the period of economic weakness earlier in the decade. Over the past year, for example, the unemployment rate has fallen nearly ½ percentage point, the number of people working part time for economic reasons has declined to its lowest level since August 2001, and the rate of capacity tilization in the industrial sector has moved up 1½ percentage points. As the utilization rates of labor and capital approach their maximum sustainable levels, continued growth in output—if it is to be sustainable and non-inflationary—should be at a rate consistent with the growth in the productive capacity of the economy. Admittedly, determining the rates of capital and labor utilization consistent with stable long-term growth is fraught with difficulty, not least because they tend to vary with economic circumstances. Nevertheless, to allow the expansion to continue in a healthy fashion and to avoid the risk of higher inflation, policymakers must do their best to help to ensure that the aggregate demand for goods and services does not persistently exceed the economy's underlying productive capacity.

Based on the information in hand, it seems reasonable to expect that economic growth will moderate toward a more sustainable pace as the year progresses. In particular, one sector that is showing signs of softening is the residential housing market. Both new and existing home sales have dropped back, on net, from their peaks of last summer and early fall. And, while unusually mild weather gave a lift to new housing starts earlier this year, the reading for March points to a slowing in the pace of homebuilding as well. House prices, which have increased rapidly during the past several years, appear to be in the process of decelerating, which will imply slower additions to household wealth and, thereby, less impetus to consumer spending. At this point, the available data on the housing market, together with on-

going support for housing demand from factors such as strong job creation and still-low mortgage rates, suggest that this sector will most likely experience a gradual cooling rather than a sharp slowdown. However, significant uncertainty attends the outlook for housing, and the risk exists that a slowdown more pronounced than we currently expect could prove a drag on growth this year and next. The Federal Reserve will continue to monitor housing markets closely.

More broadly, the prospects for maintaining economic growth at a solid pace in the period ahead appear good, although growth rates may well vary quarter to quarter as the economy downshifts from the first-quarter spurt. Productivity growth, job creation, and capitalspending are all strong, and continued expansion in the economies of our trading partners seems likely to boost our export sector. That said, energy prices remain a concern: The nominal price of crude oil has risen recently to new highs, and gasoline prices are also up sharply. Rising energy prices pose risks to both economic activity and inflation. If energy prices stabilize this year, even at a high level, their adverse effects on both growth and inflation should diminish somewhat over time. However, as the world has little spare oil production capacity, periodic spikes in oil prices remain a possibility.

The outlook for inflation is reasonably favorable but carries some risks. Increases in energy prices have pushed up overall consumer price inflation over the past year or so. However, inflation in core price indexes, which in the past has been a better indicator of longerterm inflation trends, has remained roughly stable over the past year. Among the factors restraining core inflation are ongoing gains in productivity, which have helped to hold unit labor costs in check, and strong domestic and international competition in product markets, which have restrained the ability of firms to pass cost increases on to consumers. The stability of core inflation is also enhanced by the fact that long-term inflation expectations—as measured by surveys and by comparing yields on nominal and indexed Treasury securities—appear to remain well-anchored. Of course, inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability. As to inflation risks, I have already noted that continuing growth in aggregate demand in excess of increases in the economy's underlying productive capacity would likely lead to increased inflationary pressures. In addition, although pass-through from energy and commodity price increases to core inflation has thus far been limited, the risk exists that strengthening demand for final products could allow firms to pass on a greater portion of their cost increases in the future.

With regard to monetary policy, the Federal Open Market Committee (FOMC) has raised the Federal funds rate, in increments of 25 basis points, at each of its past fifteen meetings, bringing its current level to 4.75 percent. This sequence of rate increases was necessary to remove the unusual monetary accommodation put in place in response to the soft economic conditions earlier in this decade. Future policy actions will be increasingly dependent on the evolution of the economic outlook, as reflected in the incoming data. specifically, policy will respond to arriving information that affects the Committee's assessment of the medium-term risks to its objectives of price stability and maximum sustainable employment. Focusing on the medium-term forecast horizon is necessary because of the lags with which monetary policy affects the economy.

In the statement issued after its March meeting, the FOMC noted that economic growth had rebounded strongly in the first quarter but appeared likely to moderate to a more sustainable pace. It further noted that a number of factors have contributed to the stability in core inflation. However, the Committee also viewed the possibility that core inflation might rise as a risk to the achievement of its mandated objectives, and it judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In my view, data arriving since the meeting have not materially changed that assessment of the risks. To support continued healthy growth of the economy, vigilance in regard to inflation is essential.

The FOMC will continue to monitor the incoming data closely to assess the prospects for both growth and inflation. In particular, even if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook. Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings, and the Committee will not hesitate to act when it determines that doing so is needed to foster the achievement of the Federal Reserve's mandated objectives.

Although recent economic developments have been positive, the Nation still faces some significant longer-term economic challenges. One such challenge is putting the Federal budget on a trajectory that will be sustainable as our society ages. Under

current law, Federal spending for retirement and health programs will grow substantially in coming decades—both as a share of overall Federal spending and relative to the size of the economy—especially if health costs continue to climb rapidly. Slower growth of the workforce may also reduce growth in economic activity and thus in tax revenues.

The broad dimensions of the problem are well-known. In fiscal year 2005, Federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. According to the projections of the Congressional Budget Office (CBO), by the year 2020 that share will increase by more than 3 percentage points of GDP, an amount about equal in size to the current Federal deficit. By 2040, according to the CBO, the share of GDP devoted to those three programs (excluding contributions by the states) will double from current levels, to about 16 percent of GDP. Were these projections to materialize, the Congress would find itself in the position of having to eliminate essentially all other non-interest spending, raising Federal taxes to levels well above their long-term average of about 18 percent of GDP, or choosing some combination of the two. Absent such actions, we would see widening and eventually unsustainable budget deficits, which would impede capital accumulation, slow economic growth, threaten financial stability, and put a heavy burden of debt on our children and grandchildren.

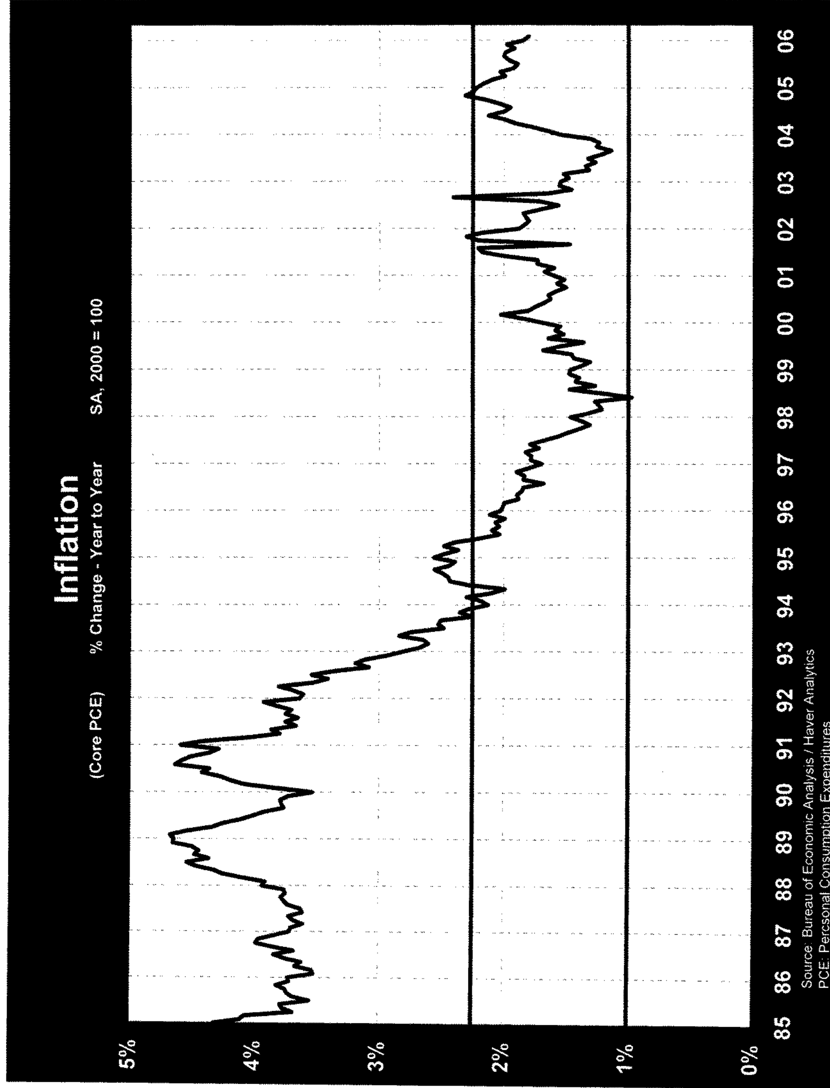
The resolution of the nation's long-run fiscal challenge will require hard choices. Fundamentally, the decision confronting the Congress and the American people is how large a share of the nation's economic resources should be devoted to Federal Government programs, including transfer programs like Social Security, Medicare, and Medicaid. In making that decision, the full range of benefits and costs associated with each program should be taken into account. Crucially, however, whatever size of government is chosen, tax rates will ultimately have to be set at a level sufficient to achieve a reasonable balance of spending and revenues in the long run. Members of the Congress who want to extend tax cuts and keep tax rates low must accept that low rates will be sustainable over time only if outlays can be held down sufficiently to avoid large deficits. Likewise, members who favor a more expansive role of the government must balance the benefits of government programs with the burden imposed by the additional taxes needed to pay for them, a burden that includes not only the resources transferred from the private sector but also the reductions in the efficiency and growth potential of the economy associated with higher tax rates.

Another important challenge is the large and widening deficit in the U.S. current account. This deficit has increased from a little more than $100 billion in 1995 to roughly $800 billion last year, or 6½ percent of nominal GDP. The causes of this deficit are complex and include both domestic and international factors. Fundamentally, the current account deficit reflects the fact that capital investment in the United States, including residential construction, substantially exceeds U.S. national saving. The opposite situation exists abroad, in that the saving of our trading partners exceeds their own capital investment. The excess of domestic investment over domestic saving in the United States, which by definition is the same as the current account deficit, must be financed by net inflows of funds from investors abroad. To date, the United States has had little difficulty in financing its current account deficit, as foreign savers have found U.S. investments attractive and foreign official institutions have added to their stocks of dollar-denominated international reserves. However, the cumulative effect of years of current account deficits have caused the United States to switch from being an international creditor to an international debtor, with a net foreign debt position of more than $3 trillion, roughly 25 percent of a year's GDP. This trend cannot continue forever, as it would imply an evergrowing interest burden owed to foreign creditors. Moreover, as foreign holdings of U.S. assets increase, at some point foreigners may become less willing to add these assets to their portfolios. While it is likely that current account imbalances will be resolved gradually over time, there is a small risk of a sudden shift in sentiment that could lead to disruptive changes in the value of the dollar and in other asset prices.

Actions both here and abroad would contribute to a gradual reduction in the U.S. current account deficit and in its mirror image, the current account surpluses of our trading partners. To reduce its dependence on foreign capital, the United States should take action to increase its national saving rate. The most direct way to accomplish this objective would be by putting Federal government finances on a more sustainable path. Our trading partners can help to mitigate the global imbalance by relying less on exports as a source of growth, and instead boosting domestic spending relative to their production. In this regard, some policymakers in developing Asia, including China, appear to have recognized the importance of giving domestic demand a greater role in their development strategies and are seeking to in-

crease domestic spending through fiscal measures, financial reforms, and other initiatives. Such actions should be encouraged. For these countries, allowing greater flexibility in exchange rates would be an important additional step toward helping to restore greater balance both in global capital flows and in their own economies. Structural reforms to enhance growth in our industrial trading partners could also be helpful. Each of these actions would be in the long-term interests of the countries involved, regardless of their effects on external imbalances. On the other hand, raising barriers to trade or flows of capital is not a constructive approach for addressing the current account deficit because such barriers would have significant deleterious effects on both the U.S. and global economies.

In conclusion, Mr. Chairman, the economy has been performing well and the near-term prospects look good, although as always there are risks to the outlook. Monetary policy will continue to pursue its objectives of helping the economy to grow at a strong, sustainable pace while seeking to keep inflation firmly under control. And, while many of the fundamental factors that determine longer-term economic growth appear favorable, actions to move the Federal budget toward a more sustainable position would do a great deal to help ensure the future prosperity of our country.


Inflation
(Core PCE)
% Change - Year to Year
SA, 2000 = 100
5%
4%
3%
2%
1%
0%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06
Source: Bureau of Economic Analysis / Haver Analytics
PCE: Percsonal Consumption Expenditures

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May 8, 2006

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chairman Bernanke:

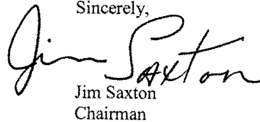
I would like to thank you for your recent testimony on the Economic Outlook before the Joint Economic Committee. Your testimony addressed a number of compelling and timely issues, and the printed record of the hearing will be an invaluable resource.

I would appreciate your addressing the attached four questions for the record.

A copy of the April 27, 2006, hearing transcript is enclosed. Please have a member of your staff return the corrected transcript, together with your answers to the submitted questions, to the Executive Director of the Joint Economic Committee, Christopher Frenze, 433 Cannon House Office Building, Washington, DC 20515. Should your staff have any questions, please call Chris on (202) 225-3953.

Thank you and I look forward to your response.

Sincerely,



Jim Saxton
Chairman

WRITTEN QUESTIONS SUBMITTED BY HON. JIM SAXTON TO HON. BEN BERNANKE

Question 1. Your testimony regarding the stance of monetary policy indicated that the Fed is not locked into a rigid, predetermined schedule of increases in the federal funds rate. Rather, future decisions will be data dependent, i.e., made on the basis of the most recent economic and financial information available. Your statement did not rule out any future increases in the federal funds rate. Is this a fair summary of the point you were making?

Question 2. As you know, there are a number of reasons why inflation targeting allows for a good deal of operational flexibility. Yet critics of inflation targeting often contend that adopting this procedure removes much of monetary policymaker's discretionary powers and flexibility.

This criticism appears questionable given the host of adjustments and exceptions used in inflation targeting. For example, numerical bands rather than point estimates are usually used as policy targets by those countries successfully implementing inflation targeting. Similarly, multi-year targets are often employed. The inflation indices normally used are adjusted for volatile components as well as for other factors. In practice, countries adopting inflation targeting have all used a flexible approach in implementing monetary policy. Doesn't this suggest that inflation targeting is quite flexible?

Question 3. What is the role of asset prices in a monetary policy focused on price stability? Should the central bank respond to asset price "bubbles" or disturbances such as a bubble in the stock market or a bubble in the real estate market? Or should it ignore such movements in asset prices?

Are there "moral hazard" problems associated with highly predictable central bank attempts to respond to asset price bubbles?

Question 4. Federal Reserve officials often refer to the PCE (personal consumption expenditure) deflator in addressing measures of price changes. What are the advantages of the PCE deflator over the CPI? Does the CPI overstate inflation to some extent?

What does the core PCE deflator currently tell us about the degree to which inflationary forces are being contained at present?

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

BEN S. BERNANKE
CHAIRMAN

May 24, 2006

The Honorable Jim Saxton
Chairman
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to enclose my responses to the questions you submitted for the record following the hearing of April 27, 2006, concerning the economic outlook.

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

Sincerely,

Enclosure

RESPONSE FROM CHAIRMAN BEN BERNANKE TO WRITTEN QUESTIONS SUBMITTED BY CHAIRMAN JIM SAXTON

Chairman Bernanke subsequently submitted the following in response to written questions received from Chairman Saxton in connection with the Joint Economic Committee hearing on April 27, 2006:

Question 1. Your testimony regarding the stance of monetary policy indicated that the Fed is not locked into a rigid, predetermined schedule of increases in the Federal funds rate. Rather, future decisions will be data dependent, i.e., made on the basis of the most recent economic and financial information available. Your statement did not rule out any future increases in the Federal funds rate. Is this a fair summary of the point you were making?

Answer. Yes. As conveyed in my testimony, monetary policy must be forward looking and depend on the Federal Reserve's best assessment of the economic outlook as inferred from economic and financial information. Indeed, the Federal Open Market Committee was quite explicit on this point in the statement issued after its meeting on May 10. The statement explained that "the Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information."

Question 2. As you know, there are a number of reasons why inflation targeting allows for a good deal of operational flexibility. Yet critics of inflation targeting often contend that adopting this procedure removes much of monetary policymaker's discretionary powers and flexibility.

This criticism appears questionable given the host of adjustments and exceptions used in inflation targeting. For example, numerical bands rather than point estimates are usually used as policy targets by those countries successfully implementing inflation targeting. Similarly, multi-year targets are often employed. The inflation indices normally used are adjusted for volatile components as well as for other factors. In practice, countries adopting inflation targeting have all used a flexible approach in implementing monetary policy. Doesn't this suggest that inflation targeting is quite flexible?

Answer. By definition, an inflation targeting framework focuses on keeping inflation low and stable, and on clearly communicating to the public both the objectives of monetary policy and the strategy for achieving those objectives. The key advantage of such a framework is that it can help anchor inflation expectations more firmly and therefore promote greater stability in both inflation outcomes and resource utilization. As you point out, however, inflation targeting frameworks can be quite flexible. For example, in practice, all inflation-targeting central banks pay important attention in their policy decisionmaking not only to inflation but also to output and employment. Objectives generally are set for some date in the future, in recognition of the fact that monetary policy affects the economy only with a considerable lag. Some inflation-targeting central banks set multi-year targets, while others set policy so as to keep their inflation projection at a certain horizon close to its target; yet others aim to keep inflation close to its target on average over the business cycle. Specifying the inflation objective as a band may help convey the reality that inflation cannot be controlled perfectly at every instant, though a band may also increase the challenges around the communication of objectives and strategies to the public. These are a few of the key design features that can be used to build flexibility into the overall policy framework.

Question 3. What is the role of asset prices in a monetary policy focused on price stability? Should the central bank respond to asset price "bubbles" or disturbances such as a bubble in the stock market or a bubble in the real estate market? Or should it ignore such movements in asset prices?

Are there "moral hazard" problems associated with highly predictable central bank attempts to respond to asset price bubbles?

Answer. In setting monetary policy to achieve price stability, a central bank should take account of all factors influencing the economic outlook. Accordingly, a central bank cannot ignore movements in stock prices, home values, and other asset prices, but should respond to them only to the extent that they have implications for future output and inflation. Some observers have argued that a central bank should respond more aggressively to asset-price booms thought to have an important speculative component. In so doing, so the argument goes, a central bank can limit the future expansion of the bubble, thereby mitigating the fallout from its eventual bursting. However, the validity of this argument rests on several conditions for which there is little or no empirical evidence, including the presumptions that the central bank is better able than the market to identify speculative bubbles and that it can successfully "deflate" such bubbles without harming the broader economy.

Given our limited knowledge of the forces driving speculative bubbles, the more prudent approach is to respond only as the overall outlook for output and inflation merits. Such a limited approach should also mitigate potential moral hazard problems that might arise were a central bank to, in effect, take responsibility for the appropriateness of asset prices.

Question 4. Federal Reserve officials often refer to the PCE (personal consumption expenditures) deflator in addressing measures of price changes. What are the advantages of the PCE deflator over the CPI? Does the CPI overstate inflation to some extent?

What does the core PCE deflator currently tell us about the degree to which inflationary forces are being contained at present?

Answer. While the PCE price index generally moves roughly in line with the CPI—and indeed is derived largely from CPI source data—it does have some advantages relative to the CPI as a measure of inflation. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition, there is some evidence that the PCE weights are measured more accurately than the CPI weights. The PCE price measure also has some disadvantages relative to the CPI; most important, its broader scope necessitates the inclusion of some prices that are not derived from market transactions and so may add some noise to the overall index as a proxy for the cost of living.

Most analysts believe that changes in the CPI overstate changes in the cost of living to some extent. In 1996, the Senate Advisory Commission to Study the CPI (The Boskin Commission) assessed the bias in CPI inflation as centering on 1.1 percentage points per year, with a range of 0.8 to 1.6 percentage points per year. This result was similar to the findings of other analysts. Since the time of these studies, the BLS has made several improvements to the CPI that have, on balance, served to reduce that bias. In part for this reason, more recent estimates of bias in CPI inflation have generally been a little smaller than estimated by the Boskin Commission. For example, a recent study by Federal Reserve economists judged the bias in CPI inflation currently to center around 0.9 percentage point per year. The PCE price index likely is also biased upward, though probably by less than the CPI in light of the PCE measure's advantages cited above.

Although increases in energy prices have pushed up overall consumer price inflation over the past couple of years, core inflation has been more stable. The core PCE price index increased 2 percent over the twelve months to March of this year, about the same as the increase over the preceding twelve months. Similarly, the core CPI has increased 21 percent over each of the past 2 years. The stability of core inflation, even as many firms have faced substantial cost increases for energy products, has been enhanced by the fact that long-term inflation expectations appear to remain well contained. Of course, inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability.

BOARD OF GOVERNORS
OF THE
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WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

January 3, 2006

The Honorable John E. Sununu
United States Senate
Washington, D.C. 20510

Dear Senator:

Thank you for inquiring about my views concerning supervision and regulation of government-sponsored enterprises (GSEs) and about how best to focus the GSEs on their public mission without destabilizing the economy. I also appreciate your kind words about my public service on the Federal Reserve Board.

Fannie Mae (Fannie) and Freddie Mac (Freddie) essentially run two lines of business: securitization of mortgage credit and holding of mortgage and other assets for investment purposes. The first line of business provides substantial benefits for affordable housing through the process of using credit guarantees to turn mortgages into marketable securities that trade in public debt markets. This process creates a wide variety of liquidity benefits, some of which flow to homeowners and mortgage originators. Moreover, creating securities from the mortgages extended to nontraditional homeowners is an important step to making mortgage credit more widely available. Focusing Fannie and Freddie on this type of securitization activity can promote affordable housing without creating significant risks to the financial system.

In contrast, once a mortgage has been securitized and sold into the public markets, Fannie's and Freddie's purchases of their own (or each other's) mortgage-backed securities (MBS) for their investment portfolios creates substantial systemic risk while yielding negligible additional benefit for homeowners, renters, or mortgage originators.[1] Under normal circumstances, GSEs are able to easily maintain and grow their large portfolios of mortgage and non-mortgage assets without the significant market checks or balances faced by other publicly traded financial institutions. These large portfolios, while enriching GSE shareholders, do not meaningfully benefit homeowners and do not facilitate secondary market liquidity. They do add systemic risk to our financial system, which normal market forces are unable to resolve.

[1] For further details, please see my April 2005 testimony before the Senate Committee on Banking, Housing and Urban Affairs, my May 2005 speech under the auspices of the Federal Reserve Bank of Atlanta, and my letters to Senators Bennett and Sununu during the summer of 2005.

In the current system of mortgage financing, the prepayment and interest rate risks associated with mortgages are concentrated in Fannie's and Freddie's large portfolios rather than being more widely dispersed across a broad range of market participants, including the overwhelming number of financial institutions that are significantly less leveraged than the GSEs (such as commercial banks and insurance companies). As Fannie and Freddie increase in size relative to the counterparties for their hedging transactions, their ability to quickly respond to changing market conditions and correct the inevitable misjudgments inherent in their complex hedging strategies becomes more difficult, especially when vast reversal transactions backed by their thin capital holdings are required to rebalance portfolio risks.[2] Furthermore, the success of interest-rate-risk management, especially the exceptionally rapid timing necessitated by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs' transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and rapid destabilizing adjustments will result in sharp changes in the interest rates required to rebalance and hedge the GSEs' mortgage portfolio.

Also, as I have testified earlier, the GSEs and their government regulator need specific and unambiguous Congressional guidance about the intended purpose and functions of Fannie's and Freddie's investment portfolios. Often, this proposal is referred to as "portfolio limits." The purpose of this guidance, however, is not just to limit the GSEs' portfolios, but to firmly anchor the GSEs' investment portfolios to their public purpose. Strong portfolio guidance by Congress is needed because GSEs are an unusual government intervention in private markets; such institutions lack the typical financial market discipline that is commonplace for other publicly traded firms.

The bill approved by the Senate Banking Committee in July 2005 (S. 190) provides this much-needed anchor and would refocus Fannie and Freddie on their important public policy mission. In addition, S. 190 appropriately strengthens the capital authority of the regulator and establishes a clear and credible receivership process for handling a failed or failing GSE.

In contrast, as I observed during my July 2005 appearances before Congress on monetary policy, the bill that passed the House of Representatives in October 2005 neither takes the steps needed to create an effective GSE regulator nor addresses the systemic risks posed by Fannie's and Freddie's investment portfolios. In the first instance, the House bill fails to sufficiently strengthen the capital authority of the regulator and does not establish a clear and credible receivership process for handling a failed or failing GSE. But, more importantly, the House bill fails to comprehensively address the problem of

[2] For mortgage portfolios in particular, misjudgments are inevitable mainly because of the inherent difficulties in forecasting households' prepayment behavior.

systemic risks presented by the GSEs' investment portfolios. Improved regulation by itself may be insufficient and could exacerbate the potential systemic problems associated with the GSEs' large portfolios if financial markets infer from such regulation that the government is more strongly backing GSE debt.

Moreover, the Federal Reserve Board believes that any legislative approach that relies mainly on the future regulator to oversee the GSEs' investment portfolios without providing that regulator with specific and unambiguous Congressional guidance is unlikely to succeed in directing these portfolios toward their important public purposes. Faced with trillions of dollars of assets and the large profits and capital gains created by the perception of government backing, the current GSE regulators have proved unable in recent years to thwart expansionary behavior and focus the GSEs on their important housing mission. The new GSE regulator needs a precise and clear statement from the Congress about the purpose of the GSEs' portfolios in order to assure these portfolios achieve their public mission in a manner that does not run the risk of destabilizing the housing finance markets or the financial system more generally.

Sincerely,