MONETARY POLICY AND THE STATE OF THE ECONOMY

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Thursday, July 20, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Baker, Pryce, Bachus, Castle, Kelly, Paul, Gillmor, Manzullo, Biggert, Miller of California, Kennedy, Hensarling, Garrett, Barrett, Pearce, Neugebauer, Price, Fitzpatrick, Davis of Kentucky, McHenry, Campbell, Frank, Waters, Maloney, Gutierrez, Lee, Moore of Kansas, Capuano, Ford, Hinojosa, Clay, McCarthy, Baca, Matheson, Miller of North Carolina, Cleaver, Bean, and Moore of Wisconsin.

The CHAIRMAN. The committee will come to order.

Chairman Bernanke, good morning. In February, this committee was proud to be the venue for your first appearance before Congress on the conduct of monetary policy. Today marks your second appearance, with many more yet to come. In 2001, shortly after I assumed the chairmanship of this committee, the very first hearing I chaired was to receive the testimony of former Chairman Greenspan. We didn't know it at the time, but we had a very rough patch of economic road ahead with the bursting of the tech bubble; and 9/11 and the resulting insurance crisis and the corporate bankruptcies. Back then, we had a weak economy that everyone said was strong. Now we have a strong economy that some are trying to convince us is weak.

Some of the credit for the current robust economy goes to the Federal Reserve, of course, where you and Chairman Greenspan have held inflation to lower levels and lower volatility than we have seen in all but 20 years of the life of the Federal Reserve. I would like to enter a chart showing that into the record.

The lion's share of the credit goes to President Bush, who had the steadiness to guide us through recession and the courage to do the right thing in seeking tax cuts to spur growth. Now we see that the biggest spurt in tax revenue growth in 40 years has trimmed our expected 2006 deficit by a third in just 6 months, and is on track to drop the deficit as a percentage of GDP to less than half of the similar share in most European economies.

Some of the credit goes to Congress, which made the tax cut stick, although we still have some work to do on making tax cuts permanent, and on spending discipline.

But the largest credit of all goes to the American people, who with determination, character, and heart, showed what a great country this really is. America suffered a recession, a massive terror attack, scandals of corporate governance, and a destructive hurricane season. Through all of that, we have added 5.4 million jobs in the last 3 years; we have had 34 uninterrupted quarters of growth; we have an unemployed rate lower than that of most of the last 40 years; and we also have growth at or above the average rate for all 6 postwar decades. In June alone, the U.S. economy created 121,000 new jobs, and maintained a low 4.6 unemployment rate.

I would be remiss if I did not point out that the unemployment rate is lower than the 6 percent floor that the economists used to call full employment. GDP growth for the first quarter was 5.6 percent, stronger than expected, and the fastest growth in two-and-a-half years. That, Mr. Chairman, is something we can all be proud of.

This is a remarkable country and a remarkable economy that constantly renews and reinvents itself—the flexibility that Chairman Greenspan talks so much about. The Federal Reserve has led monetary policy extremely well, and I am certain that will continue to be the case during your tenure.

Mr. Chairman, America is doing well, and will continue to do well. Of course, we will continue to have to work and think and innovate, because other countries have smart people and good economies as well. However, since the recession and the terror attacks, this country's economy has grown a great deal. In real terms, U.S. growth alone is half as big as the total economy of China.

So with that, Mr. Chairman, I thank you and all of the many people at the Federal Reserve, most of whom we have never met, for their insight and experience and dedication. And we look forward to your testimony, Chairman Bernanke.

And with that, I yield back the balance of my time and now recognize the ranking member, the gentleman from Massachusetts.

Mr. FRANK. Thank you, Mr. Chairman. It is true that we have had growth, but we have had the most unequally distributed growth recently in my memory, and the consequences of that are severe.

Let's begin with where we are in America today. The Doha Round is foundering, and there is a desperate need to get it done for those who want it done because of the perception that Congress would not renew the fast track authority to the President. There was a reaction to the Dubai Ports matter that I believe most in the business community, most of the economists and financial people, thought was overdone. The President found—to his surprise, I think—resistance to his approach on immigration. There are resistances coming to efforts to implement productivity.

What you have is a kind of revolt on the part of the average American against globalization, against the adaptation of new technology, which was kind of summed up somewhat wistfully by Mr. Allan Hubbard, the director of the National Economics Council—a week ago he said, "Obviously it is frustrating to us that the American people don't recognize how well the economy is doing." Or as Chico Marx said, "Who are you going to believe, me or your own pocketbook?"

The reason the American people don't recognize how well the economy is doing, and the reason they are angry and are balking at many of the things that I believe you would like to see us do, Mr. Bernanke, is that they are not doing well. The economy is, but there is a disconnect between the average American and the economy.

First, talking about jobs, it is true we have gotten some jobs; my friend, the chairman, said, "Look, 120,000 jobs." Only 120,000 jobs used to be a bad thing. What the Administration has given us is the evolution of diminishing expectations. That chart represents their projections of how many jobs will be created each month, beginning in 2003, after they said the tax cuts have had an effect and after the recession. There has been a constantly declining prediction by the Administration of how many jobs we would create. So it is true that if you define victory low enough, you can often achieve it, except that they haven't. Even as it has declined, they have rarely met it.

The other, of course, is a comparison of job creation on the left side in the Clinton years and in the Bush years. Take comparable periods, 2 years, starting 2 years into each presidency so they are not accused or blamed for what happened before. Two years in each presidency; those are the job numbers. So 120,000 jobs under the Clinton years would have been considered to be a serious problem, but the problem is not just job creation. Yes, unemployment is low, although it is low in large part because of the drop in labor participation, and exactly what causes that, we don't know. What effects that will have over long-term economic growth, we don't know. But it is also the case that we have low unemployment because we have the lowest percentage of people in the workforce.

But here is the serious problem—real wages. Real wages are the red chart; that is, wages corrected for inflation. Now, we are told that wages go up with a lag in their recovery, but the reverse has happened here. Assuming the recovery begins in 2003, maybe even earlier, real wage growth is very small in 2004—2003. It is negative in 2005—2004 and negative in 2005, and barely there today. That is, real wages are lagging inflation, and I must say, Mr. Bernanke, I was disappointed that in your discussion in the monetary report—not your statement—pages 16 and following, when you talk about compensation, it is nominal. It is not real. And I think that talking unadjusted terms about wages unfairly gives people the impression that things are better than they are. I wish that you would have used real wages.

And in your statement, part of the problem, frankly, is—and I will ask you about this on page 3 of your statement—you talk about labor costs, but you talk about wages as a cost. Your discussion of wages does not address them as the wage families support themselves, but as a constraint in the economy.

Let me quickly go to the next chart. Not only have wages lagged inflation, they have lagged productivity. They have lagged corporate profits. What we have is a—in this chart on the left, you have what has happened to the share of national income that goes to wages. It has gone from 66 percent to 63 percent. On the other side, you have what has happened—this is from 2002 to 2006, the share that has gone to corporate profits. It has nearly doubled from

8.5 percent to 14.4 percent, so real wages have dropped in the last couple of years. Labor's share of the national income has dropped from 66 percent to 63 percent, and corporate profits have gone way up.

And then finally, you do have the question of productivity on the next chart. Here we have productivity compared to real wages, and you look in particular in these last 3 years, productivity goes way up, way above historic trend, and real wages go down.

Now, we have—and I will take this 30 seconds, Mr. Chairman, thank you. We have concern that wages will be inflationary. In fact, exactly the opposite has been the case. Where you have a situation where productivity greatly outstrips real wages, you clearly have room—and here is what you have: productivity greatly outstripping real wages; real wages dropping over the last couple of years; and corporate profits skyrocketing. To continue to treat possible wage increases as a problem for the economy is to perpetuate the growing inequality we have. So when people are concerned that there appears to be too much anger on the part of the public toward the best economic decisions, those are the reasons why.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The Chair now recognizes the gentlelady from Ohio, the subcommittee chairwoman.

Ms. PRYCE. Thank you, Mr. Chairman. And thank you, Chairman Bernanke, for being with us here today.

I was pleased to read in your testimony that you believe that even though the economy is currently in a transition period, that it will continue to expand even under the pressure of increased oil prices, consumer spending, and a slowing housing market. I would like to talk about that just briefly.

Studies have shown that housing accounted for more than one-third of economic growth during the previous 5 years. The robust housing market had enabled homeowners to reduce their debt burdens and maintain adequate levels of consumer spending by tapping into the equity of their homes. Unfortunately in research done by the National Association of Home Builders, they show a serious downtrend in housing demand that many believe correlates with the rise in interest rates by the Federal Reserve.

As I have said in the past, I am concerned that this house price boom has been driven far more by investors than ever before, and could lead to a series of mortgage failures, and as the Federal Reserve tries to balance rising rates with fluctuations in the markets, I don't need to remind you that your actions have a trickle-down effect to local communities, and losses on housing investments are just one example.

A study by the Mortgage Bankers Association puts my own State of Ohio at the very top of the list of foreclosures, and so we are very concerned in the Midwest. Although we would sometimes like to think of our economy as one that stands apart from the rest of the world's sociopolitical issues, the effect of volatility overseas is reaching into our economy more than we might realize.

Just yesterday I held a hearing in my subcommittee on currency issues. We had representatives there from the Federal Reserve and the Mint discussing with us the rising cost of the commodities and

materials that make up our coins. We heard these commodities are affected by the volatility in the world or through rising demand in other markets, and are also themselves affecting our inflation here in the United States. The more they cost, the more they drive up the cost to make our currency, and the more it drives up costs overall.

In your remarks at the Senate yesterday, you touched upon a number of issues concerning citizens, such as rising rates, gas prices, and wage earnings. One of the issues that has been important to me, and a number of other members on this committee, is the ratio of consumer debt to consumer savings in America, and the effects that a slowing economy could have on a more local level. I agree with your statement yesterday that we must be forward-looking in our policy actions, and I would appreciate hearing your thoughts on what Congress can do about low savings rates, especially coupled with rising consumer costs.

Some of us, Mrs. Kelly, Mrs. Biggert, Mrs. Maloney, and myself, have worked to bring this issue to a national focus for a number of years, and we mentioned it repeatedly, working with the Administration to highlight increasing financial education in the United States, but much more needs to be done.

You also talked about an international savings glut that I believe we have here in America, a credit glut. I believe we can say it is almost a national epidemic. Consumer spending is key to our continued growth, but I believe we also need to send a message that consumer savings is just as important, and I appreciate hearing from you what the Federal Reserve and the rest of us can do to help consumer savings become a priority in this Nation. And I want to thank you once again, Mr. Chairman, for your appearance. I look forward to your testimony, and I yield back. Thank you.

The CHAIRMAN. I thank the gentlelady. Thank you for your leadership on this issue.

The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

And welcome, Chairman Bernanke. All eyes are on you and the other members of the Federal Open Market Committee as we reach a critical point in monetary policy. While the U.S. economy was going through its most protracted jobs slump since the 1930's, the Federal Reserve acted appropriately and kept interest rates very low. And when the economy began to respond, the Federal Reserve told us they were raising interest rates gradually to restore them to a level consistent with stable noninflationary growth. But that process, 17 increases in short-term interest rates, began 2 years ago, and people are naturally wondering when is it going to stop.

Ordinary American families should be wondering the most because they are the ones who have been left behind in whatever economic recovery we have seen. Regrettably, the gap between the haves and the have-nots continues to widen. GDP growth has been satisfactory, although not as strong as in the average postwar business cycle recovery, and productivity has been very strong. But as Ranking Member Frank has pointed out, what have ordinary American workers gotten in return for their hard work? Paychecks that have not kept up with inflation, much less with their increased productivity. And now rising interest rates and a slowing

economy may choke off the economic recovery before most Americans have even had a chance to benefit.

It is a challenging time for monetary policy because our fiscal policy is such a mess. The President's tax cuts were poorly designed to produce job-creating stimulus in the short run while adding to the budget deficit in the long run. The fiscal discipline built up in the 1990's has been squandered. Let us remember that President Bush inherited a budget surplus of $5.6 trillion over 5 years, but now we are back to a legacy of deficits and debt. We have record budget deficits and record debt, over $8 trillion, and a record trade deficit, the largest in history, $800 billion. Due to the debt, each American owes over $28,000. We are borrowing large amounts from the rest of the world and have had to raise our national debt limit four different times already during this current Administration.

The fiscal discipline of the 1990's allowed the Federal Reserve to pursue a monetary policy that encouraged investment and growth. The challenge is greater now because the Federal Reserve will have to fight the excesses of fiscal policy which have drained our national savings and turned us into a massive international debtor.

Chairman Bernanke, I look forward to your testimony and to exploring with you the challenges you face as you try to keep the economy growing and inflationary pressures contained so that ordinary Americans can begin to see their standard of living grow once again. Thank you.

The CHAIRMAN. The gentlelady's time has expired.

We now turn to the distinguished Chairman of the Federal Reserve. Dr. Bernanke, welcome back to the committee, and you may proceed.

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

Mr. BERNANKE. Thank you. Mr. Chairman, and members of the committee, I am pleased to be here again to present the Federal Reserve's Monetary Policy Report to the Congress.

Over the period since our February report, the U.S. economy has continued to expand. Real gross domestic product is estimated to have risen at an annual rate of 5.6 percent in the first quarter of 2006. The available indicators suggest that economic growth has more recently moderated from that quite strong pace, reflecting a gradual cooling of the housing market and other factors that I will discuss.

With respect to the labor market, more than 850,000 jobs have been added, on net, to nonfarm payrolls in the first 6 months of the year, though these gains came at a slower pace in the second quarter than in the first. Last month the unemployment rate stood at 4.6 percent.

Inflation has been higher than we anticipated in February, partly as a result of further sharp increases in the prices of energy and other commodities. During the first 5 months of the year, overall inflation, as measured by the price index for personal consumption expenditures, averaged 4.3 percent at an annual rate. Over the same period, core inflation, that is, inflation excluding food and en-

ergy prices, averaged 2.6 percent at an annual rate. To address the risk that inflation pressures might remain elevated, the Federal Open Market Committee continued to firm the stance of monetary policy, raising the Federal funds rate another three-quarters of a percentage point to 5¼ percent in the period since our last report.

Let me now review the current economic situation and the outlook in a bit more detail, beginning with developments in the real economy and then turning to the inflation situation. I will conclude with some comments on monetary policy.

The U.S. economy appears to be in a period of transition. For the past 3 years or so, economic growth in the United States has been robust. This growth has reflected both the ongoing reemployment of underutilized resources as the economy recovered from the weakness of earlier in the decade and the expansion of the economy's underlying productive potential as determined by such factors as productivity trends and growth of the labor force.

Although the rate of resource utilization that the economy can sustain cannot be known with any precision, it is clear that after several years of above-trend growth, slack in resource utilization has been substantially reduced. As a consequence, a sustainable noninflationary expansion is likely to involve a modest reduction in the growth of economic activity from the rapid pace of the past 3 years to a pace more consistent with the rate of increase in the Nation's underlying productive capacity. It bears emphasizing that because productivity growth seems likely to remain strong, the productive capacity of our economy should expand over the next few years at a rate sufficient to support solid growth in real output.

As I have noted, the anticipated moderation in economic growth now seems to be under way, although the recent erratic growth pattern complicates this assessment. That moderation appears most evident in the household sector. In particular, consumer spending, which makes up more than two-thirds of aggregate spending, grew rapidly during the first quarter, but decelerated during the spring. One likely source of this deceleration was higher energy prices, which have adversely affected the purchasing power of households and have weighed on consumer attitudes.

Outlays for residential construction, which have been at very high levels in recent years, rose further in the first quarter. More recently, however, the market for residential real estate has been cooling, as can be seen in the slowing of new and existing home sales and housing starts. Some of the recent softening in housing starts may have resulted from the unusually favorable weather during the first quarter of the year which pulled forward construction activity, but the slowing of the housing market appears to be more broad-based than can be explained by that factor alone. Home prices, which have climbed at double-digit rates in recent years, still appear to be rising for the Nation as a whole, though significantly less rapidly than before. These developments in the housing market are not particularly surprising as the sustained run-up in housing prices, together with some increase in mortgage rates, has reduced affordability and thus the demand for new homes.

The slowing of the housing market may restrain other forms of household spending as well. With homeowners no longer experiencing increases in the equity value of their homes at the rapid

pace seen in the past few years, and with the recent declines in the stock prices, increases in household net worth are likely to provide less of a boost to consumer expenditures than they have in the recent past. That said, favorable fundamentals, including relatively low unemployment and rising disposable incomes, should provide support for consumer spending. Overall, household expenditures appear likely to expand at a moderate pace, providing continued impetus to the overall economic expansion.

Although growth in household spending has slowed, other sectors of the economy retain considerable momentum. Business investment in new capital goods appears to have risen briskly, on net, so far this year. In particular, investment in nonresidential structures which had been weak since 2001 seems to have picked up appreciably, providing some offset to the slower growth in residential construction.

Spending on equipment and software has also been strong. With a few exceptions, business inventories appear to be well aligned with sales, which reduces the risk that a build-up of unwanted inventories might actually reduce production in the future. Business investment seems likely to continue to grow at a solid pace, supported by growth in final sales, rising backlogs of orders for capital goods, and high rates of profitability. To be sure, businesses in certain sectors have experienced financial difficulties. In the aggregate, however, firms remain in excellent financial condition, and credit conditions for businesses are favorable.

Globally, output growth appears strong. Growth of the global economy will help support U.S. economic activity by continuing to stimulate demand for our exports of goods and services. One downside to the strength of the global economy, however, is that it has led to significant increases in the demand for crude oil and other primary commodities in the past few years. Together with heightened geopolitical uncertainties and the limited ability of suppliers to expand capacity in the short run, these rising demands have resulted in sharp rises in the prices of which these goods are traded internationally, which in turn has put upward pressure on costs and prices in the United States.

Overall, the U.S. economy seems poised to grow in coming quarters at a pace roughly in line with the expansion of its underlying productive capacity. Such an outlook is embodied in the projections of members of the Board of Governors and the presidents of Federal Reserve Banks that were made around the time of the FOMC meeting late last month, based on the assumption of appropriate monetary policy. In particular, the central tendency of those forecasts is for real GDP to increase about 3¼ percent to 3½ percent in 2006, and 3 percent to 3¼ percent in 2007. With output expanding at a pace near that of the economy's potential, the civilian unemployment rate is expected to finish both 2006 and 2007 between 4¾ percent and 5 percent, close to its recent level.

I turn now to the inflation situation. As I noted, inflation has been higher than we expected at the time of our last report. Much of the upward pressure on overall inflation this year has been due to increases in the prices of energy and other commodities, and in particular to the higher prices of products derived from crude oil.

Gasoline prices have increased notably as a result of the rise in petroleum prices as well as factors specific to the market for ethanol.

The pickup in inflation so far this year has also been reflected in the prices of a range of goods and services as strengthening demand may have given firms more ability to pass energy and other costs through to consumers. In addition, increases in residential rents as well as in the imputed rent on owner-occupied homes have recently contributed to higher core inflation.

The recent rise in inflation is of concern to the FOMC. The achievement of price stability is one of the objectives that make up the Congress' mandate to the Federal Reserve. Moreover, in the long run, price stability is critical to achieving maximum employment and moderate long-term interest rates, the other parts of the Congressional mandate.

The outlook for inflation is shaped by a number of factors, not the least of which is the course of energy prices. The spot price of oil has moved up significantly further in recent weeks. Futures quotes imply that market participants expect petroleum prices to roughly stabilize in coming quarters. Such an outcome would, over time, reduce one source of upward pressure on inflation. However, expectations of a leveling out of oil prices have been consistently disappointed in recent years, and as the experience of the past week suggests, possible increases in these and other commodity prices remain a risk to the inflation outlook.

Although the costs of energy and other raw materials are important, labor costs are by far the largest component of business costs. Anecdotal reports suggest that the labor market is tight in some industries and occupations, and that employers are having difficulty attracting certain types of skilled workers. To date, however, moderate growth in most broad measures of nominal labor compensation and the ongoing increases in labor productivity have held down the rise in unit labor costs, reducing pressure on inflation from the cost side.

Employee compensation per hour is likely to rise more quickly over the next couple of years in response to the strength of the labor market. Whether faster increases in nominal compensation create additional cost pressures for firms depends in part on the extent to which they are offset by continuing productivity gains. Profit margins are currently relatively wide, and the effect of a possible acceleration in compensation in price inflation would also depend on the extent to which competitive pressures force firms to reduce margins rather than to pass on higher costs.

The public's inflation expectations are another important determinant of inflation. The Federal Reserve must guard against the emergence of an inflationary psychology that could impart greater persistence than what could otherwise be a transitory increase in inflation. After rising earlier this year, measures of expectations, based on surveys and on a comparison of yields on nominal and inflation-indexed government debt, have edged down and remain contained. These developments bear watching, however.

Finally, the extent to which aggregate demand is aligned with the economy's underlying productive potential also influences inflation. As I noted earlier, FOMC participants project the growth in economic activity should moderate to a pace close to that of the

growth of potential both this year and next. Should that moderation occur as anticipated, it should help to limit inflation pressures over time.

The projections of the members of the Board of Governors and the presidents of the Federal Reserve Banks, which are based on information available at the time of the last FOMC meeting, are for a gradual decline in inflation in coming quarters. As measured by the price index for personal consumption expenditures excluding food and energy, inflation is projected to be 2¼ percent to 2½ percent this year and then to edge lower to 2 percent to 2¼ percent next year.

The FOMC projections, which now anticipate slightly lower growth in real output and higher core inflation than expected in our February report, mirror the somewhat more adverse circumstances facing our economy which have resulted from the recent steep run-up in energy costs and higher-than-expected inflation more generally. But they also reflect our assessment that with appropriate monetary policy, and in the absence of significant unforeseen developments, the economy should continue to expand at a solid and sustainable pace, and core inflation should decline from its recent level over the medium term.

Although our baseline forecast is for moderating inflation, the committee judges that some inflation risks remain. In particular, the high prices of energy and other commodities in conjunction with high levels of resource utilization that may increase the pricing power of suppliers of goods and services have the potential to sustain inflation pressures. More generally, if the pattern of elevated readings on inflation is more protracted or is more intense than currently expected, this higher level of inflation could become embedded in the public's expectations and in price-setting behavior. Persistently higher inflation would erode the performance of the real economy and would be costly to reverse. The Federal Reserve must take into account these risks in making its policy decisions.

In our pursuit of maximum employment and price stability, monetary policymakers operate in an environment of uncertainty. In particular, we have imperfect knowledge about the effects of our own policy actions as well as of the many other factors that will shape economic developments during the forecast period. These uncertainties bear importantly on our policy decisions because the full influence of policy actions on the economy is felt only after a considerable period of time. The lags between policy actions and their effects imply that we must be forward-looking, basing our policy choices on the longer-term outlook for both inflation and economic growth. In formulating that outlook, we must take into account the possible future effects of previous policy actions, that is, of policy effects still in the pipeline. Finally, as I have noted, we must consider not only what appears to be the most likely outcome, but also the risks to that outlook and the costs that would be incurred should any of those risks be realized.

At the same time, because economic forecasting is far from a precise science, we have no choice but to regard all of our forecasts as provisional and subject to revision as the facts demand. Thus, policy must be flexible and ready to adjust to changes in economic projections. In particular, as the committee noted in the statement

issued after its June meeting, the extent and timing of any additional firming that may be needed to address inflation risks will depend on the evolution of the outlook for both inflation and economic growth as implied by our analysis of the incoming information.

Thank you. I would be happy to take questions.

The CHAIRMAN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Bernanke can be found on page 57 of the appendix.]

The CHAIRMAN. Again, welcome back to the Financial Services Committee.

Your predecessor was always emphasizing price stability as probably the key element to the charge that Congress gave the Federal Reserve way back when the Federal Reserve was created. And obviously your statement reflected that continuum on that issue. I have always been struck by the economic analysis of core inflation, minus—or not counting food and energy, and I am wondering if you could share that differential with the committee.

I say that because to the average person, when they think of inflation, they think of going to the gasoline pump, they think of going to the grocery store, probably has more of an effect on people's daily lives than any other form of inflation, and yet the Federal Reserve talks about core inflation minus those two components.

Could you share how that affects the decisions by the FOMC and how that is reflected in the policy?

Mr. BERNANKE. Yes, Mr. Chairman. First of all, you are absolutely correct that what matters to the average person is overall inflation, including energy prices and food prices, and we take that very seriously. Overall inflation is probably also what guides inflation expectations as people think about what inflation rate is likely to occur in the future, and that is another reason to be concerned about overall inflation.

There are two reasons why we look at core inflation as well as overall inflation. The first has to do with forecasting. Historically oil prices, energy prices have been rather volatile, and if you look even today at the futures markets, the futures market predicts energy prices will be relatively flat over the next couple of years. If you take that forecast as correct, then today's core inflation rate is actually a reasonable forecast of tomorrow's total inflation rate if energy prices do, in fact, flatten out as the markets seem to expect.

The CHAIRMAN. Could I interject there?

Mr. BERNANKE. Certainly.

The CHAIRMAN. Flatten out where; flatten out at $70 a barrel, $80 a barrel?

Mr. BERNANKE. Futures suggest they will be a little more increased, but roughly speaking, energy oil prices will flatten out between $75 and $80 over the next 2 years.

The CHAIRMAN. So there is no expectation at this point—wouldn't really make any sense that oil prices would slide back below $50.

Mr. BERNANKE. Not based on those futures markets quotes. There is also a great deal of uncertainty about where energy prices are going to go.

The CHAIRMAN. But the betting would be clearly on the upside as opposed to the downside.

Mr. BERNANKE. Well, if you look at the options on futures, which suggest something about the uncertainty the traders feel about oil prices, you see it is quite a wide range. There is a possibility in their mind that prices might fall $20 and a possibility in their mind that prices might rise $20. So there is a lot of uncertainty about what those prices will do. But our best guess is just to look at where the futures quotes are, and that suggests that energy prices should stay roughly in the area where they are today.

The CHAIRMAN. Assuming that is the case, and I think that is a fair assumption, at what point does the market mechanism provide the incentive for extra exploration, going into shale—oil shale, all of those things that could be triggered, if there is good news that we triggered by the higher prices, the incentive to go after tertiary recovery. Is that correct?

Mr. BERNANKE. Mr. Chairman, there are many alternatives to oil that are probably profitable at $40 or $50 a barrel. So if prices stay at this level over a period of time, you would expect to see a number of alternative supplies coming on line. The problem on that side, of course, is that many of these alternatives take some time to become available, and therefore, we don't get immediate relief. Of course, on the demand side as well there is also an incentive to conserve, reduced usage of oil. That should also provide, I hope, some relief.

The CHAIRMAN. Have you seen any indication that at this point that is beginning to take hold?

Mr. BERNANKE. We are seeing a lot of activity in drilling and mining, for example. It is very difficult to find petroleum workers or drilling rigs because the activity has risen. We are seeing activity in Canada and elsewhere on sands and shale. We are seeing some reduction in the demand for oil, although perhaps less than we would like.

What we saw in the past when oil prices rose very significantly in the 1970's was that the short-term effect was relatively small, but over a decade or more, we saw a very significant reduction in the amount of oil that the U.S. economy uses per dollar of real GDP.

The CHAIRMAN. I know you are not the Secretary of Energy, you are Chairman of the Federal Reserve, but obviously those components play a large part in their decisions. It struck me, for example, in the area of natural gas, there were all these dire predictions last winter that the price of natural gas would go through the roof, partly because of a mild winter and so forth. Now we seem to have a surplus of natural gas. Almost impossible, I guess, to predict it with any accuracy, which I guess makes your job that much more difficult. Is that a fair assumption?

Mr. BERNANKE. Yes, sir. That is a piece of good news, the natural gas prices have come down from the $12 to $14 level that we were seeing earlier. Natural gas is a bit different from oil in that natural gas is a regional market. We don't ship it internationally to the same extent that we do oil. And so we are very sensitive to the domestic supply-and-demand conditions, such as the effects of Hurri-

cane Katrina last year and the effects of the weather over the winter. So it is a more volatile price in that respect.

The CHAIRMAN. Thank you. My time has expired.

The gentleman from Massachusetts.

Mr. FRANK. Mr. Chairman, I want to get back to the wage issue because I really am troubled by an inattention to the problems that are there. And I am going to talk now about inconsistency in the language in your report, and I don't think it was conscious. I think it is more serious than that. It is a mindset where people automatically do it.

As you seem to be acknowledging, when I was talking about your discussion in wage increases in the monetary report, it is all without saying it is nominal. That is when you talk about the wage increases, you were talking about increases that are not corrected for inflation. And they look obviously better when they are that way, and you don't even say that.

But I went through the report as we were sitting here, and in every other sector where there is a discussion, you are talking about real. You are talking about real household expenditures. I mean, just—real outlays for goods on page 5. Real outlays for consumer services. Housing activity is measured by real expenditures. Real outlays for equipment software, real business fixed investment, real business spending. Real expenditures for nonresidential construction. Federal deficit was real. Real expenditures by State and local governments.

Frankly, it is only with wages that you don't get real, and that is a serious problem because what this does is allows people to—had a debate with a member of this committee in which he was told by Treasury how much wages have gone up, but I am sure they were using nominal wages. When Secretary Snow testified here, he used nominal wages. How can you justify talking about real, i.e., corrected for inflation, numbers in every other sector where there is a sector discussion but not with regard to wages? How do you justify that?

Mr. BERNANKE. Congressman, the nominal wage discussions are related to some cost issues, and it is a different topic. I agree with you absolutely that real wages are extremely important. I would also like to add in case there is any confusion that increases in real wages are entirely consistent with low inflation. There is no contradiction with those two things.

Mr. FRANK. Okay. I appreciate it, but now I will get back to the point in your statement where you talked about wages purely as a cost rather than as the way most people in America support themselves. In the report, you analyze sector by sector by sector, and in every sector you talk about real, and in labor you talk about nominal. That is a mindset that I think is unfortunate.

But now let me ask you with regard—and let us go to the productivity chart, because what you get is—in your statement it is, well, frankly, the tone is almost lucky for us that wages have stayed down. I mean, that is the context of it, because in the context of your statement, given the focus on inflation, the fact that wages have lagged both productivity and, in fact, inflation for the last year, that seems to be a good thing. And we have people writing—and you and I talked about this, and you have said that this

doesn't reflect you, but I think we have to make this public—in the financial pages wages are a bad thing, increases in wages are a bad thing. And people will write, the Federal Reserve is worried wages may go up.

So let me ask you now, given this chart with regard to real wages versus productivity, and given, as you have acknowledged, that profits are at an all-time high as a percentage of national income, do you believe there is room for wages to go up at least—not at least—to the level of productivity increases without that having an inflationary impact?

Mr. BERNANKE. Yes, I do. And I do expect nominal wages to rise.

Mr. FRANK. You said nominal again.

Mr. BERNANKE. Nominal wages and real wages to rise.

Mr. FRANK. You expect them, but I don't mean to be rude, nobody can eat your expectations. We have to eat our own work sometimes, but other people can't get much. And you acknowledge, I guess, in a question, we were told, well—it is the recovery, wages are coming, wage increases are coming. Well, the recovery is now leveling off, and wage increases ain't been here yet. And this—and by the way, I hear—and here is where I think we have a problem. It is not truly a force of nature. And, I mean, it goes with this. You acknowledge that wages are well below what they could be without there being an inflation effect?

Mr. BERNANKE. They could rise without inflation effect.

Mr. FRANK. Good. And they are below inflation—below productivity, below inflation. So workers in this great economy that we have had, and in many ways it has been a very good one, most of them—I am not talking about 20 percent, I am talking about 80 percent, the people who get paid by wages, their compensation, their wages have dropped. You are talking about compensation there, but that includes, you know—let's be careful when we talk about overall compensation in this report. One of the things we are talking about is when the employer pays more for health care, the worker can't bring that money home. So real wages have lagged. And here is the fact; it is not purely a force of nature.

When you refuse to raise the minimum wage so inflation erodes it, when you have an active policy of breaking labor unions, and when you have a tax policy that favors people at the high end, you are reinforcing those tendencies. And so what we have is a national policy which takes advantage of factors that are keeping real wages depressed and keeping productivity way ahead of wages so that all the increase—as Alan Greenspan said 2 years ago and apparently is still the case, virtually all of the increased wealth in this society that comes from increased productivity goes to the owners of capital, and obviously they should be getting some of it, but not all of it. It is not healthy.

And so you get that situation, you get a public policy that reinforces it, and then Mr. Hubbard shouldn't wonder why the American people don't give him credit for this wonderful economy. They don't give him credit because they are not getting any cash.

Thank you, Mr. Chairman.

The CHAIRMAN. I recognize the gentleman from Illinois.

Mr. GUTIERREZ. Thank you very much, Mr. Chairman.

I intended to ask Mr. Bernanke about the positive effect of immigration, but I have a scheduling conflict, so I would like to ask unanimous consent to have some items entered into the record. The first is an open letter on immigration to President Bush and all Members of Congress signed by 500 American economists, Mr. Chairman.

The CHAIRMAN. Without objection.

Mr. GUTIERREZ. The second is a July 10, 2006, open letter on immigration with 33 conservative signatories as published in The Wall Street Journal.

The CHAIRMAN. Without objection.

Mr. GUTIERREZ. And the third, Mr. Chairman, is an op-ed piece from the Wall Street Journal entitled, "Reagan on Immigration." The article discusses President Reagan's support for legalization and includes Mr. Reagan's account of his visit with the President of Mexico to get his ideas on "how we can make the border something other than a locale for a 9-foot fence."

Thank you, Mr. Chairman.

The CHAIRMAN. Without objection, so ordered.

The gentlelady from Ohio.

Ms. PRYCE. Thank you, Mr. Chairman, and you, Mr. Chairman, for your testimony.

We have—many of us on this committee have worked very hard on legislation to reform the Committee on Foreign Investment in the United States, the CFIUS process. Yesterday The Wall Street Journal quoted economist Lawrence Kotlikoff's recent study which said that foreign investment helps offset the low savings rate in the United States and has helped to raise the average wage of American workers by increasing productivity.

The savings rate in America continues to be terribly low, as I said in my opening statement. Can you discuss your thoughts on if certain pieces of this legislation does become law, and it looks like we in the House will be maybe dealing with that as early as next week, will it make that harder for foreign companies to invest in the United States? Do you believe it will be detrimental to our economy, especially the savings rate debt—rate/credit debt ratio facing Americans? And are you familiar enough with the House and Senate versions of the legislation to be able to comment on either one of them?

Mr. BERNANKE. Congresswoman, I would just make, I think, the general point that keeping our capital markets open to foreign investment is extremely important for the welfare of Americans. Capital that comes in allows us to invest more than we otherwise could. It provides jobs, it provides new technologies that come with foreign investment, at the same time that our open markets give us more opportunity to invest abroad and to achieve those returns.

So I think America has one of the most open, free capital markets in the world. It is to our benefit to try to maintain that. I fully recognize that there are circumstances in which national security concerns might come into play. I think we need to walk a very fine line to make sure that we are restricting ourselves to genuine concerns and that we don't, you know, unwarrantedly restrict legitimate capital inflows.

So I can't really comment on the two bills. I don't think it is really even my sphere to do so. But I hope that in thinking about this that Congress will weigh the very important benefits of capital inflows against the also very important concerns about national security.

Ms. PRYCE. Thank you.

Let me talk a little bit about insurance, and terrorism risk insurance specifically. Do you have any thoughts about what the financial mechanisms available are to enhance the private market capacity to take on terrorism risk when TRIA expires? And it seems to be a very difficult problem that isn't solving itself in the marketplace quite yet. And is government intervention stopping the market from working, or is it just inevitable that it is not possible for the market to absorb this?

Mr. BERNANKE. Congressman, I am a member of the President's Working Group on Financial Markets, as I am sure you know, and we are required to submit a report by September 30th to Congress evaluating the availability of terrorism risk insurance. The staff of the PWG has been exhaustively meeting with various groups. We have solicited comments which have been arriving, but we have not yet come to the point where the staff have summarized and brought the material together and briefed the principals of the PWG on this issue. I assure you when that time comes, we will look at it very seriously, because I understand it is an important issue to many people.

Ms. PRYCE. And lastly, for some time we have been discussing the evolving downsizing of the housing market as a moderate and orderly cooling process. I think that is how you have referred to it. Aren't you concerned about the considerable downside risk to the intrasensitive housing sector over the balance of the year? Can we hear your comments on that?

Mr. BERNANKE. Well, as you indicated, the downcurrent in the housing market so far appears to be orderly. The level of activity is still relatively high on an historical basis, but we recognize the risk you are pointing to. We are watching it very carefully.

I would just note that there are other aspects of the economy which are to some extent taking up the slack, so to speak, created by a slowing housing market, including investment in nonresidential construction and exports, among others. So we are looking at the overall economy. We are looking at housing. Clearly that is a very important sector we are watching very carefully.

Ms. PRYCE. We are very concerned in Ohio, and I appreciate your attention.

Thank you. I yield back.

The CHAIRMAN. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you.

Chairman Bernanke, I have been very concerned about the growing gap between the haves and the have-nots in the American people. The Federal Reserve has recently published some pretty disturbing evidence in this regard in the Survey of Consumer Finances. That survey is similar to others in showing weak growth in median income, but it has unique data on wealth. I have seen figures that the top 1 percent of families hold more wealth than the bottom 90 percent of families combined. Is that true?

Mr. BERNANKE. I believe that is correct.

Mrs. MALONEY. That suggests that for most families wages are the main source of income, doesn't it?

Mr. BERNANKE. Yes.

Mrs. MALONEY. And building on the conversation of Mr. Frank, the employment costs have not been a source of inflationary pressure at any point in the current recovery, and so that that may leave room for wages to grow without causing the Federal Reserve any worry. Is that a correct statement?

Mr. BERNANKE. As I said to Congressman Frank, I expect wages to rise, and I do think that higher real wages are completely compatible with low inflation

Mrs. MALONEY. Great. Thanks.

There are a lot of people who have not benefited from this economic recovery so far. And aren't those the people who are most vulnerable to the economic downturn if the Federal Reserve miscalculates and tightens monetary policy too much?

Mr. BERNANKE. Our concern, Congresswoman, is to achieve a sustainable growth path. We don't want to get into a situation where we get into a boom and bust. We don't want to get into inflation, because inflation also detracts from the buying power of workers and the consumers. So we are looking to try and achieve a sustainable growth path. We are aware of the risks to that, and we are going to do our utmost to achieve that.

Mrs. MALONEY. Following up on Congresswoman Pryce's comments on raising rates and the impact on mortgages, and I want to talk a little bit about the risk of both going too far in raising rates as it pertains to housing. First, aren't households with adjustable-rate mortgages the ones who feel the immediate effects of higher interest rates? What percentage of mortgages or home equity loans are immediately affected when interest rates go up?

Mr. BERNANKE. Our estimate is that about 20 percent of all mortgages outstanding have variable rates, and we expect about half of those, or about 10 percent, of the outstandings to reprice during 2006. So there will be some effect on variable-rate mortgages, but it should be a relatively slow process, and that would provide some cushion.

Mrs. MALONEY. Many New Yorkers are some of the most vulnerable homeowners. They are the people who made purchases with very little money down and obtained mortgages in a subprime market. Is there a danger of a wave of foreclosures and people losing their homes if interest rates keep rising?

Mr. BERNANKE. We have so far seen very little increase in delinquencies or problems in the mortgage market, but we will watch that very carefully.

Mrs. MALONEY. One of the great benefits of the strong economy of the 1990's, when the unemployment rate got down to 4 percent, more than half a percentage point lower than it is now, is that a great deal of people who did not have a firm attachment to the labor force got jobs and experience with full-time work, and aren't those the people who are most vulnerable if an economic expansion is choked off prematurely by tightening monetary policy too much?

Mr. BERNANKE. Congresswoman, again, our objective is to achieve a noninflationary sustainable expansion. There are risks to

that in both directions. It is possible to overtighten and to have the growth be slower than the potential; it is also possible to not sufficiently address inflation problems, and inflation rises. Both cut into buying power and create a risk that the Federal Reserve would have to raise interest rates more later.

So there are risks. Again, our objective is to try and create a noninflationary expansion.

With respect to mortgage rates, I would just like to add that one of the best things the Federal Reserve can do to keep mortgages rates low is to keep inflation low. When you look at the 1970's and early 1980's, when mortgage rates were in the 18 percent range, we are not seeing anything like that, of course, and it is because inflation is low and expected to stay low.

Mrs. MALONEY. And finally, my time is almost—

The CHAIRMAN. Your time is up.

Mrs. MALONEY. I just want to know, were the markets right when they rallied yesterday after your testimony?

Mr. BERNANKE. I don't comment on the market move.

The CHAIRMAN. Nice try, Carolyn.

The gentleman from Iowa, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

I would like to just make a comment first on your opening statement, sir. I appreciate very much the clarity of it, the transparency of it, as well as the modesty of judgment. It is very impressive. In particular, your comments on interest rates are as precise as this committee has ever heard, as well as your predictions on where you think GDP growth is going.

I would like to ask about a couple of definitional issues. One is a new economic term that has taken on great import and one that I gave very positive implications to, and I wonder if you would like to suggest whether it is positive or negative, and the term is a one-word term called "pause." Do you like this idea?

Mr. BERNANKE. Do I like the idea?

Mr. LEACH. Yes, of a pause.

Mr. BERNANKE. Well, as I spoke about in my testimony before the Joint Economic Committee, I raised the possibility that at some point—and I emphasize at some point—the Federal Reserve may want to vary its pattern of policy changes to look to vary the pace of tightening to get more information about the state of the economy. Neither then nor now am I making any specific commitments to future policy actions.

Mr. LEACH. Fair enough. But I just want to lay on the table that I think a lot of people in America find this idea of a pause in interest rate raising a very attractive idea.

The second issue I want to raise is employment, because you were precise—in December it was a little—not perfectly good news because we had about—the last reporting period was 4.6 unemployment. You are predicting for the next year and a half it is going to go between 4¾ percent and 5 percent, which means a slightly higher unemployment rate.

But the definition of unemployment is getting to be more interesting, and this contrast between the Household Survey and the numbers that is reported through corporations seems to be at a greater variance than any time in history, with the household em-

ployment rates going up substantially higher than the traditional measurements.

So I would like to ask you, when you referred to the 4¾ percent to 5 percent, what unemployment rate are you referring to? And does this relate to the household statistics or the traditional definitions? And might one reported rate be actually less optimistic than the situation, or vice versa?

Mr. BERNANKE. Congressman, let me just note that when these forecasts were made at the last FOMC meeting, I believe the unemployment rate was 4.7 percent at that point. We are not that precise in our forecasting. I think the thrust of our forecast is that the unemployment should stay at about the same region as it is today.

The unemployment rate is calculated from the Current Population Survey, which is a survey of 60,000 households; that is the one that we are referring to. The discrepancies that have arisen in the past are between the job creation numbers from that survey and the job creation numbers from the payroll survey, which we are perhaps more familiar with. Those two surveys have come closer together in recent years, and in the last few months we have seen some divergence again, but they have been somewhat more aligned than they were a few years ago.

Mr. LEACH. Fine. I appreciate that and have no further questions.

The CHAIRMAN. The Chair recognizes the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, I am interested in hedge funds and their impact on the economy. As I understand it, it is $1.2 trillion and growing, mostly held by—within 200 hedge funds. Obviously there is a lot more than that, but about 200 hold most of that money.

Hedge funds are no longer restricted to the wealthy, so-called sophisticated investor; they are open to the small investors. They are attracting larger and larger investments from pension funds, both public and private.

The growth in hedge funds has resulted in lower returns, on average, which in turn has led to some investment strategies that might be a little bit more risky than they had been in the past.

Recently the SEC, as you know very well—the SEC was knocked out in court from their attempt to not regulate, but to simply gather data and to make sure that that data was accurate and had the integrity so it could be relied on. It was not an attempt to regulate, yet the SEC was told they couldn't even gather this data.

I am just curious. Do you think the SEC should be gathering this data, or do you think that there is no need to do so?

Mr. BERNANKE. I think the SEC has an important role in making sure that the information that the hedge funds provide to their investors is accurate, and I would support their actions to do that.

I think, broadly speaking, that the best way to make sure the hedge funds are not taking excessive risk or excessive leverage is through market discipline, and there are two primary mechanisms. First, the SEC and the Federal Reserve supervise the large banks and investment banks which are the primary counterparties of the hedge funds. And ever since the PWG's report after the LTCM cri-

sis a few years ago, we have made very strong efforts to ensure that those banks and investment banks are very carefully monitoring the risks of the hedge funds that they work with, and are stress testing and are requiring sufficient margin and the like.

In addition, I think that the investors in hedge funds, which for the most part should be large and sophisticated investors, are also a source of market discipline. And I would support the SEC's investor protection activities to make sure that they get the information they need to make those judgments.

Mr. CAPUANO. So you would have no objection to this Congress passing a bill that clarified that the SEC's actions are within the law, or actually making it clear that the law allows them to have done only what they did. I am not suggesting—I would say it is not regulation, but simply gathering information.

Mr. BERNANKE. Well, the Board doesn't really have a position in that specific element. I think there is a trade-off. There are some benefits to the information, but we need to be a bit careful to make sure that the public is not misled into thinking that there is a full-fledged regulatory regime here which would then lead them to be less careful in their dealings with the hedge fund.

Mr. CAPUANO. I think that is a very fair statement.

I am glad to hear that, because some of the quotes that I read from you got me a little concerned. And I guess—jumping off of that into the next point, at some point regulation—I am not convinced it is necessary yet, but I guess I am leaning that way at some point. I have a quote here from you—actually, let me back up. The president of Bear Stearns is—well, he is not quoted, but it is reported that he considers hedge funds risky and have become a focus of concern because of their rapid growth and concentration in the industry. And it is reported that he has suggested that this could trigger a financial crisis. And obviously Bear Stearns, I don't think anybody would consider them radical left wing, over-regulating types of supporters.

Here I have a quote from you—and again, maybe misquoted, "Direct regulation may be justified when market discipline is ineffective at constraining excessive leverage in risk taking."

Well, I guess the question I have is does this suggest that we shouldn't even consider regulation until after there is a crisis of some sort, until after we find out that the market forces may not work, until after pension funds are looking to cover my mother's pension, or—I understand your hesitancy, and I am not suggesting we should rush into it at all, but I also think that there might be a balance at some point as hedge funds grow, that we might want to consider the possibility of reviewing some regulation. Again, I am not suggesting we jump into it headlong, but I think there is something between no regulation and waiting until after a crisis. And I want to see if I can clarify at least that quote that is attributed to you.

Mr. BERNANKE. First let me say that hedge funds provide some very important positive benefits. They add a lot of liquidity to markets, they add a lot of efficiency to the markets. We don't want to do anything that would inhibit those very positive—

Mr. CAPUANO. And I agree with that.

Mr. BERNANKE. That quote, I think, was a general statement, not referring to hedge funds. The thrust of my speech on hedge funds at Sea Island, Georgia, was to affirm the general principle that the President's Working Group put forward after LTCM, which is that the best way to achieve good oversight of hedge funds is through market discipline, through the counterparties, through the investors.

There are also other ways to try to make sure that hedge funds work better. I would just point to the work that the Federal Reserve Bank of New York has done to try to improve deferring settlement of credit default swaps, for example. And there are international groups like the Committee for Payments and Settlement Systems, which is sponsored by the BIS, which is also looking at this issue quite broadly. But at this point I think that the market discipline has shown its capability of keeping hedge funds well disciplined.

The CHAIRMAN. The gentleman's time has expired.

Mr. CAPUANO. Thank you very much, Mr. Chairman. Thank you for those opening remarks.

The CHAIRMAN. The gentleman from Louisiana.

Mr. BAKER. I thank the chairman.

Just to follow up a little bit on Mr. Capuano's remarks, there was, in 1999, H.R. 2924, which would have required hedge funds above a certain size to disclose information to the Federal Reserve for the intended purpose of identifying potential systemic risk events, and I will forward that over for comment and advisory. I, in retrospect, look at the product and feel that it needs to be made more clear that no proprietary disclosure be made to ensure that it is only a blind view as to who is sitting at what table and—beyond what the counterparty risk disclosure may give to you now.

I wanted to move quickly to the subject of GSE reform. I read with great interest your response to Senate questions on the matter of portfolio limitations wherein I believe you characterized your view to be that no hard dollar amount nor some arbitrary percentage reduction be made applicable, but rather that some relationship between portfolio scale and mission compliance pursuant to charter requirement be made effective.

In given conversations I have had with Secretary Paulson and Director Lockhart on the matter, I, for whatever it is worth, share that view—would like to request that you work with the Director and the Secretary to compound some sort of language that you think would be helpful in breaking the last remaining element I believe that is blocking the adoption of significant and, I think, very badly needed GSE reform.

There is another issue that I wanted to get on the record that I think is very important. I am concerned not so much about the domestic economic condition and our ability to maintain a reasonable rate of growth, except for the enhanced global competitive market we now face. I believe there are conditions brought on by our own regulatory constraints that may be inhibiting international capital flows which would generate the job opportunities and, hence, the increased wages which some have expressed concern about.

The result is that some regulators have suggested actions that might be helpful. Recently the Chair of FASB has indicated that a move toward a more principles-based accounting methodology might be a way to help industries' current cost of compliance. Chairman Cox has indicated his strong support for the deployment of XBRL to help us move away from the enormous paper-based reporting methodologies that we now have to deal with.

Many in the market have expressed some concerns about some of the compliance cost with the Sarbanes-Oxley Act. My last general question is to help us going forward and maintain our U.S. competitive edge, are there certain regulatory areas that you could recommend to the Congress to review where, without diminishing transparency, appropriate disclosure, gauging systemic risk potential—are there things that are now on the books that, in light of our current technological sophistication, are no longer warranted and might be worthwhile to set aside?

Mr. BERNANKE. Congressman, first, it is important to recognize that these regulations have a positive purpose, that Sarbanes-Oxley has addressed some important issues like corporate governance and disclosures, internal controls and the like. I think it is important that we think hard, particularly at the implementation phase, about aligning the costs and the benefits of individual actions.

As you may know, my former colleague Mark Olsen has just left the Federal Reserve to become the head of the Public Company Accounting Oversight Board. I have a lot of confidence in Mr. Olsen and in Chairman Cox. I am sure they are reviewing all these issues very carefully. And I think that for the implementation phase, the regulation phase, I think that they will look for areas where cost can be reduced without compromising the overall, in part—

Mr. BAKER. Let me jump in before my yellow turns red.

I met Mr. Olsen yesterday, and had a great conversation about these general parameters. The last piece of this, I believe, is that the most insidious force in market function were CEO's and CFO's trying to beat the street every 90 days with manipulation of the rules to exceed market expectation.

Do you support, as I do, and I believe others have expressed, including the Chamber, encouraging companies to move away from the 90-day reporting, and would that in a way deter investors' abilities to make proper judgments about economic condition of corporations?

Mr. BERNANKE. I thought about that issue, Congressman. I think that good corporate governance, though, should establish a longer-term strategic approach rather than meeting short-term earnings goals.

The CHAIRMAN. The gentleman's time has expired.

Mr. FRANK. Mr. Chairman, I have a unanimous consent request on behalf of our colleague, the gentleman from Texas, Mr. Hinojosa, who was called away by the little matter of redistricting, which is, as you know, a constant theme of Texas. So he has a unanimous consent request.

And he wanted me particularly to express his thanks to the Chairman of the Federal Reserve for addressing the regional issues conference, and particularly on the issue of financial literacy. So

these remarks are from Mr. Hinojosa, in which he expresses his gratitude to Chairman Bernanke for his support for the issue of financial literacy and for his work on that. That is for the record.

The CHAIRMAN. Without objection.

The gentleman from Missouri, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Chairman, we have many pension funds that have lost hundreds of millions of dollars. We have many citizens who have seen their investments lost whether because of corporate scandals, investment fraud, poor management decisions, or having to cash out and replace lost wages, yet we still hear how great investment returns are.

Who are these investment returns actually going to? How much of the investment returns is going to individuals not in the top 1½ percent of income earners?

Mr. BERNANKE. Congressman, you are referring, I think, in part to defined benefit pensions or defined contribution pensions. With regard to defined benefit pensions, we have had some problems, obviously, with companies not able to meet their promises. I think it is very important that Congress pass reform that requires companies to meet their promises, provides transparency so their workers can see what the state of the pension fund is, and protects taxpayers as well. So I think that is a very important area.

With respect to defined contribution plans, many workers are now moving toward defined contribution. I think they are receiving market returns on average, but one thing I would point out is that what we have learned is that people will not voluntarily join the defined contribution plan unless they are put in there by default. And one of the things that we encourage employers to do is have an opt-out option so that people don't take an action that they automatically enroll, because one of the important things we need to do is help middle-income and low-income families build wealth, and a 401(k) at work is one important mechanism for building wealth.

Mr. CLAY. And you are comfortable with the performance of the defined contributions?

Mr. BERNANKE. For 401(k)'s. I am not aware of any information that they have received lower returns than other investments. As Congresswoman Maloney pointed out earlier, there is inequality of wealth in the country, and people in the lowest levels of wealth have, you know, much smaller wealth relative to their income than those in the upper echelons.

Mr. CLAY. Thank you for that response.

We know that job creation in the Bush Administration does not nearly approach the average job growth monthly rate of the previous Administration. The Clinton Administration outpaced the Bush years by nearly 100,000 jobs a month. And we have seen the effects of this in my State, Missouri, with the loss of jobs. We additionally see that existing wages have not kept pace with inflation. Wages adjusted for the effects of inflation have not risen at all over the past 3 years. We have had an extended period of solid GDP growth, but this has not brought any real benefits to workers in general.

What is the direction of the Federal Reserve in addressing this problem?

Mr. BERNANKE. Well, we have no objection. You know, as I said, higher real wages are entirely consistent with low inflation.

With respect to jobs, there is an issue, I think, that is worth putting on the table which relates to some research that has been done by Federal Reserve economists. They have found evidence that for demographic reasons the labor force participation rate, the share of the adult population that is working or looking for work, will be declining over time, reflecting such factors of the leveling off of female participation, more young people going back to school, and then particularly the aging population. Older people are less likely to be in the labor force than younger people.

Because the labor force participation seems to have a downward trend to it, it probably takes fewer jobs each month to keep the unemployment rate at a constant level. So the job numbers, I think, going forward are going to be smaller, but not necessarily in a way that is going to raise unemployment, because the number of people looking for work is probably going to be growing more slowly in years to come than it was in the past.

With respect to wages, there are alternative measures of wages that give somewhat different answers, but I agree that average hourly earnings for production workers, as measured by the Payroll Survey, have not shown real gains. And one of the key problems there I think it is important to note is, in fact, the increase in energy prices, so what people get at the pay stub they lose at the gas pump. That is an issue and a reason for worrying a bit about inflation.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you.

Chairman Bernanke, I notice that you were confronted with a chart by Mr. Frank, and, in fact, yesterday you were questioned in the Senate about job compensation. Now, I don't know where he got his chart, there are Democratic charts and there are Republican charts, and then there is actually a chart—and I would like to turn it towards you here a minute if I could. There is a chart—did they hand you a copy of the chart?

Mr. BERNANKE. No, sir, but I can—

Mr. BACHUS. I had asked them to do that, and I apologize.

This is the Treasury Department chart on compensation growth, and it is entitled—and this is from the career people at the Treasury Department, this isn't from the DNC or the RNC or a dueling Member of Congress, and it is titled, "Compensation Growth Is Better than Comparable Point in Previous Cycle." It talks about real hourly compensation. And as I said, this is a national survey, National Compensation Survey—I am having Members on both sides take a look at it, and I would like unanimous consent to pass it out.

The CHAIRMAN. Without objection.

Mr. BACHUS. It shows that in the past year real hourly compensation has gone up 7.4 percent. Now, Mrs. Maloney and Mr. Frank keep talking about real, real, real. Well, if you will notice—and if you will turn that chart towards the chairman—actually, I

am sorry, you have one in front of you, I think. It talks about real compensation per hour is worker pay plus benefits adjusted for inflation and the number of hours worked. And what it shows is that in this job cycle, as opposed to the previous recovery, that workers are 7.4 percent better off in compensation. I just wanted to give you those talking points—in case you are asked about real numbers again.

Mr. FRANK. Would the gentleman yield for 1 minute?

Mr. BACHUS. And also, I would like to say that we have created 5½ million jobs, and job growth is stronger than it was under the last recovery.

But let me ask you this. You have been asked for 2 days—you have heard Members of Congress, you have heard the media talking about the anemic economy and the slow economy and the slowing economy. And I think The Wall Street Journal said it best. They called it the "Dangerfield economy, it is the economy that gets no respect."

Bottom line: What is your view about the economy? Is it as strong as some claim? Is it as weak as others claim? Just talk to us about the economy.

Mr. BERNANKE. I think the U.S. economy is a very strong economy; it is very resilient. It has passed through a number of very severe shocks going back to the stock market decline in 2000; 9/11; corporate scandals; and Hurricane Katrina. All these things have hit us, and yet the economy continues to grow at a rate that is faster than most other industrial countries, so in that respect it is very positive.

Mr. BACHUS. Do you know why there is such fear-mongering presently about the economy and about representations—and if you pick up the newspaper, every day you can read an article about how bad the economy is, and this economy is stronger than it has been in previous cycles, it is very strong.

Mr. BERNANKE. I would say the most favorable aspect of the economy is that productivity growth has picked up. We saw it pick up from the 1970's and 1980's. In the mid-1990's we saw it pick up, and in the last 5 years or so we have seen an additional pick-up, and that is a very positive feature of our economy, and one that compares well with other industrial countries.

Mr. BACHUS. And the fact that you are having to fight inflation is—part of that factor is a strong economy; is it not? If the economy was weak and unemployment was high, we wouldn't be having inflationary problems, would we?

Mr. BERNANKE. Congressman, I think there are a number of factors affecting inflation, but probably one of the most important is the fact that energy and commodity prices have gone up so much. And that affects, to some extent, the strength of the global economy, which has been very strong for the 3 or 4 years, and the increased demand for energy coming from China and other places has driven up those prices, and that has been a contributing factor to our inflation issue.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New York, Mrs. McCarthy.

Mr. FRANK. Will the gentlelady yield?

Mrs. MCCARTHY. Certainly.

Mr. FRANK. What the gentleman from Alabama completely misunderstands is the distinction between wages and compensation. When he and I were debating this on television, we were talking about wages, and he kept saying that wages were going up. I now understand the source of his error. It was that he has confused wages and compensation.

Real hourly compensation—as you will see if you read the Monetary Policy Report on page 18—includes employer contributions to health care costs, and, in fact, according to the Monetary Report, the cost of health insurance, which accounts for one-fourth of overall benefit costs.

So, yes, it is true that compensation has gone up if you count the amount of health care increases. What I was talking about was wages, the take-home pay, and that is very different than compensation. And, yes, as health care costs have accelerated, more has been paid out for the same health care, but for the worker taking home wages, that hasn't meant anything. So that is the fundamental difference.

There was also, as the report said, a burst in compensation in 2004 as companies made up for pension deficits, so they put money into the pensions that they were supposed to have had in there, and that also increased. You are talking about compensation, which includes pensions and health care, and I don't think, for the average worker, knowing that the boss is now paying more for the same health care he or she used to get when the wages in real terms have gone down is of great comfort.

The other thing is I am just struck by the timing of the comparison. You compare two quarters here, two periods, but you leave out the Clinton years. You talk about the Bush years, the second Bush years, and then you compare that to 1990 to 1995. So what is left out here is 1995 to 2000, the main thrust of the Clinton years, when apparently things were better, which is why they were left out.

But the fundamental flaw in the gentleman's reasoning is to equate compensation with wages, and it is wages that are eroding, and that is a real problem—

Mr. BACHUS. Point of personal privilege—

Mr. FRANK. There is no point of personal privilege for my remarks.

The CHAIRMAN. The gentlelady is recognized.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

I would like to bring this back down to a little perspective. I happen to think that the average person is having a hard time, and I will just—I know how much money I take out of my ATM. I go to the ATM once a month, and that is my budget, and I have always done it since I have been here, and I have done fine with it. I am a little thrifty, but I have to tell you, I have to go to my ATM machine now twice a month, mainly because the cost of my gasoline has gone up. In the New York area we have probably gone up a little bit higher; we are probably comparable to New York. But it is also when I go food shopping.

Now, I am a single woman. I go food shopping on Saturday morning, and I basically pick up my regular things, with a little bit more fruit. Fruit. The prices of fruit have gone up. This is what

the daily life of someone is going through. So I have seen my costs go up.

Certainly we in Congress, we get a COLA every year, so our pay increase has gone up 2 point something. But I have to tell you, my fuel costs—and I have gas at my home, and even though it was a mild winter, I ended up paying almost $1,800 more this past winter because of the surcharge. So you take that out of my yearly schedule, and you wonder why the middle-income families are having a hard time. They are; this is not a myth. If I am feeling a squeeze, and I probably make more money than a lot of my middle-income families, then certainly they are feeling the squeeze, because my medications have gone up, certainly dramatically, in the last 6 months. So there is pain out there for my middle-income families, and it is real pain.

So with that, though, I actually wanted to talk to you about—we are now in the hurricane season. We suffered a terrible loss financially here in the Treasury with Katrina. We are predicting more storms this year. And there are many of us who are basically looking at a reinsurance program.

And I guess, Mr. Chairman, my question to you is has the Federal Reserve looked at the potential impact of another major natural catastrophe on the U.S. economy? Can the Treasury afford another 50- or $100 billion response to any kind of natural disaster? Could a natural disaster reinsurance program protect the economy? And risk management insurance is better than debt. And I guess the final part of the question is, given the limited resources, is the cost of limited insurance better than the cost of unlimited debt?

Mr. BERNANKE. Well, of course, as you know, the hurricanes last year did enormous damage and created a very heavy fiscal burden. There is no question about that. I am glad to see that there has been some attention to trying to reform the Flood Insurance Program, put that on a more sound actuarial basis. You can buy insurance, but, of course, insurance will be expensive as well. There is really no free lunch in this case in order to protect against these risks.

So my summary is that this is a risk, and if it happens again, it will be a very heavy cost one way or the other to the Treasury. The only silver lining that I can point to is that the U.S. economy as a whole is very resilient, very strong, and we have been through a number of natural disasters, including hurricanes, earthquakes that we had, of course, the terrorist events, and the overall economy has proven to be rather resilient and has been able to continue to grow despite these terrible shocks. But I don't see any way to avoid the costs, except to try to make provision in terms of, for example, in the Gulf, providing stronger protections against those potential catastrophes.

The CHAIRMAN. The gentlelady's time has expired.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

The CHAIRMAN. The people indicate there are 10 minutes left in this vote. There is a series of three votes on the Floor. It would be the expectation of the Chair to recognize the gentleman from Delaware for questions and the gentleman from North Carolina, and then we will recess and return after those votes.

The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Bernanke, let me just agree with Mr. Baker on the GSE's and leave that at that. Let me also agree with the gentleman from Iowa, Mr. Leach, on the clarity of your comments and on your statements. I spent many a day up here listening to Chairman Greenspan, trying to figure out what he had written and never quite understanding it, trying to figure out what he had said, but never understanding it, but having great admiration for him because the economy always did well under him. And I understand you with clarity, and I hope this does as well—I don't know if clarity is good or not.

But I would like to have some reassurance here, because I listened to and read your comments as you were reading them with respect to the area of inflation, and when it is all said and done, that is what people really look at. And you can't comment on what seems to drive the stock market, what you are going to do with interest rates, or whatever. And I am not saying I see it differently, I just want to be reassured—and you may even say it in the same words, or perhaps in different words—but with energy prices and other commodity prices, even by your statement, we are probably not through with increases. And it is highly unpredictable, as you have indicated and as we all know.

But it is beyond just oil prices; I mean, there are a whole lot of commodity prices that are up tremendously, and it is a trickle-down effect. For example, in Delaware we entered into some cockamamie agreement whereby we didn't increase electric rates for 7 years or something, and now all of a sudden there is about a 50 percent jump at one time. But that is maybe atypical, but those kinds of things are happening out there. So all commodity prices concern me.

Labor costs, I think, are definitely—I mean, we see it here—there is definitely going to be a push as far as labor costs are concerned, which I think is going to be a major issue before it is all said and done.

I am going to ask you a question later if I have time on housing, because I am not sure where that is going with respect to this. Plus this sort of public expectation in terms of inflation is there as well. I am taking most of this, at least I am summarizing, from what is written here. So I am not saying anything is wrong, I just, based on what we see and know and sort of the uncertainty—and I realize economics is an uncertain practice, as you also said in your testimony. What reassurance can you give us that these projections of inflation being somewhat more in control than they have been in recent months, which has been of—well, maybe not the last couple of months, but before that was pretty significantly higher than anticipated, I think, by anybody, what reassurance can you give us that these projections are correct, that the inflation rate will hopefully stay where it is now or even decline slightly?

Mr. BERNANKE. Well, Congressman, as you point out, there is uncertainty. We have a baseline forecast which assumes that energy prices don't do another big increase, that expectations remain contained, as they appear to be currently. We have talked about the cost side of labor costs, which seem not at this point to be a problem from a cost perspective.

So from all that perspective, again, we have the baseline forecast that the inflation will gradually decline over the next couple of years. At the same time, we talk about risks, and we think there are some risks. The risk that I talk about in my testimony is that, given the tightening of markets, product markets in particular, that some firms may be better able to pass through those energy and commodity prices that you mention, and that that might become possibly embedded in the expectations of the public. So we do see some upside risks, and we have to take that into account as we make policy.

Mr. CASTLE. Thank you. It just seems to me there is a little more uncertainty than usual. But let me change subjects because time is going to flee here.

I want to talk about—when you talk about the housing market, not just now, but in general, I always get a little confused about what we are specifically talking about. Is it the economic—I know you were talking about the housing market as a whole, and you are going to say all of these components, but is it the new basic housing market, that is, the home builders and the banks and the others, who would profit from that, or is it the resale?

I mean, a lot of people in this room have houses, and they are worried about the resale of their houses going down, which may only benefit a limited number of brokers and a few other people, but not the housing market per se.

When we talk about housing, you have indicated a couple of times not housing per se, but other construction, which could be anything, I mean, offices, shopping malls, whatever it may be. My question to you is when you say the housing market having strengthened in recovery of the economy and slowing down, are you talking about all of these items, or are you talking about more specifically the new housing market? Can you break out the housing market a little more?

Mr. BERNANKE. Yes. What contributes to GDP is new construction of homes; that has been slowing. Construction of multifamily homes and apartments has been stable. Nonresidential construction has been actually strengthening.

As far as existing homes are concerned, that is relevant in two ways; one, commissions that realtors get from buying and selling does enter the GDP; but secondly, and more importantly, if home prices flatten out, it affects the equity that homeowners have, and it may affect their spending pattern, and that is a subsidiary effect that could come from a slowing housing market.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you.

Chairman Bernanke, I am very pleased to see a Dillon County, South Carolina, boy doing well. You probably remember that there are a lot of Millers from Dillon County. My grandfather was one of them, moved early in the last century to North Carolina. Actually, my grandmother was also a Miller. The gene pool in Dillon County at the beginning of the last century was not Olympic sized, and if I seem a little quirky, it may be the result of recessive traits. But I am pleased to see you doing well.

I do have questions based upon your discussion with Mr. Bachus and with Mr. Frank. Chairman Greenspan always distinguished in his testimony between supervisory wages and nonsupervisory wages, and said supervisory wages, which is only about 20 percent of employees, were going up much more rapidly than nonsupervisory wages. Is that consistent with your own observations in the time you have been—

Mr. BERNANKE. That appears to be true. The number that Congressman Frank is referring to is average hourly earnings, is for production workers, that is, nonsupervisory workers, and that hasn't grown very quickly in part because of, again, the high energy prices, which have taken away purchasing power.

Mr. MILLER OF NORTH CAROLINA. And for those 80 percent of the workforce who are nonsupervisory, in fact, they have not been keeping up with inflation, have they? Or only just barely at best.

Mr. BERNANKE. It is about even, yes.

Mr. MILLER OF NORTH CAROLINA. Chairman Greenspan, on many occasions before this committee, although undoubtedly a devoted believer, a devout believer, in capitalism, was very concerned about rising income inequality and the effect that it had on democracy. And I understand you addressed that the last time you were here. You said in July of last year that there is a really serious problem here, as I have mentioned many times before this committee, in the consequent concentration of income that is rising. In response to questions that I asked about supervisory and nonsupervisory wages, he said, we are giving a bivariate income distribution. And as I have said many times in the past, for a democratic society this is not helpful, to say the least. And as I have indicated on numerous occasions, I believe this is an education problem.

Chairman Bernanke, do you also think that the rising income inequality, the rising concentration of wealth is a problem for our society and a problem for our democracy?

Mr. BERNANKE. The short answer is yes. I would like to point out that the increase in inequality is a very long-term trend. We have been seeing this for about 25 years. I believe it is linked to education and skills in our technologically oriented society. But Chairman Greenspan's point that if the people in the bottom end are not sharing in the benefits of open markets and flexible capitalism, that they are going to react against it politically, I think that is a potential risk, and I agree with that assessment.

Mr. MILLER OF NORTH CAROLINA. Well, 80 percent is not just the bottom end. Actually the vast majority of workers are not sharing in whatever economic prosperity may be coming from production increases. Eighty percent is not just the bottom end. That is the vast majority of Americans.

Mr. BERNANKE. Well, I do want to point out that it has been very difficult in the past when we have had periods of energy price increases as large as we have seen, for example, the 1970's is another example, it is very hard for wages to keep up with that because it is such a big part of family budgets.

Mr. MILLER OF NORTH CAROLINA. Chairman Greenspan did identify, as you just did, education—and, of course, in part of what I read you mention education—he specifically spoke of community colleges. Community colleges is something that I have pushed in

the time that I have been here. I know how important they are to my State. Eleven- or twelve million Americans are in community colleges every year; it is where they go to learn job skills to get new jobs and better jobs.

In the time that I have been here, I have seen funding, Federal support for community colleges, decrease, not increase, or for some programs not keep up with inflation. The real support has diminished. And the taxes, the tax cuts going to people who receive inherited wealth. Chairman Bernanke, can you identify a single policy of this Congress or of the Bush Administration that appears directed at closing income inequality or the concentration of wealth?

Mr. BERNANKE. Well, I could point to the expansion of the child care credit and the earned income tax credit, if you are looking for a single example.

I want to agree with you about the community colleges. I think one of the great strengths of our system is that we have a very flexible educational training system; we have community colleges, vocational schools, technical schools, online learning. We don't have to wait for a whole new generation for people to acquire these skills. I think people can be retrained and can learn even as adults, and lifelong learning is a very important goal.

The CHAIRMAN. The gentleman's time is expired.

The Chair would indicate we will go in recess, and the committee will stand in recess until 12:15 p.m..

[Recess]

The CHAIRMAN. The committee will reconvene. And the next person in line is our good friend from Texas, Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Good afternoon, Chairman Bernanke.

I have a question dealing with the Working Group on Financial Markets. I want to learn more about that group and actually what authority they have and what they do. Could you tell me, as a member of that group, how often they meet and how often they take action, and have they done something recently? And are there reports sent out by this particular group?

Mr. BERNANKE. Yes, Congressman. The President's Working Group was convened by the President, I believe, after the 1987 stock market crash. It meets irregularly; I would guess about 4 or 5 times a year, but I am not exactly sure. And its primary function is advisory, to prepare reports. I mentioned earlier that we have been asked to prepare a report on the terrorism risk insurance. So that is what we generally do.

Mr. PAUL. In the media, you will find articles that will claim that it is a lot more than an advisory group you know, if there is a stock market crash, that you literally have a lot of authority, you know, to impose restrictions on the market. And we are talking about many trillions of dollars slushing around in all the financial markets, and this involves Treasury and, of course, the Federal Reserve, as well as the SEC and the CFTC. So there is a lot of potential there.

And the reason this came to my attention was just recently there was an article that actually made a charge that out of this group came actions to interfere with the price of General Motors stock. Have you read that, or do you know anything about that?

Mr. BERNANKE. No, sir, I don't.

Mr. PAUL. Because they were charging that there was a problem with General Motors, and then there was a spike in GM's stock price.

But back to the issue of meeting. You tell me it meets irregularly, but are there minutes kept, or are there reports made on this group?

Mr. BERNANKE. I believe there are records kept by the staff. There are staff mostly from Treasury, but also from the other agencies.

Mr. PAUL. And they would be available to us in the committee?

Mr. BERNANKE. I don't know. I am sorry, I don't know.

Mr. PAUL. The other question I have deals with a comment made by one of the members of the Federal Reserve Board just recently. He made a statement which was a rather common statement made. He expressed a relief that the economy was weakening, mainly—inferring that this would help contain inflation. And I hear these comments a lot of times, the economy is too strong, and therefore we need a weaker economy. If this assumption is correct—would you agree that this assumption—that a weaker economy is helpful when you are worried about inflation?

Mr. BERNANKE. Congressman, as I talked about in my testimony, we need to go to a sustainable pace. We need to have a pace which matches the underlying productive capacity; that will probably be a bit less robust than the last few years, because over the last few years we were also reemploying underutilized resources, and going forward we don't have that slack to put to work.

Mr. PAUL. But if you accept the principle, as it seemed to be in this quote, that if you are worried about inflation, you slow up the economy, and then inflation is brought down, it is lessened, it infers that inflation is caused by economic growth, and I don't happen to accept that, because most people accept the fact that inflation is really a monetary phenomenon. And it also introduces the notion that growth is bad, and yet I see growth as good. Whether it is 3 or 4 or 5 or 6, if you don't have monetary inflation, we don't need to worry, because if you have good growth in the marketplace rather than artificial growth, that it is this growth that causes your productivity to increase. You have an increase in productivity, and it does help bring prices down, but it doesn't deal with inflation.

And I think what I am talking about here could relate to the concerns of the gentleman from Massachusetts about real wages. There is a lot of concern about real wages versus nominal wages, but I think it is characteristic of an economy that is based on a fiat currency that is just losing its value that it is inevitable that the real labor goes down. As a matter of fact, Keynes advocated it. He realized that in a slump, that real wages had to go down, and he believed that you could get real wages down by inflation, that the nominal wage doesn't come on and keep the nominal wage up, have the real wage come down and sort of deceive the working man. But it really doesn't work because ultimately the working man knows he is losing, and he demands cost-of-living increases.

So could you help me out in trying to understand why we should ever attack economic growth. Why can't we just say economic

growth is good and it helps to lower prices because it increases productivity?

Mr. BERNANKE. Congressman, I agree with you. Growth doesn't cause inflation; what causes inflation is monetary conditions or financial conditions that stimulate spending which grows more quickly than the underlying capacity of the economy to produce. Anything that increases the economy to produce, be it greater productivity, greater workforce, or other factors that are productive, is only positive. It reduces inflation.

Mr. PAUL. Do you see our deficits that we produce—and that you have no control on—as a burden to the Federal Reserve in managing monetary affairs and maintaining interest rates as well as maybe even living with a lower increase in the money supply?

Mr. BERNANKE. Well, in our short-term monetary policymaking, we are able to adjust for the conditions of fiscal policy, however they may be. I think fiscal issues are more important in the long-term sense because of the long-term obligations we have, for example, for entitlements. We have not found the fiscal situation to be a major impediment to our short-term management of monetary policy.

Mr. PAUL. I guess we can—

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Kansas, Mr. Moore.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Thanks for your testimony this morning.

I am concerned that we have a serious fiscal problem in our country today. Last year our Federal budget deficit was $319 billion, and last week the Administration released its updated Fiscal Year 2006 budget deficit estimate of $296 billion. Isn't it true that the Fiscal Year 2006 deficit is closer to $477 billion when Social Security is excluded?

Mr. BERNANKE. I don't know the exact number, but it is true that without the Social Security surplus, the deficit would be larger.

Mr. MOORE OF KANSAS. And it looks like a smaller number when you take it out, correct?

Mr. BERNANKE. That has been the consolidated budgeting cost for some time now.

Mr. MOORE OF KANSAS. Should that be changed?

Mr. BERNANKE. I think it should be recognized that our budget deficit—and again, this is a practice of some standing—reflects current revenues and current spending, it doesn't reflect the unfunded obligations that are arising for future entitlement?

Mr. MOORE OF KANSAS. So that can be very misleading then, can't it?

Mr. BERNANKE. It can be misleading in the long-run sense. And as I have said a number of times, and my predecessor said, I think our greatest long-run challenge will be to find ways to meet the promises that we have made to an aging population.

Mr. MOORE OF KANSAS. Last week David Walker, the Comptroller General of the United States, and head of the GAO, delivered a speech in Dallas, Texas, and he said that, "The United States is now the world's largest debtor nation. In the last 5 years alone, our Nation's total liabilities and unfunded commitments

have gone up from about $20 trillion to over $46 trillion." Is he correct?

Mr. BERNANKE. Those are numbers which I think are consistent with the actuaries for Social Security and Medicare.

Mr. MOORE OF KANSAS. Are we the world's largest debtor right now as a Nation?

Mr. BERNANKE. If you are referring to external debt. I don't think it is true in terms of share of GDP, it would be in terms of actual dollars.

Mr. MOORE OF KANSAS. I am talking about actual dollars.

Mr. BERNANKE. I believe that is true.

Mr. MOORE OF KANSAS. Mr. Walker pointed out that our country today has several serious budget deficits. The first is our budget deficit, the second is our savings deficit, and the third is our balance of payments deficit. Is he correct on these three?

Mr. BERNANKE. Those are all issues I think we need to address, yes.

Mr. MOORE OF KANSAS. All right. We do, in fact, have a budget deficit, which we have already discussed, and have had for several years, correct?

Mr. BERNANKE. Yes.

Mr. MOORE OF KANSAS. Okay. And I believe—you didn't say it in exactly these words, but isn't it a fact that we are, in effect, mortgaging the future of our children and grandchildren right now by the way we are conducting our fiscal policy now?

Mr. BERNANKE. Again, I think the real issue is the long-term entitlement situation, and that is the one we are going to have to address better sooner than later.

Mr. MOORE OF KANSAS. Are we, in effect, charging new spending and tax cuts on a national charge card and passing the bill on to our kids for payment and our grandkids for payment?

Mr. BERNANKE. It would be better if we could be saving more and planning for these entitlement costs that are going to be coming down the pike very soon.

Mr. MOORE OF KANSAS. Would it be better if we were living within a budget?

Mr. BERNANKE. If we were to live within our budget, we would have a higher national saving rate and be better prepared for the long-term fiscal obligations that we have incurred.

Mr. MOORE OF KANSAS. So is the answer yes?

Mr. BERNANKE. Yes.

Mr. MOORE OF KANSAS. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman.

Mr. Chairman, I would like to get your views on ILC's, industrial loan companies. There has been a tremendous explosion in recent years of commercial firms buying ILC's in order to get into banking. Congressman Frank and I sponsored an amendment to prohibit those ILC's from branching nationwide, which passed the House, but hasn't passed the Senate. We now have a bill which would eliminate some future purchases of ILC's and also provide for the FDIC to regulate the holding companies.

I guess my question to you is what is your view on this situation of commercial firms buying ILC's, and attempting to get into banking? And how should we deal with that; and in particular, in terms of regulation of the holding companies?

Mr. BERNANKE. Well, Congressman, the Federal Reserve has testified on this issue. We have broadly two concerns from a public policy point of view. The first is the mixing of banking and commerce, which occurs when ILC banks are acquired by commercial firms. The Congress, through Gramm-Leach-Bliley, has indicated that it wants to keep banking and commerce separate, and I think this is inconsistent with that general approach.

The second concern we have is that the FDIC is only given authority to supervise the ILC banks themselves, but not to do consolidated supervision of the parents. And we feel that safe and sound regulation and supervision requires consolidated supervision that takes into account the financial condition of the parent as well as the ILC itself.

Mr. GILLMOR. Let me ask you, should we maintain—is it important for the health of the financial system to maintain that split between commerce and banking?

Mr. BERNANKE. It is a long-debated question among economists. My personal opinion is that it is a good idea to try to keep some separation between banking and commerce.

Mr. GILLMOR. Very good.

I want to ask you, in terms of mortgages, explosion of different kind of mortgage instruments, or, you know, no money down, a lot of adjustable rates, and those are promoted very heavily, and we now have millions of Americans with them. Those are basically low-interest-rate products, and now we are beginning to see interest rates go up.

Do you have concerns to the financial system and the ability to repay as interest rates go up and these are reset?

Mr. BERNANKE. There might be some risks in some of those situations. The Federal Reserve and the other banking agencies have issued proposed guidance for comment about nontraditional mortgages and how they should be managed.

About nontraditional mortgages and how they should be managed, and among other things, we are asking banks to underwrite not just the initial payment, but to underwrite the ability of the borrower to pay even as interest rates rise, as we go to a maximum payment, and we are also asking banks and other lenders to make sure that the consumer understands fully the implications of these sometimes complicated mortgages. So we are trying to address it from a guidance perspective.

Mr. GILLMOR. Let me—because I presume I am about out of time. Let me just go back and tie down one thing. In terms of holding companies of ILC's, would I be misstating it if I said it is your opinion that they ought to be regulated if they are a commercial firm? I guess two questions, one, should a commercial firm be able to buy them at all? And I am guessing the answer is, no. But secondly, if you do have a firm owning an ILC, should the holding company be regulated by the financial regulatory authorities?

Mr. BERNANKE. The purchase of a bank by a commercial firm violates the separation of banking and commerce, and so I wouldn't

advise allowing that, but if you do allow it, then it would be better to have consolidated supervision, which includes an overview of the financial condition of the parent, that is, the commercial firm as well as of the ILC subsidiary.

Mr. GILLMOR. Thank you very much, Mr. Chairman. I yield back.

The CHAIRMAN. Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. And I would like to thank Chairman Bernanke for being here this morning and for staying so long. These hearings just seem to go on and on and on. But I would like to ask you, how do you factor poverty into your work, into your calculations, into your predictions and what you do? How do you consider poverty? And how do you consider the implications of your decisions relative to poverty?

Mr. BERNANKE. Well, the evidence suggests that when the labor market is strong, poverty tends to fall. And so from the Federal Reserve's perspective, our mandate from Congress is price stability and maximum sustainable employment. So from our perspective, of course, ours is not a comprehensive approach to poverty. There are many other issues related to poverty but from our own perspective, if we keep a strong economy, we feel we are doing our bit to help reduce poverty.

Ms. WATERS. Have you ever written anything about poverty? Have you ever written a paper, or presented any analysis, or have you done anything to indicate the relationship of poverty to the Federal Reserve's decisionmaking process on interest rates and monetary policy?

Mr. BERNANKE. I have spoken on issues of community development, on issues of financial asset building by low- and moderate-income families. In some of my speeches and activities, I have been very much interested in economic redevelopment and issues related to low-income communities.

Ms. WATERS. Do you have anything in writing?

Mr. BERNANKE. Yes, ma'am. They are all on the Federal Reserve Web site, and we would be happy to send them to you.

Ms. WATERS. Thank you. And I will ask my staff to check them out.

The other thing I would like to ask about is employment opportunities at the Federal Reserve. What about minorities? What about African-Americans? Do you have any minorities in high-level positions at all?

Mr. BERNANKE. We have addressed this issue. And we have worked to increase the number of women and the number of minorities in the Federal Reserve system. I would be happy to provide you with numbers.

Ms. WATERS. Do you have any African-Americans that you know about in any high-level managerial positions?

Mr. BERNANKE. Until a month or two ago, the Vice Chairman of the Federal Reserve was an African-American, and he just left recently to retire from that position. A number of our highest-level economists and policy advisors are African-American or other minorities.

Ms. WATERS. Do you have—can you talk about the percentages of African-American women, Latinos, and Asians employed at the

Federal Reserve? Do you have an assessment in writing anywhere? Where can I find that?

Mr. BERNANKE. Vice Chairman Ferguson, I believe, testified on this matter at one point, and we can update that information and send it to you. We have an officer who is in charge of diversity and these types of issues, and I am sure she could provide you with the latest information.

Ms. WATERS. Would you please submit that for the record? You can submit it either to the chairman, or to my office. I would like to take a look at it.

Mr. BERNANKE. We will do that.

Ms. WATERS. To see how well you are doing with diversity at the Federal Reserve.

Now, finally, let me just ask you about the deficit. As you know, it was just a few years ago that everyone was so concerned about the deficit. President Clinton did a fabulous job of eliminating that deficit. Now we continue to have a deficit, and all that I hear is, oh, it is 2 percent less than it could have been; deficits are not so bad, particularly when we see some reductions, and we think that it is going in—are you concerned about the deficit?

Mr. BERNANKE. Congresswoman, as I have indicated, I think the real fiscal problems are long-term issues. We have some very substantial obligations for Social Security, for Medicare, and for other entitlement programs. They are largely at this point unfunded. And I think that we need to be moving towards a fiscal situation where we will be able to make those payments, we will be able to meet those obligations. I think that is the real long-term fiscal issue right here.

Ms. WATERS. I have never heard any alarm or any real concern written about or discussed by you about the deficit. I appreciate the answer that you just gave me, but I guess my question is, are you concerned about the size of this deficit?

Mr. BERNANKE. I don't think you can discuss it in isolation. I think it is part of the—

Ms. WATERS. I just want to know how you feel. I really don't need an intellectual answer. Are you concerned at all about the deficit?

Mr. BERNANKE. I am only concerned in the context of the fact that we need more national saving in the country. We need to work down the current account deficit over a period of time, and we need to prepare ourselves for our long-term transfer obligations. And for all those reasons, I think the fiscal situation ought to be improved. I don't—

Ms. WATERS. Does that spell, "I am concerned?"

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you very much.

Dr. Ferguson visited my Congressional district a couple of years ago. I would extend the same to you. We have one of the most highly concentrated areas in the country in manufacturing. I would like to show you some of the exciting things going on. I will give that to you in writing obviously.

My understanding is that the core inflation which does not take into consideration food and energy is at 2.6 percent. If you add en-

ergy, it is at 4.3 percent. And my question is, do you believe raising interest rates decreases consumption of gasoline for vehicles and oil feedstocks for manufacturing?

Mr. BERNANKE. Well, I will answer your question indirectly. One of the reasons we pay attention to the core inflation rate, which excludes energy, is we don't have a lot of control, obviously, over the price of energy, and so one of our concerns is that higher energy commodity raw materials costs don't get passed through into other goods and services. If we can sort of stop it at the first round, that will lead us to a more stable inflation situation when energy prices level off.

Mr. MANZULLO. But on the other hand, if inflation were at 2.6 percent, you might be raising interest rates. Is that correct? That is a trick question.

Mr. BERNANKE. It is a trick question. As I said in my testimony, our expectation is that core inflation will be moderating over the next 2 years for a variety of reasons. However, we do see some risks, and one of the risks would be that because product markets are tight, that there would be ability of firms to pass through energy and commodity prices into other goods.

Mr. MANZULLO. Well, it is unfortunately, in manufacturing, you can't do it, I mean, because of imports. And in the farming sector, you can't do it either. I have a lot of agriculture in my district, and so I think that the consumers and the farmers and the manufacturers are being hit with an additional tax which is the increase of inflation, and we can't do anything about it. And as I understand it, the reason you raise interest rates is to decrease consumption and cool off the economy. And so I think that raising interest rates, because of the increase in energy, not only is bad economics but it fuels the inflation. For example, most people charge—I think it is 60 percent of the people charge gasoline on their charge cards. And the interest rate on many credit cards is determined by the Federal Reserve. So whenever you increase your interest rate, you increase the interest rate that they are paying on the gasoline that they are charging. So you are actually fueling the problem and making it worse. Now that is not a trick question.

Mr. BERNANKE. The increase in energy prices is clearly making the economy worse off, both in terms of real activity and in terms of inflation. There is no question about it.

Mr. MANZULLO. Right.

Mr. BERNANKE. And we have very little control over energy prices themselves. Our objective is to make sure that it doesn't get into a wage-price spiral where energy prices spill over into other—

Mr. MANZULLO. So, therefore, the answer to your question—my question would be, by raising interest rates, you believe that that will decrease the consumption of energy?

Mr. BERNANKE. No. We expect it is going to reduce the ability of firms to pass through those costs to the final consumer prices.

Mr. MANZULLO. Why, by making it more difficult for them to borrow money for the production lines?

Mr. BERNANKE. By making product markets less tight.

Mr. MANZULLO. Such as—

Mr. BERNANKE. Well, again, as I mentioned before, if financial conditions are such that aggregate demand is greater than the underlying productive capacity of the economy—

Mr. MANZULLO. Right.

Mr. BERNANKE. Then you are going to have a lot of power of firms to pass through their cost because high demand means that they will have the power to raise their prices. What we want to make sure is that those high energy prices—

Mr. MANZULLO. But what that does is that makes our foreign competitors more competitive, those that have—for example, in Europe and Asia where natural gas is half what it costs here in this country, where natural gas is 80 percent of the feedstock of plastics. I just think—that is why I wanted you to come to my district to examine the impact on manufacturing because there is—every time you increase that interest rate, you not only tighten up the ability for these manufacturers to borrow money for the production line, but you make it more difficult for them to export, and that is going to hurt the economy as a whole.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Baca.

Mr. BACA. Thank you very much, Mr. Chairman, and Ranking Member Frank, for having this hearing.

And thank you, Mr. Bernanke, for being here as well. First, I want to start on the housing crisis. As the housing crisis market slows, areas like California, the Inland Empire where I have quite a few people moving in from L.A., Orange County, into the area, have been heavily dependent on real-estate-related employment will suffer the most. If prices start to drop in San Bernardino County, and homes stay on the market for 5 months instead of the 5 days, it hurts more than just the sellers. It also leads to less work for people, and I state less work for people who build new homes and those who help sell, finance, or insure them. Thousands of people's jobs are at stake, including home construction, real estate agents, mortgage brokers, inspectors, and more. Question number one is what industries of the economy have enough strength to pick up the slack as the housing market continues to cool? And question number two is what will the cooling housing market mean for job growth and unemployment numbers?

Mr. BERNANKE. Well, as I indicated in my testimony, there are other sectors that are going to pick up some of that slack, and they include nonresidential construction, which is quite strong, business investment, and exports. And also multifamily housing has remained at about the same level as recent years. So I think there are other components of the economy that are picking up some of that slack.

Mr. BACA. But at the same time, though, because of the outsourcing that we have done, and we have done quite a lot of outsourcing, that also hurts in that endeavor, too, as well when we look not only at our national deficit, but we continue to do most of the outsourcing. When most of the jobs are done outside, then all we have is distribution centers, and then it becomes a profit for individuals yet jobs are being lost here in the United States, and it is very difficult to pick up. Isn't that so?

Mr. BERNANKE. The labor market has strengthened considerably in the last couple of years. We always want it to be better, but it has been improving. In terms of outsourcing, we don't want people to lose jobs. And when people are displaced by—

Mr. BACA. We are losing jobs when we do outsourcing. We have lost quite a few jobs here in the United States.

Mr. BERNANKE. When that happens, I think it is important for us to help people retrain and find new work.

Mr. BACA. The labor market, too, as well because the minimum wages are low, and they are not up as well, and so it becomes very difficult. And we have not kept up with inflation, and that makes it very difficult, even for the original question that I asked on housing, is that correct?

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

Mr. BACA. Well, the connection is, with a lot of the outsourcing, we have lost a lot of jobs in the area. And as we have done that, we have not kept up with inflation in terms of even at labor jobs that are even done here because a lot of the labor jobs are at minimum wage, and we have not even increased the minimum wage to keep up with the inflation and the cost of living. Therefore, it impacts us. Is that correct or not?

Mr. BERNANKE. We have a large surplus in trade and services. A lot of people outsource to us—financial services, accounting services, educational services, and tourism. So it is a two-way street, and our labor markets benefit from transplants from foreign direct investment. I think keeping our economy open to the world is good for our labor market and good for our economy.

Mr. BACA. The next question that often runs along the same lines, and the question was just asked about gas pricing in my area or in the State of California, basically the cost of gas, prices have almost escalated to about $4 a gallon, which becomes very difficult for a lot of us, so it has jumped considerably. If the trend of raising gas prices coupled with the stagnated wages continues, how will the impact be felt in our communities across the Nation because it becomes very difficult even with the minimum wage right now that they are earning just to fill a tank of gas. It costs anywhere between $50, $60, and $70, which means that one day's work pays for a gas tank that only takes them to 2 days work. So it becomes very difficult in terms of—to keep up with their mortgage payments, putting food on the table, and paying their medical expenses. Could you reply how it affects us across the Nation?

Mr. BERNANKE. I agree absolutely. We have seen about a tripling of energy prices over the last few years. That has raised gasoline prices, raised heating oil and other kinds of energy prices, and it has reduced our growth and been a burden on consumers and firms, and it has been inflationary for us so it has obviously been a problem for our economy.

Mr. BACA. Okay. Well, the spending of gas prices growing faster than spending for other basic items such as healthcare, housing and college, what impact will this have on long-term economic growth? And do you believe that there should be a greater sense of urgency for Congress and this Administration to do something to stop the rising gas prices?

The CHAIRMAN. The gentleman's time has expired.

The chairman may respond.

Mr. BERNANKE. The higher prices have reduced our growth. We have estimates that GDP has been reduced between ½ percent and 1 percent from growth in the last few years, but I think it is important going forward that we look to other sources of energy and trying to diversify our portfolio of energy sources and trying to increase our conservation, and doing all that, we will, I think, ultimately overcome this problem.

Mr. BACA. If I had another question, I would have asked it on higher education, and the cost that has been there, too, as well, and its impact, it has not only on minorities and others getting into an education institution, but I didn't have time to do that. But I thought I would throw that in.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman.

And thank you, Mr. Chairman. If we are talking about the price of gasoline and the price of crude oil being a component of that, isn't crude oil simply a function of supply and demand? If we increased the supply, then the price would fall?

Mr. BERNANKE. Yes, Congressman. There is a global market.

Mr. PEARCE. Really affect the price of gasoline if we were to drill in ANWR in the outer continental shelf, if we were able to get those things through legislative bodies in this town, might affect the price of gasoline in some way.

Mr. BERNANKE. Yes.

Mr. PEARCE. Okay. Just making sure my facts were right. And I am also—as far as labor I would tell you that, in my home county, we do gas work. Those are basically labor jobs with no high school education required. And a kind of a minimum salary right now in the oil field is about $30,000. If you have some experience, it is up around $50,000. And if you are actually one of the lead forepersons, it is up around $100,000. So I don't really find anybody even at the Burger King, the entry-level price is $8.50. And I don't always see that the minimum wage is what is pulling us into financial difficulty as a country. You had made an observation earlier about the price of natural gas not accelerating, and I would point out that nationwide we have got about 1,400 or 1,500 drilling rigs and over 1,000 of those are drilling for natural gas, only about 300 or 400 drilling for oil, which tells us why the price of oil continues to go up. And so, again, we find that the supply and demand actually can be affected right now in today's current situation. So I continue to be a little bit surprised by our land management agencies that restrict access to the service of them. They restrict access. So if you ever have a chance to comment on that, I won't ask you to do it at this point, but we are choosing policies which absolutely give us a higher price of gasoline and then cause inflationary pressures. I think my question is, what price do you—you have adequately stated that labor is a little bit harder driver in inflationary pressures. But what price of crude oil would you be very concerned that we have inflationary pressures, significant inflationary pressures from energy?

Mr. BERNANKE. Well, I don't have a specific price in mind. The futures markets right now have oil prices rising a bit over the next

few months and then stabilizing. If that were to happen, then that source of upward pressure on the inflation rate, and also the adverse effect on growth, would be removed over time. Obviously, any significant $10 or $15 increase from where we are now would have significant consequences.

Mr. PEARCE. And again, it kind of lets us know that we probably should be doing some things on our energy policies, because of the descriptions in the Middle East, a $10 or $15 increase would be fairly easy to achieve, fairly within reach. The problem in the Middle East then brings us up to a different point, and that is even the availability of crude oil at any price. And could you see a scenario that might play out where the lack of energy, the lack of ability to move products around could drive us toward deflation rather than inflation? Would that be a potential scenario if the price—let's say that there is no price at which the Middle East would ship oil to the rest of the world.

Mr. BERNANKE. Well, it is a global market, and there are many different sources. I expect that oil would be available but potentially at a very high price, and I would think the primary effects of that would be inflationary because of the impact on costs and impact on the consumer prices at the pump and so on. And also it would be a hit to growth if oil prices were to rise very, very significantly.

Mr. PEARCE. I don't know that it is correct, but I have heard estimates that Saudi Arabia has about 60 percent of the world's oil and that is probably 15-year-old data. But even if it is 40 percent, I can see where—that it would not be available at any price if you add Iran and Saudi Arabia together, and I worry about the other end. If we faced deflation, what would be your view of responses that we should take?

Mr. BERNANKE. Well, deflation is not an immediate issue here in the United States. The Japanese have faced deflation for the last few years, and they used some nonstandard monetary policies, including what is called quantitative easing and a zero interest rate policy, and that seems to be helping. And their economy is currently growing, and they have recently left that unusual policy and returned to a more normal poll monetary policy regime.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Wisconsin, Ms. Moore. If the gentlelady would yield, the Chair would like to accommodate the rest of the members here, Mr. Chairman, if that is okay with you. And then we will be finished. We will try to keep the questions as brief as possible. Thank you.

Mr. FRANK. Let me join you in thanking the chairman for coming. The members really appreciate it.

The CHAIRMAN. The gentlelady from Wisconsin.

Ms. MOORE OF WISCONSIN. Well, thank you so much, Mr. Chairman. Thank you, Mr. Chairman. You can feel relief because, whenever they call on me, it is absolutely the end of the line. I am a new member, and so it is very important to me, sir—and you are a new chairman. It is very important for me to try to understand what the monetary philosophy is, and so as I look through your testimony here, you really say that the U.S. economy appears to be in a period of transition that has been growing, and it is robust.

And when I compare your optimism about our economy with what is happening to individuals, I see it is a negative savings rate, certainly I am guilty of that. You point out that some of the weakness in our economy prior to the last few years was seen in the lack of productivity of employees, but yet people are working harder, and they are earning less. I have heard numbers of my colleagues have probably complained about no increase in the minimum wage and the flattening of wages and so forth. They have less purchasing power. So they can't really buy things. You have admitted in your testimony that we are adding jobs at a much lower pace. And of course, we all know that the unemployment rate does not reflect the numbers of people who are eligible to be in the workforce that have just given up.

In my own hometown of Milwaukee, Wisconsin, we have a 52 percent unemployment rate among African-American men. But yet, on the other hand, in the last 5 years, we have seen corporate profits increase by 69 percent. We have seen executive compensation, which might account for some, you know, some increase in wages, we have seen the increase in corporate wages such that a corporate executive, on January 2nd, by lunchtime, has earned as much as a minimum wage worker will all year.

In your testimony, you said you touted business investments and exports. So am I to glean from all this that you really see a shift—that the shift in the economy has been to increase the capital, improvement of corporations and individuals and investors, and that basically we should just concede the strength of our economy by having people with good jobs and purchasing power and able to go out and buy goods and services, that our strength—that your perspective of the strength of our economy is in favor of capital; couple that with the cuts in programs that hurt families and all of the tax cuts that this Administration has put forward, should I conclude that strengthening our strong economy is because we prefer the accumulation of capital as opposed to our labor assets?

Mr. BERNANKE. Congresswoman, I am taking an overall perspective on the economy. I think that accumulation of capital helps workers. It provides jobs and raises productivity. I think exports provide jobs, give more opportunity. But I have also agreed with the comments made earlier that there is widening inequality in this country. It has been going on for about 25 years. I agree it is a concern. And nothing in my testimony contradicts that.

Ms. MOORE OF WISCONSIN. Okay. I do have a few more minutes. Well, I am glad to hear that because, Mr. Chairman, there are people in jail right now for painting a rosy picture about the value and assets of their companies and painting the rosy picture to their investors and consumers. So I would hope that the Federal Reserve would adhere to the discipline that I think that they are used to, you know, in terms of looking at the economy from both perspectives. Our concern, many of our concerns is that, you know, a few rich investors—I mean, they can only eat one hamburger, two hamburgers if they are really greedy, and it would be so much better to provide enough money in the economy so that thousands, yet millions of people could have a hamburger, could go out and enjoy an evening at the movies. It is not clear that these investors are really investing in American products. Can you comment on that

before my time expires? Are they making investments here at home? Because the job growth is slowing. You have admitted that. Or are they making investments abroad?

Mr. BERNANKE. Well, we have a global capital market. We have domestic investors investing both here and abroad, and we have foreign investors investing here as well. I think the process of investment, creating more capital is really one of the basic means by which we increase productivity, increase job opportunities.

The CHAIRMAN. The gentlelady's time has expired. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

And thank you, Mr. Chairman, as well. And one of the first comments at the very beginning of the day from the other side of the aisle, that all the credit can be given to you for the rise in the stock market yesterday based on your testimony—I think we are about halfway through the trading day. I have not seen whether or not there has been an inflection one way or the other based on testimony today. But there was an article in, I think, The Washington Post about a month ago where economists from some investment firm made some sort of comments saying that, well, the chairman is selected by the President, confirmed by the Senate; his real bosses are really in Wall Street. I just wonder how you take that sort of comment or criticism.

And then following that, though, a more serious note, and that is the point of the discussion that we have had so far on wages here. You touched part of this with regard to the unemployment rate. My question is two-part. One, what are the impediments, if any, that are holding down a significant or any real increase in wages? As I say, you touched upon the aspect of the unemployment rate being basically at historic lows for the period of time. On the other side of it, what are the impediments on the other side, or what could be pressures that we could use to, if we wanted to, to see a raise of wages? Is there something Congress has done in the past or is there something Congress should be doing in the future in this area? We know that, just a couple of years ago, in light of the economic doldrums that we were in, this Congress passed an economic growth package and—all the markets were going down; we passed the economic growth package, and you had the charts, you would see all the charts were going up in the other direction in a positive direction because of that. We passed tax cuts in this Congress which basically shifted the tax burden. There was a progressive tax cut, basically shifted the tax burdens so those who were making at the higher end of the income range are now paying a bigger, a larger percentage, a larger portion of the pie of the entire tax burden than they did before. So is there anything that we have done in the past that has been a negative impact, if you will, if that is the correct term, as far as the wage growth or lack of wage growth? And conversely, is there something we haven't done because we have heard from several members already with regard to the minimum wage, and we haven't moved on that in maybe over a half dozen years but maybe just comment what impact that would have anyway just considering the size of the population that is currently at the minimum wage and whether that would have any significant impact overall on wage growth?

Mr. BERNANKE. Well, on the slowing, the fact that real wages have not grown as quickly as we would like, there are a number of factors. Again, energy prices are very important. They have raised the cost of living. Congressman Frank talked about the difference between compensation and wages. Some parts of benefits are in fact useful to workers, but some of it reflects higher costs, for example, the medical insurance and the like, and they may not perceive that as being an increase in their standard of living, and then there is the fact that real wages have lagged to some extent behind productivity. I believe that will improve, but it hasn't entirely done so yet. I think the best thing that can be done to increase real wages and reduce inequality, and it has been said before, but I remain convinced, is upgrading skills and training. If we look at the labor market today, we see people with skills, generally—of course, there are always exceptions, but generally—not having difficulty finding jobs, and those with the lower levels of skills are the ones who are having the most difficulty finding good jobs. On the minimum wage, I think the statistic is about 2.5 percent of the labor force is actually at the minimum wage.

Whether a raise in minimum wage would assist is a controversial issue. Clearly, those who kept their jobs and had a higher wage would be better off. The question is whether or not some people would lose their jobs because of a higher wage. I have in the past, and I think it makes sense, suggested that perhaps a more targeted way to help lower-income people would be through the earned income tax credit, which doesn't have these negative employment effects and provides direct assistance to people who are low-income working families.

Mr. GARRETT. Switching subjects now quickly over to the GSE's, you made a comment on that earlier, you made some comments yesterday in your testimony in that regard, looking for a compromised solution, a middle ground, so to speak, on the portfolio limitations, and you are suggesting that may be one that goes up if the market is down—or if the economy is down, giving the rate a flexibility for them to come in and conversely restricting at other times, if I am understanding your testimony. Is the history, though, of GSE's, of Fannie Mae and Freddie Mac, have we seen them be able to do that in the past and do so appropriately? Because some critics say, in past crises, instead of what we ask them to do, what we expected them to do, actually what they did instead was basically take the cream of the crop and just basically take their own advantage as opposed to helping the economy. So would this be something to just benefit the GSE's if we did that compromise?

The CHAIRMAN. The gentleman's time has expired. The chairman may respond.

Mr. BERNANKE. Our research at the Federal Reserve has not found a significant impact of interventions by the GSE's in terms of assisting the housing market during difficult times.

Mr. GARRETT. Thank you.

The CHAIRMAN. The gentlelady from California, Ms. Lee.

Ms. LEE. Thank you, Mr. Chairman. Good to see you again Mr. Chairman.

I don't want to have to get back on my soap box on this, but I guess I will because I have been trying to get, since Chairman Greenspan, some real answers to this issue so that we can move forward. So in the past, and I think I have talked to you a little bit about this the last time you were here, I have sought to work with Chairman Greenspan to address the obvious racial and ethnic disparities in small business lending and home mortgage lending as well as I have talked with the CEO of our local Federal Reserve, Janet Yellen. Now, unfortunately, the response that I have received in each case has been totally inadequate. And this has been going on for several years. Mr. Greenspan suggested that the cost to business would prohibit stronger data collection, discounting the positive effects to the economy of increasing minority homeownership and small business lending. And Ms. Yellen also indicated that it would be way beyond the capacity of the Federal Reserve to undertake a community survey of minority homeownership and suggested that we wait until the 2010 Census.

I think the Federal Reserve must do more to ensure accountability to these unfair lending practices and to meaningfully address the tremendous gap, and it is tremendous in minority homeownership. Toward that end, I am interested in looking at ways to link the Community Reinvestment Act ratings with lending practices, and I have written you a letter—you probably haven't seen it yet—on July 12th, summarizing all this. CRA, of course as you know, was written to address how banking institutions meet the credit needs of their low- and moderate-income neighborhoods and ensure that banks invested in and strengthened the communities in which they were doing business. And part of this goal also was to reach out to traditionally underserved communities and provide them with access to capital if they needed it so that they could grow with their community bank. But disappointingly, according to much of the data that we have received, and I am sure you know this data, most banks provide on average—now this is on average—about a 1 to 2 percent conventional loan rating to their—in terms of home loans to African-Americans and to Latinos and yet the CRA ratings are "A's", and "outstandings", and what have you. And so what I am trying to figure out is, understanding the CRA doesn't currently focus on lending to minorities, don't you think that it makes sense to strengthen the statute to do so or at least to increase the amount of data, just increase the amount of data that is collected based on race and ethnicity because I believe—and I wanted to get your sense of this—that the potential economic benefits would definitely outweigh the minimal costs posed to businesses for collecting such information. And again, I hope to hear from you in writing because I did write this up again on July 12th.

And just the second question is—or well, yes, it is a question. I wanted to get your sense of the Wachovia regulatory approval of its acquisition of World Savings. That is located in my district, and we, since I have been in Congress, haven't been through this type of acquisition, and I wanted to hear what the underlying factors are in the Federal Reserve's decision and what your timetable is for the approval.

Mr. BERNANKE. I can answer the first three at least. The Federal Reserve has recently expanded the data collection under HMDA,

the Home Mortgage Disclosure Act, which collects data on every single home mortgage loan essentially made in the country including pricing, including denial rates, and including ethnicity. So we have a great deal of data on that issue, and we are using it as an initial screen to check for fair lending violations. With respect to CRA, it is absolutely correct that if the purpose of CRA is to get banks and other institutions to reach out to underserved communities, and they get credit for doing that when they do, and if they violate the fair lending laws, that's a debit in their CRA rating.

Ms. LEE. But that is not so at this point.

Mr. BERNANKE. I believe it is. But we will get back to you on your letter and give you exact information about that. You are correct that the CRA talks about underserved communities and lower- to middle-income communities. It doesn't specifically talk about race and ethnicity, and that is in the statute, and that would be, of course, up to Congress if they wanted to make that change.

Ms. LEE. But if we wanted to make the change, could we get your support for that?

Mr. BERNANKE. I would have to discuss it with other board members and the like, but I would certainly think about whether it makes sense in this context. Again, there are other ways to address the issue, through fair lending, for example, but I would certainly be willing to consider that issue.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

And, Mr. Chairman, the good news is I think I am the second to the last. In listening to some of the questions and some of the comments on the other side of the aisle, it would lead us to believe that we were on the verge of a great depression. I think what I have observed in our economy is that we have more Americans working now than ever. We have created—we, the economy, capitalists have created over 5 million new jobs in the last several years. We have a lower unemployment rate than we had in the 1970's, 1980's, and 1990's. Homeownership is at an all-time national record. Household wealth is at an all-time national record. Inflation adjusted after tax income is up. And then I know that you do not have a perfectly clear crystal ball, and I understand that economic forecasting is an imprecise science, but if I heard your testimony right, barring unforeseen circumstances, I think you said employee compensation is likely to rise over the next couple of years. You predict a gradual decline in inflation in coming quarters and that the economy should continue to expand at a solid and sustainable pace. Given where we have been, given where—given the facts that are available to the extent that you can forecast, my precise question is, what is your opinion of this economy relative to U.S. history? And what is your opinion of this economy relative to the Western industrialized world, say the EU and Japan?

Mr. BERNANKE. It is a very strong economy. Two very impressive aspects of it are, first, the very high productivity gains. We didn't see that in the 1970's and 1980's. We are now seeing productivity gains which are the envy of the industrialized world. The other thing about our economy which is impressive is its resilience. We have been through a number of very severe shocks in the last 5 or

6 years, and the economy has managed to continue to grow. It is certainly not a perfect economy, but there are some very strong elements, and I think those are two that I would point to.

Mr. HENSARLING. Much of the questioning has had to do with near-term economic and monetary policy. Let me turn our attention long term. I have a great concern over the spending patterns of the Federal Government, and I am sure you have probably poured over some of the similar reports that I have poured over and GAO and OMB and CBO that essentially lead me to conclusion, and I think others, and I am paraphrasing from a recent GAO report, that within one generation, America is facing a rather nasty fork in the road. One fork is going to lead to a Federal Government consisting of almost nothing but Medicare, Social Security, and Medicaid. The other fork in the road is going to lead to doubling taxes in real terms for the American people in one generation from roughly $22,000 for a family of four to $44,000. Assuming you have seen similar data and concluded to be accurate, there has been a lot of talk here of the economic implications of certain policies on low-income people. If we do not change the growth rates in the big three entitlement programs and we double taxes on the American people, what does the American economy look like in the next generation? And precisely what is its impact on low-income people?

Mr. BERNANKE. Well, your numbers are correct. We currently spend about 8 percent of GDP on those three programs, and according to the actuaries, by 2045, we will be spending about 16 percent. Since the Federal revenue collection is about 18 percent historically, that would be essentially the entire government. And this is the point I have been addressing that we need really to make up our minds about how we want to proceed. I do think if the taxes were to be raised to the level that you are describing, I think it would be a drag on growth and a drag on the efficiency of the economy. So Congress needs to think about what size government it wants and what the appropriate tax rate is that is associated with that government.

Mr. HENSARLING. There have been a couple of questions on GSE's, and forgive me if I am applying some old ground. But your predecessor had a rather high anxiety level about the GSE's holding their own debt in their portfolios. I know there has been a couple of questions about it, but if I decide to toss and turn tonight, how much time should I spend worrying about portfolio limitations on the GSE? To what extent on the anxiety barometer, how much time should we worry about the systemic risk that that poses?

Mr. BERNANKE. Well, I think there is a risk there. And indeed the recent report from OFHEO about some of the inadequacies of the GSEs' internal controls and their accounting makes us wonder about their ability to manage these very large and complex portfolios. I am not saying there is anything immediately about to happen, but I do think that these portfolios do present a systemic risk and that it would be in our interest to try to address that issue.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Miller, to wrap up.

Mr. MILLER OF CALIFORNIA. Thank you.

Welcome. I always enjoyed Mr. Greenspan when he was here, and I come from the building industry, about 35 years involved in

that. I enjoyed your testimony. I listened to it from my office. I actually had to write some of this down because I wanted to make sure I get everything correct and get a response on what you had been saying. You said in the hearing today that one of the best things to keep mortgage rates low is to keep inflation under control. And that in and of itself sounds reasonable, but you say in your testimony that increase in residential rents as well as in the imputed rent on owner-occupied homes has recently contributed to higher core inflation. You have also indicated in testimony that there has been a gradual cooling in the housing market, and I think that might be an understatement, but that is a statement. But I believe this cooling in the housing market is due to interest rate hikes. Every time you raise interest rates, you reduce the number of qualified buyers on the market. Kept out of the housing market due to a lack of affordability, these individuals turn to the rental market. This contributes to the increase in rents which you say is an indicator of inflation. In a way, it is kind of a circular reasoning. Affordability decreases when interest rates rise; rents rise due to lack of affordability in the housing market. This increase in rents leads you to determine the higher core inflation, so you increase rates. Some have said that the Federal Reserve has been relying too heavily on owner-equivalent rents to nationalize the interest rate hikes. The owner component of the core inflation is an imputation made by government statisticians to determine inflation. In essence, a weakening of home buying is increasing the demand for rental units, and the firming of rents translates into sizable increases in homeowner equivalent rents.

You are saying there is a problem in rents rising, but aren't you really creating the problem in rents rising by increasing rates?

Mr. BERNANKE. Congressman, we are aware of the issues associated with this imputed rent. On the one hand, I am a little bit reluctant to look at an inflation indicator that takes out energy, food, and shelter. At that point, we are looking at a very narrow measure of inflation, but the point you make has some validity. It is one reason why we tend to focus more on the core PCE deflator—rather than PCI. And I would say also that, as I mentioned in the testimony, that the pickup in core inflation is much broader based than this imputed rent component.

Mr. MILLER OF CALIFORNIA. Significant factor in your determination; am I not correct?

Mr. BERNANKE. What is significant is that this increase in core inflation seems to be a broadbased phenomenon, and so we don't think it is a statistical illusion.

Mr. MILLER OF CALIFORNIA. But when interest rates go up, any person who owns an apartment complex looks at demand, and what they are paying for cost of funds. And when you have a market that is being impacted because affordability has decreased, every time you raise it a quarter percent, "X" amount of people are driven out of the marketplace. Not only are people building homes impacted, the people who own homes are impacted. In California, it seems, after the recession we experienced in the 1990's as you recall, after 1989, some people in California had to wait until 2000 to have their home be worth what it was in 1989. So California is rather trying to catch up on the stagnant 11 years we experienced

there, and you have had a robust housing market that has, in my opinion, based on people I know in industry, has solely been impacted recently because of the rise in interest rates. People are being forced out of the market. And as that happens, not only are they impacted trying to sell their home, the cost of land has remained consistent. The cost of government process remains consistent, but this equation you are using on rents is just making the situation worse than it otherwise would have to be. And not only just rising rents, but you have discussed other factors that you think have contributed to this cooling in the market. What might those be?

Mr. BERNANKE. Well, the main factor is that housing prices have risen at double-digit rates for about 5 years. I think that quantitatively is the main reason that people have been getting priced out in some markets. And, you know, that obviously can't go on forever because affordability begins to bite and—

Mr. MILLER OF CALIFORNIA. Well, when supply and demand equal each other, that is true, but right now, the demand is huge. Rates being reasonable, they are having trouble producing enough product out there to meet that demand. But every time you raise these rates, more people are forced out of the marketplace that otherwise—you know, if you go back a year, year and a half, people who qualified to buy a home today can't even dream of it because the interest rate hike. And I am not trying to be argumentive, but you trying to stop inflation is absolutely devastating to the housing market and devastating to individuals who own homes who want to sell to relocate. They are unable to do that.

The CHAIRMAN. The gentleman's time has expired. This concludes the hearing.

Mr. Chairman, this will be our last hearing together. As I leave the Congress, I just want you to know how much we have appreciated your excellent testimony two times before the committee and look forward to—my successor, I am sure, looks forward to your continued cooperation and appearances on a regular basis before the Financial Services Committee. Again, thank you for your service.

Mr. BERNANKE. Thank you, Mr. Chairman.

[Whereupon, at 1:24 p.m., the committee was adjourned.]

A P P E N D I X

July 20, 2006

Opening Statement

Chairman Michael G. Oxley

Financial Services Committee

Federal Reserve Chairman Ben S. Bernanke
Monetary Policy Testimony
July 20, 2006

Mr. Chairman, good morning. In February, this Committee was proud to be the venue for your first appearance before Congress on the conduct of monetary policy. Today marks your second testimony with many more to come.

In 2001, shortly after I assumed the chairmanship of this Committee, the very first hearing I chaired was to receive the testimony of former Chairman Greenspan. We didn't know it at the time, but we had a very rough patch of economic road ahead, with bursting of the tech bubble, 9/11, the resulting insurance crisis, and the corporate bankruptcies.

Back then, we had a weak economy that everyone said was strong. Now, we have a strong economy that some are trying to convince us is weak.

Some of the credit for the current robust economy goes to the Fed, of course, where you and Chairman Greenspan have held inflation to lower levels and lower volatility than we have seen in all but 20 years of the life of the Fed. I'd like to enter a chart showing that into the record. The lion's share of the credit goes to President Bush, who had the steadiness to guide us through recession and the courage to do the right thing in seeking tax cuts to spur growth. Now we see that the biggest spurt in tax revenue growth in 40 years has trimmed our expected 2006 deficit by a third in just six months and is on track to drop the deficit as a percentage of GDP to less than half of the similar share in most European economies.

Some of the credit goes to Congress, which made the tax cuts stick, although we still need to work on making tax cuts permanent and work on spending discipline. But the largest credit of all goes to the American people, who with determination and character and heart showed what a great country this is. America suffered a recession, a massive terror attack, scandals of corporate governance, and a destructive hurricane season. Through all of that, we added 5.4 million jobs in the last three years, we've had 34 uninterrupted quarters of growth. We have an unemployment rate

lower than that of most of the last 40 years and we also have growth at or above the average rate for the all six post-war decades.

In June alone, the U.S. economy created 121,000 new jobs, and maintained a low 4.6 unemployment rate. I would be remiss if I did not point out that the unemployment rate is lower than the six percent floor that the economists used to call full employment. GDP growth for the first quarter was 5.6 percent, stronger than expected and the fastest growth in two-and-a-half years.

That, Mr. Chairman, is something for us all to be proud of. This is a remarkable country and a remarkable economy that constantly renews and reinvents itself. The Fed has led monetary policy extremely well, and I am certain that will continue to be the case during your tenure.

Mr. Chairman, America is doing well and will continue to do well. Of course, we will continue to have to work, to think, and to innovate, because other countries have smart people and good economies, as well. However, since the recession and the terror attacks, this country's economy has grown a great deal. In real terms, U.S. growth alone is half as big as the total economy of China.

So with that, Mr. Chairman, I thank you and all the many people at the Fed we never have met for their experience and dedication.

We look forward to your testimony, Chairman Bernanke, and with that I yield back the balance of my time and recognize the gentleman from Massachusetts.

U.S. Congresswoman
Ginny Brown-Waite

Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Committee on Financial Services
Testimony from Fed Chairman Bernanke
Thursday, July 20, 2006

Statement for the Record

Thank you Mr. Chairman.

And I want to thank you Chairman Bernanke for being here. I am eager to hear your testimony today.

The two most important issues, I know to my constituents, are rising energy costs and the housing market. So many of my constituents are retirees on fixed incomes. I do not represent a rich district. All that many of them have are Social Security and the equity in their home. So as this housing market cools, their anxiety over future retirement needs increases. And Florida has an additional layer of concern – skyrocketing homeowners insurance rates. Mix these worries together with volatile gas and energy prices, and you have a group of seniors who aren't exactly living carefree in their golden years.

Therefore, I look forward to hearing what you the Fed is doing to keep our economy growing and inflation stable during these unpredictable times. I know that you have a daunting task, Chairman Bernanke, and I thank you for sharing your insight with us today.

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

Opening Remarks
Representative Maxine Waters, D-CA 35th

Committee on Financial Services

Hearing to Receive the Testimony of the

Chairman, Ben Bernanke of the Federal Reserve Board of Governors

Thursday, July 20, 2006

Good Morning. Mr. Chairman and Ladies and Gentlemen, I want to welcome our Federal Reserve Board of Governors, Chairman, Dr. Ben Bernanke, back to the Committee. When we heard from Chairman Bernanke, shortly after his confirmation hearings and swearing in as the new Fed Chairman in February of 2006, things were relatively calm. Things have changed.

Back then, Chairman Bernanke identified three issues in his testimony that he felt could influence the economy --energy prices, slowing of the housing market, and resource utilization. Much has happened since February; in particular we have seen a steady rise in energy prices. Of course, with events unfolding in the Middle East, there appears to be no end in sight to the increase in energy prices. Since February the price of crude oil has risen by more than 30 percent from around $55.00 a barrel to its current price of $78.00 a barrel. The economy has been able to weather the price increases, but will it be able to do so in the future. To the extent that energy prices continue to rise, we are likely to witness a major slow down in the economy that could be the precursor of a more ominous future and even recession. In addition, the simmering housing market has slowed down considerably, and resources are being stretched because of increased global demands.

One issue that your past testimony did not cover was the enormous debt. A week ago, the Administration released its Mid-Session Review of the Budget, which revealed that we are not on a path to a balanced budget, and there is no plan, process or prospect for balancing the budget. While the Administration claims credit for bringing the deficit down, it should be given credit for producing these huge deficits in the first place.

The Administration's estimate of $296 billion deficit for 2006 is the fourth largest in history, and is $601 billion worse than the surplus that the Administration estimated in 2012. If the Social Security surplus is excluded, the 2006 deficit is $473 billion. Even under the Administration's five year forecast, deficits never get better than $123 billion. But once likely costs omitted for the Administration's numbers are included like the war -- the budget deficit is really around $229 billion. Unfortunately, these large deficits add to mounting debt that only future generations will have to pay -- from $8.5 trillion at the end of 2006 to more than $11.0 trillion at the end of 2011. I would submit to you Chairman Bernanke that something is wrong with this picture, something is amiss.

While I know you are here to update the Committee on the economy and monetary policy, I also wanted to raise the issue of minority employment in the financial services industry. Just last week, the Subcommittee on Investigations and Oversight of our Committee heard testimony concerning the financial services industry and minority managerial positions. Not only was I surprised by the trends in the industry, I could not believe that minority managers had grown in absolute terms by 1 percent in terms of the numbers employed in the last ten years, 4.6 percent in 1993 to 5.6 percent in 2004. The financial services industry has been one of the fastest growing sectors for employment, but one of the slowest in promoting minorities to participate in the rewards. This is a trend that must be reversed, if we are to grow an economy that is fair and equitable.

Mr. Chairman, I would like to get your sense of whether we are headed in the right direction. I am concerned about how long we can expect the economy to continue to grow and to expand opportunity. Or are we confronting a double edged sword with energy prices, huge deficits that will result in loss income, unemployment and high inflation. Do you believe that we should be considering policies to turn-off the Administration's automatic pilot on the economy, reversing the policies that have led to our current fiscal situation, as well as our economic position in the global economy. Mr. Chairman. Thank you.

For release on delivery
10:00 a.m. EDT
July 20, 2006

Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

July 20, 2006

Mr. Chairman and members of the Committee, I am pleased to be here again to present the Federal Reserve's Monetary Policy Report to the Congress.

Over the period since our February report, the U.S. economy has continued to expand. Real gross domestic product (GDP) is estimated to have risen at an annual rate of 5.6 percent in the first quarter of 2006. The available indicators suggest that economic growth has more recently moderated from that quite strong pace, reflecting a gradual cooling of the housing market and other factors that I will discuss. With respect to the labor market, more than 850,000 jobs were added, on net, to nonfarm payrolls over the first six months of the year, though these gains came at a slower pace in the second quarter than in the first. Last month the unemployment rate stood at 4.6 percent.

Inflation has been higher than we had anticipated in February, partly as a result of further sharp increases in the prices of energy and other commodities. During the first five months of the year, overall inflation as measured by the price index for personal consumption expenditures averaged 4.3 percent at an annual rate. Over the same period, core inflation--that is, inflation excluding food and energy prices--averaged 2.6 percent at an annual rate. To address the risk that inflation pressures might remain elevated, the Federal Open Market Committee (FOMC) continued to firm the stance of monetary policy, raising the federal funds rate another 3/4 percentage point, to 5-1/4 percent, in the period since our last report.

Let me now review the current economic situation and the outlook in a bit more detail, beginning with developments in the real economy and then turning to the inflation situation. I will conclude with some comments on monetary policy.

The U.S. economy appears to be in a period of transition. For the past three years or so, economic growth in the United States has been robust. This growth has reflected both the

ongoing re-employment of underutilized resources, as the economy recovered from the weakness of earlier in the decade, and the expansion of the economy's underlying productive potential, as determined by such factors as productivity trends and growth of the labor force. Although the rates of resource utilization that the economy can sustain cannot be known with any precision, it is clear that, after several years of above-trend growth, slack in resource utilization has been substantially reduced. As a consequence, a sustainable, non-inflationary expansion is likely to involve a modest reduction in the growth of economic activity from the rapid pace of the past three years to a pace more consistent with the rate of increase in the nation's underlying productive capacity. It bears emphasizing that, because productivity growth seems likely to remain strong, the productive capacity of our economy should expand over the next few years at a rate sufficient to support solid growth in real output.

As I have noted, the anticipated moderation in economic growth now seems to be under way, although the recent erratic growth pattern complicates this assessment. That moderation appears most evident in the household sector. In particular, consumer spending, which makes up more than two-thirds of aggregate spending, grew rapidly during the first quarter but decelerated during the spring. One likely source of this deceleration was higher energy prices, which have adversely affected the purchasing power of households and weighed on consumer attitudes.

Outlays for residential construction, which have been at very high levels in recent years, rose further in the first quarter. More recently, however, the market for residential real estate has been cooling, as can be seen in the slowing of new and existing home sales and housing starts. Some of the recent softening in housing starts may have resulted from the unusually favorable weather during the first quarter of the year, which pulled forward construction activity, but the slowing of the housing market appears to be more broad-based than can be explained by that

factor alone. Home prices, which have climbed at double-digit rates in recent years, still appear to be rising for the nation as a whole, though significantly less rapidly than before. These developments in the housing market are not particularly surprising, as the sustained run-up in housing prices, together with some increase in mortgage rates, has reduced affordability and thus the demand for new homes.

The slowing of the housing market may restrain other forms of household spending as well. With homeowners no longer experiencing increases in the equity value of their homes at the rapid pace seen in the past few years, and with the recent declines in stock prices, increases in household net worth are likely to provide less of a boost to consumer expenditures than they have in the recent past. That said, favorable fundamentals, including relatively low unemployment and rising disposable incomes, should provide support for consumer spending. Overall, household expenditures appear likely to expand at a moderate pace, providing continued impetus to the overall economic expansion.

Although growth in household spending has slowed, other sectors of the economy retain considerable momentum. Business investment in new capital goods appears to have risen briskly, on net, so far this year. In particular, investment in nonresidential structures, which had been weak since 2001, seems to have picked up appreciably, providing some offset to the slower growth in residential construction. Spending on equipment and software has also been strong. With a few exceptions, business inventories appear to be well aligned with sales, which reduces the risk that a buildup of unwanted inventories might act to reduce production in the future. Business investment seems likely to continue to grow at a solid pace, supported by growth in final sales, rising backlogs of orders for capital goods, and high rates of profitability. To be sure,

businesses in certain sectors have experienced financial difficulties. In the aggregate, however, firms remain in excellent financial condition, and credit conditions for businesses are favorable.

Globally, output growth appears strong. Growth of the global economy will help support U.S. economic activity by continuing to stimulate demand for our exports of goods and services. One downside of the strength of the global economy, however, is that it has led to significant increases in the demand for crude oil and other primary commodities over the past few years. Together with heightened geopolitical uncertainties and the limited ability of suppliers to expand capacity in the short run, these rising demands have resulted in sharp rises in the prices at which those goods are traded internationally, which in turn has put upward pressure on costs and prices in the United States.

Overall, the U.S. economy seems poised to grow in coming quarters at a pace roughly in line with the expansion of its underlying productive capacity. Such an outlook is embodied in the projections of members of the Board of Governors and the presidents of Federal Reserve Banks that were made around the time of the FOMC meeting late last month, based on the assumption of appropriate monetary policy. In particular, the central tendency of those forecasts is for real GDP to increase about 3-1/4 percent to 3-1/2 percent in 2006 and 3 percent to 3-1/4 percent in 2007. With output expanding at a pace near that of the economy's potential, the civilian unemployment rate is expected to finish both 2006 and 2007 between 4-3/4 percent and 5 percent, close to its recent level.

I turn now to the inflation situation. As I noted, inflation has been higher than we expected at the time of our last report. Much of the upward pressure on overall inflation this year has been due to increases in the prices of energy and other commodities and, in particular, to the higher prices of products derived from crude oil. Gasoline prices have increased notably

as a result of the rise in petroleum prices as well as factors specific to the market for ethanol. The pickup in inflation so far this year has also been reflected in the prices of a range of non-energy goods and services, as strengthening demand may have given firms more ability to pass energy and other costs through to consumers. In addition, increases in residential rents, as well as in the imputed rent on owner-occupied homes, have recently contributed to higher core inflation.

The recent rise in inflation is of concern to the FOMC. The achievement of price stability is one of the objectives that make up the Congress's mandate to the Federal Reserve. Moreover, in the long run, price stability is critical to achieving maximum employment and moderate long-term interest rates, the other parts of the congressional mandate.

The outlook for inflation is shaped by a number of factors, not the least of which is the course of energy prices. The spot price of oil has moved up significantly further in recent weeks. Futures quotes imply that market participants expect petroleum prices to roughly stabilize in coming quarters; such an outcome would, over time, reduce one source of upward pressure on inflation. However, expectations of a leveling out of oil prices have been consistently disappointed in recent years, and as the experience of the past week suggests, possible increases in these and other commodity prices remain a risk to the inflation outlook.

Although the costs of energy and other raw materials are important, labor costs are by far the largest component of business costs. Anecdotal reports suggest that the labor market is tight in some industries and occupations and that employers are having difficulty attracting certain types of skilled workers. To date, however, moderate growth in most broad measures of nominal labor compensation and the ongoing increases in labor productivity have held down the rise in unit labor costs, reducing pressure on inflation from the cost side. Employee compensation per

hour is likely to rise more quickly over the next couple of years in response to the strength of the labor market. Whether faster increases in nominal compensation create additional cost pressures for firms depends in part on the extent to which they are offset by continuing productivity gains. Profit margins are currently relatively wide, and the effect of a possible acceleration in compensation on price inflation would thus also depend on the extent to which competitive pressures force firms to reduce margins rather than pass on higher costs.

The public's inflation expectations are another important determinant of inflation. The Federal Reserve must guard against the emergence of an inflationary psychology that could impart greater persistence to what would otherwise be a transitory increase in inflation. After rising earlier this year, measures of longer-term inflation expectations, based on surveys and on a comparison of yields on nominal and inflation-indexed government debt, have edged down and remain contained. These developments bear watching, however.

Finally, the extent to which aggregate demand is aligned with the economy's underlying productive potential also influences inflation. As I noted earlier, FOMC participants project that the growth in economic activity should moderate to a pace close to that of the growth of potential both this year and next. Should that moderation occur as anticipated, it should help to limit inflation pressures over time.

The projections of the members of the Board of Governors and the presidents of the Federal Reserve Banks, which are based on information available at the time of the last FOMC meeting, are for a gradual decline in inflation in coming quarters. As measured by the price index for personal consumption expenditures excluding food and energy, inflation is projected to be 2-1/4 percent to 2-1/2 percent this year and then to edge lower, to 2 percent to 2-1/4 percent next year.

The FOMC projections, which now anticipate slightly lower growth in real output and higher core inflation than expected in our February report, mirror the somewhat more adverse circumstances facing our economy, which have resulted from the recent steep run-up in energy costs and higher-than-expected inflation more generally. But they also reflect our assessment that, with appropriate monetary policy and in the absence of significant unforeseen developments, the economy should continue to expand at a solid and sustainable pace and core inflation should decline from its recent level over the medium term.

Although our baseline forecast is for moderating inflation, the Committee judges that some inflation risks remain. In particular, the high prices of energy and other commodities, in conjunction with high levels of resource utilization that may increase the pricing power of suppliers of goods and services, have the potential to sustain inflation pressures. More generally, if the pattern of elevated readings on inflation is more protracted or more intense than is currently expected, this higher level of inflation could become embedded in the public's inflation expectations and in price-setting behavior. Persistently higher inflation would erode the performance of the real economy and would be costly to reverse. The Federal Reserve must take account of these risks in making its policy decisions.

In our pursuit of maximum employment and price stability, monetary policy makers operate in an environment of uncertainty. In particular, we have imperfect knowledge about the effects of our own policy actions as well as of the many other factors that will shape economic developments during the forecast period. These uncertainties bear importantly on our policy decisions because the full influence of policy actions on the economy is felt only after a considerable period of time. The lags between policy actions and their effects imply that we must be forward-looking, basing our policy choices on the longer-term outlook for both inflation

and economic growth. In formulating that outlook, we must take account of the possible future effects of previous policy actions--that is, of policy effects still "in the pipeline." Finally, as I have noted, we must consider not only what appears to be the most likely outcome but also the risks to that outlook and the costs that would be incurred should any of those risks be realized.

At the same time, because economic forecasting is far from a precise science, we have no choice but to regard all our forecasts as provisional and subject to revision as the facts demand. Thus, policy must be flexible and ready to adjust to changes in economic projections. In particular, as the Committee noted in the statement issued after its June meeting, the extent and timing of any additional firming that may be needed to address inflation risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by our analysis of the incoming information.

Thank you. I would be happy to take questions.

For use at 10:00 a.m., EDT
Wednesday
July 19, 2006

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

July 19, 2006

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

July 19, 2006

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 19, 2006

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on July 19, 2006, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy continued to expand at a brisk rate, on balance, over the first half of 2006. Spending in the first quarter, which was especially robust, was temporarily buoyed by several factors, including federal spending for hurricane relief and the effects of favorable weather on homebuilding. The pace of the expansion moderated in the spring, to some degree because the influence of these special factors dissipated. More fundamentally, consumer spending slowed as further increases in energy prices restrained the real incomes of households. In addition, home sales and new homebuilding dropped back noticeably from the elevated levels of last summer, partly in response to higher mortgage interest rates. Outside of the household sector, increases in demand and production appear to have been well maintained in the second quarter. Demand for U.S. exports was supported by strong economic activity abroad, and business fixed investment remained on a solid upward trend. Early in the year, as aggregate output increased rapidly, businesses added jobs at a relatively robust pace, and the unemployment rate moved down further. Since April, monthly gains in payroll employment have been smaller but still sufficient to keep the jobless rate steady.

Thus far in 2006, inflation pressures have been elevated. Higher prices for crude oil contributed to a further run-up in domestic energy costs; this year's increases, combined with the steep increases in 2004 and 2005, not only boosted the prices of gasoline and heating fuel but also put upward pressure on the costs of production for a broad range of goods and services. Partly as a result of these cost pressures, the rate of core consumer price inflation picked up. Nevertheless, measures of inflation expectations remained contained, and the rate of increase in labor costs was subdued, having been held down by strong gains in productivity and moderate increases in labor compensation.

Taking a longer perspective, the U.S. economy appears to be in the midst of a transition in which the rate of increase in real gross domestic product (GDP) is moving from a pace above that of its longer-run capacity to a more moderate and sustainable rate. An important element in the transition is the lagged effect of the changes in monetary policy since mid-2004, changes that have been intended to keep inflation low and to promote sustainable economic expansion by aligning real economic activity more closely with the economy's productive potential. Moreover, longer-term interest rates have risen, contributing to increased borrowing costs for both households and businesses. Over time, pressures on inflation should abate as the pace of real activity moderates and, as futures markets suggest, the prices of energy and other commodities roughly stabilize. The resulting easing in inflation should help contain long-run inflation expectations.

Even as the rate of increase in real economic activity moderates, the prospects for sustained expansion of household and business spending appear favorable. Higher energy prices have put strains on household budgets, but once that effect fades, households should experience gains in real income consistent with the ongoing expansion of jobs. Household balance sheets remain generally sound; although some pockets of distress have surfaced, average delinquency rates on mortgages and other consumer debt are still low. Similarly, in the business sector, balance sheets are strong, credit quality is high, and most firms have ready access to funds. Sustained expansion of the global economy, along with the effects of the earlier depreciation of the foreign exchange value of the dollar, should support demand for U.S. exports. The potential for efficiency gains, as well as further declines in the relative cost of capital, are likely to continue to spur capital spending. Indeed, the ongoing advances in efficiency should sustain solid growth of labor productivity, providing support for gains in real wages and income.

As always, considerable uncertainties attend the outlook. Regarding inflation, the margin between production and consumption of crude oil worldwide is quite narrow, and oil markets are especially sensitive to news about the balance of supply and demand and to geopolitical events with the potential to affect that balance; adverse developments could result in yet another surge in energy costs. Indeed, futures markets provide only imperfect readings on the prospects for energy markets, as witnessed by the fact that the surprises in crude oil prices during the past few years have been predominantly to the upside. In addition, a further rise in prices of other, non-energy materials and commodities, if it materializes,

could also intensify cost pressures. Another risk is that the effect on imported-goods prices of earlier declines in the foreign exchange value of the dollar, which has been limited to date, could become larger. More broadly, if the higher rate of core inflation seen this year persists, it could induce a deterioration in longer-run inflation expectations that, in turn, might give greater momentum to inflation. However, the risks to the inflation outlook are not entirely to the upside. In the current environment of elevated profit margins, competitive forces, both in domestic markets and from abroad, could impose significant restraint on the pricing decisions of businesses.

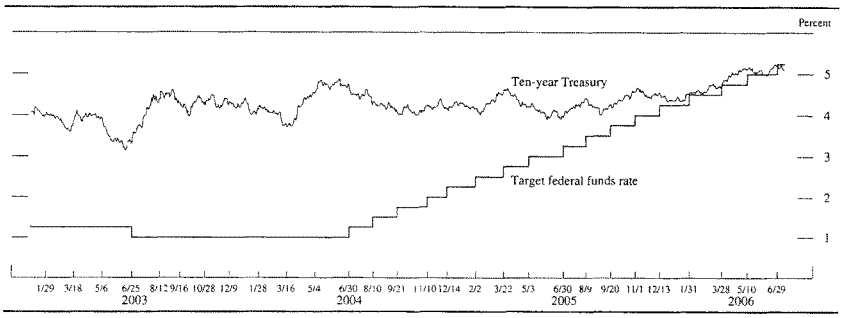
Regarding risks to the outlook for real activity, rates of increase in real GDP have been uneven during the past year, complicating the assessment of whether the pace of the economic expansion is moving into line with its underlying potential rate. One possible risk to the upside is that the softer tone of the recent data on real activity will prove transitory rather than mark a shift to a more sustainable underlying rate of expansion. For example, slower spending and hiring in recent months may represent a shorter-lived adjustment to a higher level of energy prices or to the unusually robust increases in economic activity earlier in the year. In coming months, a sharp rebound in consumer spending accompanied by an acceleration of capital spending could return real activity to a pace that would be unsustainable over the longer run. But downside risks also exist. In particular, the slowing in real estate markets since last summer has been moderate, and the easing of house-price inflation has been gradual. If the softening in the demand for housing and in real estate values becomes more pronounced, the resulting drop in construction activity and the erosion of household wealth could weaken aggregate demand noticeably. Consumer spending might be depressed by the loss of income and wealth, and that effect could be amplified if the downturn is abrupt enough to shake households' confidence about their ability to finance spending or manage their current financial obligations.

The Conduct of Monetary Policy over the First Half of 2006

The Federal Open Market Committee (FOMC) continued to firm the stance of monetary policy over the first half of 2006. At the time of the January meeting, available information suggested that underlying growth in aggregate demand was solid at the turn of the year. The expansion of real GDP in the fourth quarter of 2005 was estimated to have slowed temporarily, in part because of the disruptions associated with last autumn's hurricanes. Core inflation had stayed relatively low, and inflation expectations had remained contained. With rising energy prices and increases in resource utilization having the potential to add to inflationary pressures, the FOMC decided to extend the firming of policy that it had implemented over the previous eighteen months by tightening the policy rate 25 basis points, to 4½ percent. The Committee indicated that some further policy firming might be needed to keep the risks to price stability and to sustainable economic growth roughly in balance.

By March, economic activity appeared to be expanding rapidly, propelled by robust consumer spending and accelerating business investment. Although readings on core inflation for January and February were generally favorable, higher prices for energy and other commodi-

Selected interest rates, 2003–06



NOTE The data are daily and extend through July 12, 2006. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE Department of the Treasury and the Federal Reserve.

ties, together with relatively tight labor and product markets, threatened to add to existing inflation strains. Against this backdrop, the Committee raised the target federal funds rate another 25 basis points, to 4¾ percent. The statement released at the end of the meeting continued to point to the possible need for further policy firming.

Data received by the time of the May meeting confirmed that the economy had expanded robustly in the first quarter, though both consumer spending and housing activity appeared to have moderated in late winter. In addition, inflationary pressures had intensified as core consumer prices rose more rapidly in March than in earlier months. Inflation expectations, as measured by some surveys and by comparisons of yields on nominal and inflation-indexed Treasury securities, also rose in April. The Committee still judged those expectations to be contained, but it was mindful that a further increase could impart additional momentum to inflation, as could the surge in energy and other commodity prices and the drop in the foreign exchange value of the dollar that took place in April and early May. To gain greater assurance that inflationary forces would not intensify, the FOMC decided to raise the target federal funds rate another 25 basis points, bringing it to 5 percent. The FOMC also indicated in the policy statement that some further policy firming could be required. However, the Committee was aware that the cumulative effects of past monetary policy actions on economic activity could turn out to be larger than expected. Accordingly, the FOMC stressed that the extent and timing of any further firming would depend importantly on the evolution of the economic outlook as implied by incoming data.

By the time of the June meeting, available data appeared to confirm that economic growth had moderated from the strong pace evident earlier in the year. Consumer spending had softened, and activity in housing markets had continued to cool gradually. Evidence of inflationary pressures was accumulating, however, and core price inflation had increased. In addition, the high levels of resource utilization and of the prices for energy and other commodities had the potential to spur further inflation. Consequently, the FOMC decided to increase the target federal funds rate an additional 25 basis points, to 5¼ percent. The Committee recognized that the moderation in the growth of aggregate demand that appeared to be under way would help to limit inflationary pressures over time, but it judged that, even after its policy action, some upside inflation risks remained. Yet the FOMC made clear that the extent and timing of any additional firming needed to address those risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

In recent years, the FOMC has worked to improve the transparency of its decisionmaking process, and it continues to seek further improvements. Between the March and May meetings, the Chairman appointed a subcommittee to help the FOMC frame and organize the discussion of a broad range of communication issues. At the June meeting, the Committee discussed the subcommittee's plans for work in coming months and decided to begin its consideration of communication issues at its August meeting and to lengthen meetings later this year to allow a fuller discussion of these issues.

Economic Projections for 2006 and 2007

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2006 and 2007. In broad terms, the participants expect a sustained, moderate expansion of real economic activity during the next year and a half. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 3¼ percent to 3½ percent over the four quarters of 2006 and 3 percent to 3¼ percent in 2007. The central tendency of their forecasts for the civilian unemployment rate is 4¾ percent to 5 percent in the fourth quarter of this year, and the jobless rate is expected to still be in that range at the end of 2007. For inflation, the central tendency of the forecasts is an increase in the price index for personal consumption expenditures excluding food and energy (core PCE) of 2¼ percent to 2½ percent over the four quarters of 2006; in 2007, the forecast shows

Economic projections for 2006 and 2007

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2006	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5½–6½	6–6¼
Real GDP	3–3¾	3¼–3½
PCE price index excluding food and energy	2¼–3	2¼–2½
Average level, fourth quarter		
Civilian unemployment rate	4½–5	4¾–5
	2007	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6	5–5½
Real GDP	2½–3¼	3–3¼
PCE price index excluding food and energy	2–2¼	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4½–5¼	4¾–5

1 Change from average for fourth quarter of previous year to average for fourth quarter of year indicated

a slower rate of 2 percent to 2¼ percent, which is similar to the rate of core PCE price inflation in 2004 and 2005.

A slowing in activity now appears to be under way in the housing sector, where home sales and residential construction have receded from the elevated levels of last summer. The associated easing in house-price appreciation will likely temper gains in household wealth, which, over time, may be a factor in damping consumer spending. However, households' financial positions should receive a boost from an acceleration of real income if energy prices stabilize as suggested by futures markets. In the business sector, participants view the outlook for fixed investment over the forecast period as positive. Although outlays for new equipment and software may increase a little more slowly with the deceleration in real output, investment opportunities appear to remain attractive: The relative user cost of capital for equipment, particularly high-technology items, is expected to remain favorable, and competitive pressures should maintain strong incentives to exploit opportunities for efficiency gains and cost reduction. At the same time, nonresidential construction seems likely to continue to move up. Finally, the strong performance of the economies of the United States' major trading partners should continue to stimulate U.S. exports of goods and services.

The more moderate pace of expansion and the stability in resource utilization, when coupled with less pressure from the prices of energy and other commodities, should contribute to an environment in which inflation expectations are contained and inflation edges lower. Moreover, ongoing solid gains in productivity should work to limit increases in unit labor costs.

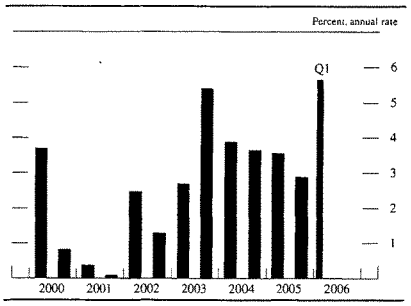
Over the next year and a half, FOMC participants expect the economy to achieve a sustainable rate of economic expansion. That rate will be determined in large part by the rate of increase in productivity. Productivity has been rising at a solid rate over the past two years, albeit more slowly than the especially rapid pace that prevailed during the first three years of the expansion. A strong trend in productivity is likely to be maintained as businesses take advantage of new investment in facilities and equipment, as diffusion of technology continues, and as organizational advancements and business process improvements yield further increases in efficiency.

Economic and Financial Developments in 2006

Although last year's hurricanes caused the pace of aggregate economic activity around the turn of the year to be uneven, real GDP increased at an average annual rate of 3.6 percent in the final quarter of 2005 and first quarter of 2006—about the same pace that prevailed during the preceding year and a half. Over this period, payroll employment posted additional solid gains, and the unemployment rate declined further. In recent months, the incoming information on real activity has suggested that the pace of the expansion is moderating, with the deceleration in spending most apparent in the household sector. Still, as of midyear, resource utilization in labor and in product markets remained high.

Inflation picked up over the first five months of the year, boosted importantly by the effects of rising energy prices. Long-term inflation expectations fluctuated over the period but remained contained, and increases in unit labor costs were subdued. Although short-term market interest rates rose in line with the FOMC's firming of monetary policy, financial market conditions were still generally supportive of economic expansion in the first

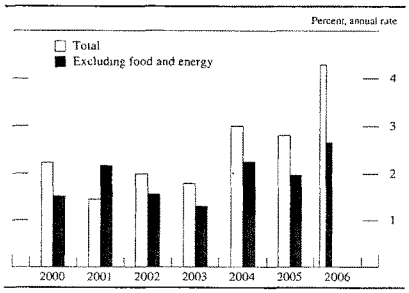
Change in real GDP, 2000–06



Note: Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period

Source: Department of Commerce, Bureau of Economic Analysis

Change in PCE chain-type price index, 2000–06



Note The data are for personal consumption expenditures (PCE) Through 2005, change is from December to December, for 2006, change is from December to May

Source Department of Commerce, Bureau of Economic Analysis

half of 2006. Long-term interest rates rose but were still moderate by historical standards, and credit spreads and risk premiums stayed narrow.

The Household Sector

Consumer Spending

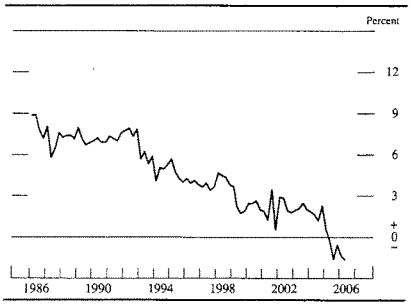
After increasing at a robust rate around the turn of the year, consumer spending has been rising at a more moderate pace in recent months. Over the first half of 2006, rising employment and the lagged effect of increases in wealth continued to provide support for spending by households. However, consumers' purchasing power was restrained by a further run-up in energy costs in the spring.

Sales of new cars and light trucks bounced back sharply at the turn of the year; those sales had slackened in late 2005 after manufacturers ended the special "employee discount" programs that had boosted sales last summer. New light vehicles sold at an annual rate of 16.8 million units between January and April, about the same as the average rate in 2004 and 2005. However, elevated gasoline prices affected the composition of demand, and consumers shifted their purchases away from light trucks and sport-utility vehicles (SUVs) and toward autos. That shift led to an increase in the market share captured by foreign producers. As households' concerns about the higher price of gasoline weighed on their attitudes toward buying vehicles, sales dipped to an annual rate of 16.2 million units in May and June.

Spending for other household goods, such as furniture, electronic equipment, food, and clothing, was quite strong in the first quarter of 2006; real outlays for goods other than motor vehicles increased at an annual rate of 8¾ percent. Some moderation was to be expected after such a surge in spending. Estimates of retail sales, which are available through June, suggest that real expenditures for these goods rose more slowly in the second quarter. In contrast to the uneven pattern of spending for goods, real outlays for consumer services remained on a moderate upward trend over the first half of 2006; they rose at an annual rate of 2½ percent from the fourth quarter of 2005 through May 2006.

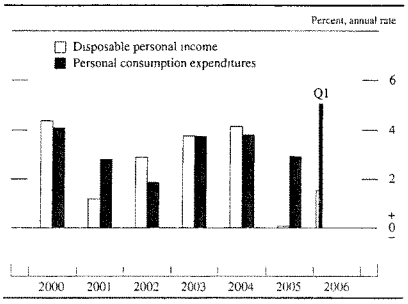
Boosted by gains in nominal wage and salary income, after-tax aggregate personal income rose at an annual rate of 4 percent over the first five months of 2006. However, the acceleration in consumer prices held real income about constant. As a result, the steep decline in the personal saving rate, which began in 2004, extended into 2006. Since 2003, rising household wealth has provided

Personal saving rate, 1986–2006



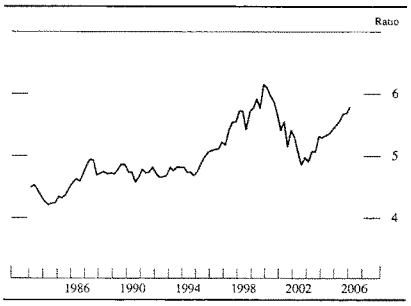
NOTE: The data are quarterly and extend through 2006:Q2; the reading for 2006 Q2 is the average for April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real income and consumption, 2000–06



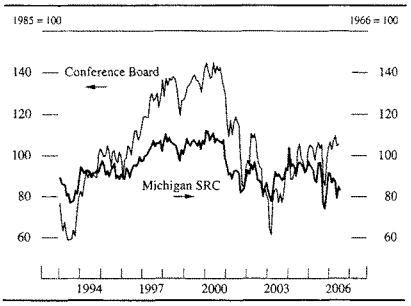
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Wealth-to-income ratio, 1983–2006



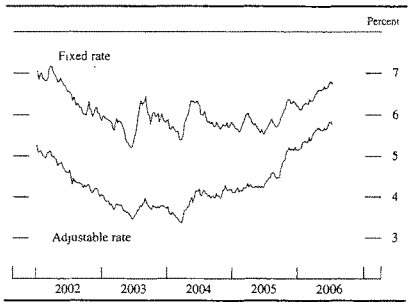
NOTE: The data are quarterly and extend through 2006:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Consumer sentiment, 1993–2006



NOTE: The Conference Board data are monthly and extend through June 2006 The Michigan SRC data are monthly and extend through a preliminary estimate for July 2006.
SOURCE: The Conference Board and University of Michigan Survey Research Center.

Mortgage rates, 2002–06



NOTE: The data, which are weekly and extend through July 12, 2006, are contract rates on thirty-year mortgages
SOURCE: Federal Home Loan Mortgage Corporation.

important support for spending, even as gains in real income have been damped by increases in energy prices. In 2005 and the first part of 2006, much of the increase in wealth was the result of the rapid appreciation in the value of homes.

According to the survey by the University of Michigan Survey Research Center (SRC), the run-up in energy prices contributed importantly to the deterioration in consumer confidence this spring. Consumers' pessimism peaked in May and then lessened somewhat, on average, in June and early July. Nonetheless, at midyear, households indicated that they were still concerned about the effect of the high cost of energy on their financial situation. In addition, households' assessments of current and expected business conditions remained considerably less optimistic than they were at the beginning of the year.

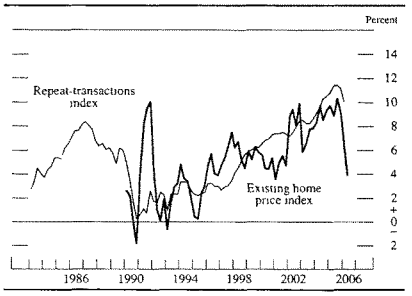
Residential Investment

The demand for homes had begun to soften in the summer of 2005, and, by the spring of 2006, starts of new single-family homes were well below the very rapid pace that had prevailed in the preceding two years. The reduced level of activity in real estate markets also led to some easing in house-price appreciation early this year.

Sales of new and existing single-family homes, which had been climbing steadily since 2003, stopped rising during the third quarter of 2005. By May, sales of new and existing homes together were 7¼ percent below their peak in June 2005. The cooling in sales caused inventories of unsold homes to rise. In May, the backlog of unsold new homes equaled 5½ months' supply at that month's selling rate, and the backlog of existing homes on the market was 6½ months' supply; in 2005, the stocks of both unsold new and existing homes averaged roughly 4½ months of supply.

An increase in mortgage rates contributed to the slackening in the demand for housing. Since the middle of 2005, the average rate for a thirty-year fixed-rate mortgage has increased about 1 percentage point, to 6¾ percent, and the average for a one-year adjustable-rate mortgage has risen a bit more, to 5¾ percent. According to respondents to the Michigan SRC survey, the rise in borrowing costs has been an important consideration damping their assessment of buying conditions for homes since mid-2005; the rise in home prices has apparently also weighed on consumers' attitudes.

Change in prices of single-family houses, 1983–2006



NOTE: The data are quarterly, and change is from one year earlier The repeat-transactions index extends through 2006:Q1 For the years preceding 1991, that index includes appraisals associated with mortgage refinancings, beginning in 1991, it includes purchase transactions only. The existing home price index extends through 2006 Q2, and the reading for Q2 is the average for April and May compared with the same period a year earlier
SOURCE For repeat transactions, Office of Federal Housing Enterprise Oversight, for existing home prices, National Association of Realtors

Although recent increases in house prices have been smaller than those that accompanied the robust real estate markets of 2004 and 2005, the deceleration thus far appears to have been modest. The repeat-transactions index of house prices, which is published by the Office of Federal Housing Enterprise Oversight, increased at an annual rate of 7¼ percent in the first quarter of 2006, the smallest quarterly increase since the fourth quarter of 2001; that index attempts to control for the quality of existing single-family homes sold by using prices of homes involved in repeat transactions (excluding refinancings). The first-quarter reading brought the year-over-year change in this measure to 10 percent; in the second and third quarters of 2005, purchase prices according to this index were up 11½ percent from the level of a year earlier. An alternative measure of house prices is the average price of existing single-family homes sold, which is published by the National Association of Realtors. This measure, which does not control for the type of homes sold, showed that the year-over-year change in prices peaked at 11½ percent in August 2005 and then fell to 4 percent in April and May of this year. The greater deceleration in the latter measure suggests that, in addition to some softening in prices, the mix of existing units sold may have shifted toward lower-priced homes.

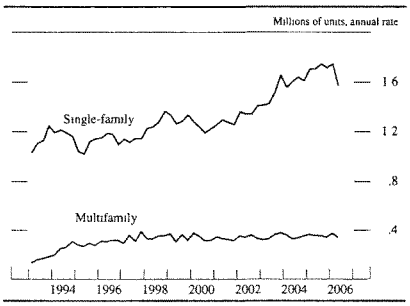
The effect of the slowdown in demand on new construction became apparent during the second half of 2005, when the number of permits issued for new single-family homes began to fall. This year, the decline in permit issuance was relatively steady from January to May. Nonetheless, new single-family homes were started at an exceptionally high annual rate of 1.75 million units during the first quarter, when builders were able to begin work on scheduled projects earlier than normal because of favorable weather conditions. With some starts having been advanced into the first quarter, single-family starts dropped to an average rate of 1.57 million units in April and May. In contrast to the recent trend in the single-family sector, construction of new multifamily homes averaged an annual rate of 360,000 units from January to May, about where it has been for more than four years.

Housing activity, as measured by real expenditures on residential structures, contributed almost ½ percentage point per year to the annual rate of increase in real GDP in 2004 and 2005. In the first quarter of 2006, that contribution dropped to 0.2 percentage point; with the reduced pace of sales and construction since the winter, a decline in residential investment is likely to have held down the rise in real GDP in the second quarter.

Household Finance

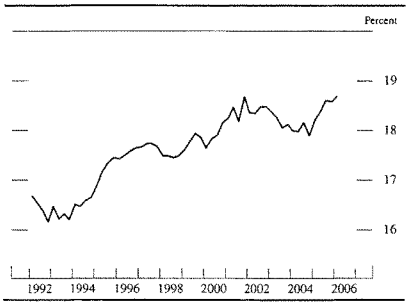
Household debt expanded at an annual rate of about 11½ percent in the first quarter of 2006, about the same pace as in 2005. Despite the rise in mortgage rates and the slowing in housing activity, home mortgage debt expanded rapidly again early in the year as homeowners apparently continued to extract some of the substantial gains in equity that they have accumulated on their homes in the past several years. Indeed, according to industry estimates, although the number of homeowners refinancing their mortgages has remained well below that seen during the refinancing boom of several years ago, a large fraction of homeowners who have refinanced so far this year have chosen to withdraw equity from their homes. As has been the case in recent years, this mortgage-related borrowing likely replaced, in part, some consumer

Private housing starts, 1993–2006



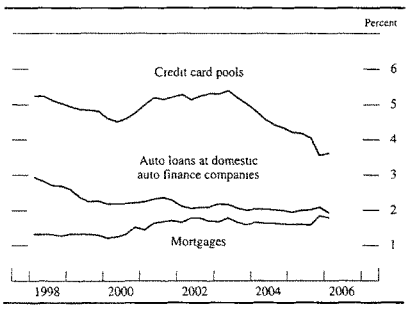
NOTE. The data are quarterly and extend through 2006 Q2, the readings for 2006 Q2 are the averages for April and May
SOURCE Department of Commerce, Bureau of the Census

Household financial obligations ratio, 1992–2006



NOTE: The data are quarterly and extend through 2006:Q1. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowner's insurance, and property taxes, all divided by disposable personal income
SOURCE Federal Reserve Board

Delinquency rates on selected types of household loans, 1998–2006



NOTE The data are quarterly and extend through 2006:Q1.
SOURCE. For credit cards, Moody's Investors Service, for auto loans, the financing subsidiaries of the three major U.S. automobile manufacturers; for mortgages, Mortgage Bankers Association.

credit borrowing, which, at an annual rate of a bit less than 3 percent, continued to expand modestly in the first five months of 2006.

The ratio of household financial obligations to disposable income rose 0.1 percentage point in the first quarter to about 18¾ percent, narrowly exceeding the top of its historical range. Nonetheless, the evidence points to only limited pockets of financial distress in the household sector. Delinquency rates on residential mortgages were low by historical standards in the first quarter, though they have edged higher since the middle of last year, particularly in the subprime sector. Delinquency rates on consumer debt also continued to be low. Meanwhile, household bankruptcy filings remained subdued in the first half of 2006, running at a pace well below the average of recent years. Bankruptcies have likely been damped this year in part by the decision of some households in the fall of 2005 to accelerate their filings to avoid the implementation of a stricter bankruptcy law in October. More recently, they may also have been restrained by the greater costs of bankruptcy under the new law.

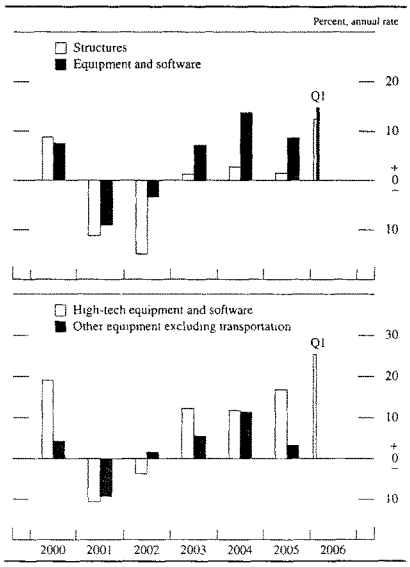
The Business Sector

Fixed Investment

Real business fixed investment increased at a solid rate, on average, during the final quarter of 2005 and the first quarter of 2006. Over that period, real business spending for new equipment and software rose at an annual rate of 9¾ percent, a pace similar to that over the first three quarters of 2005. In addition, investment in nonresidential structures, which had remained weak in 2005, turned up noticeably in early 2006. The underlying determinants of capital spending have stayed quite positive: Businesses have seen steady increases in sales, robust profits, and declining user costs for equipment; they have ample liquid assets; and, despite the rise in interest rates, credit quality is strong.

Real outlays for equipment and software rose at an annual rate of 14¾ percent in the first quarter after having risen at a 5 percent rate in the fourth quarter of 2005. As can often be the case, the timing of spending for a number of types of equipment was uneven between these two quarters. Business purchases of cars and trucks slowed in late 2005, after manufacturers reduced their special discounts on light vehicles, and then recovered in the first quarter. The first-quarter rebound was strengthened by a further acceleration of outlays for medium and heavy trucks. According to industry analysts, businesses have been pulling forward these purchases because the engines in the 2007 models will be required to meet new emission regulations by the Environmental Protection Agency that will make the new vehicles more costly to operate. Deliveries of commercial aircraft to domestic

Change in real business fixed investment, 2000–06



NOTE High-tech equipment consists of computers and peripheral equipment and communications equipment
SOURCE Department of Commerce, Bureau of Economic Analysis

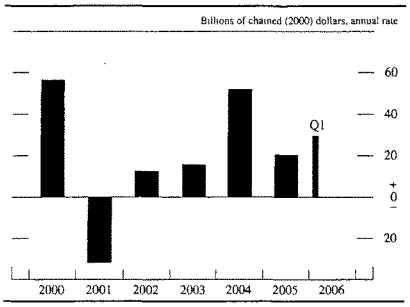
customers also rebounded in the first quarter from a very low level in the fourth quarter.

Demand for high-technology equipment stepped up noticeably in the first quarter because of a sharp jump in outlays for communications equipment. Providers of telecommunications services appear to be investing heavily in fiber-optic networks, which will allow them to offer a wider range of Internet services; the recent spurt likely also includes some replacement demand for equipment damaged by last year's hurricanes. In contrast, business demand for computing equipment, while still increasing at a double-digit pace in real terms, has been relatively modest by historical standards so far this year. Industry analysts suggest that firms may be delaying investment in anticipation of introductions, later this year and in early 2007, of several products that will allow faster and more energy-efficient processing. Spending on equipment other than transportation and high-tech goods continued to trend up at a solid pace, on average, during the fourth and first quarters. Demand was particularly strong for metalworking and general industrial machinery as well as for equipment used in construction, energy extraction, and services industries.

Demand for equipment and software appears to have risen again in the second quarter. The information from U.S. manufacturers on their orders and shipments of nondefense capital goods and the data on imports of capital goods suggest that business spending for equipment other than transportation and high-tech items remained on a strong upward trajectory in April and May. The elevated backlog of unfilled orders at domestic firms likely provided support for factory production of capital equipment in the second quarter. The indicators of demand for high-tech equipment suggest that spending for communications equipment remained at a high level, and real outlays for computing equipment were still rising slowly. Sales of medium and heavy trucks continued to be robust in the second quarter, although they eased slightly from the exceptional rate at the beginning of the year.

Real expenditures for nonresidential construction increased at an annual rate of 12½ percent in the first quarter after having edged up slightly during 2005. Last year, the small net increase in this sector reflected a sharp upturn in spending on structures used in domestic energy exploration; construction of new office and industrial buildings was restrained by elevated vacancy rates. However, vacancy rates for office and industrial properties gradually declined over the course of 2005, and, by the turn of the year, nonresidential construction began to firm. As a result, the increase in nonresidential investment in the first quarter of 2006 was broadly based; it included pickups in outlays in the office, retail, and industrial sectors in addition to another steep rise in spending on structures associated with energy exploration.

Change in real business inventories, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis

Inventory Investment

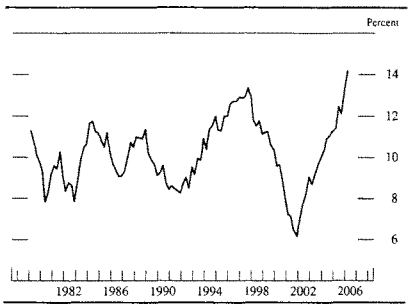
Business inventories appear generally to be well aligned with sales. In surveys taken during the first six months of 2006, about two-thirds of purchasing managers at manufacturing firms who responded characterized the level of their customers' inventories as about right. A similar proportion of respondents at nonmanufacturing firms reported that they were comfortable with their own levels of inventories. However, dealer stocks of new light motor vehicles, particularly trucks (including SUVs), have risen noticeably as sales have slowed; inventories of light trucks reached an uncomfortable 89 days' supply in May. In late June, a number of manufacturers introduced a new round of incentives aimed at reducing dealer stocks in advance of the introduction of their new models this fall.

Corporate Profits and Business Finance

Corporate profits were again strong in the first quarter of 2006, and earnings per share for S&P 500 firms rose about 15 percent from the same time last year. Gains were widespread but were especially large for firms in the energy sector. Before-tax profits of nonfinancial corporations measured as a share of sector GDP rose to about 14 percent in the first quarter, above the previous peak reached in 1997.

The expansion of business debt picked up to an annual rate of nearly 10 percent in the first quarter of this year, and data in hand suggest a robust pace in the second quarter. A substantial fraction of borrowing proceeds reportedly went to finance mergers and acquisitions in the first half of the year. Net bond issuance has been strong so far in 2006. Short-term borrowing by nonfinancial corporations stepped up in the first quarter of 2006 after slowing somewhat in the fourth quarter of last year; it

Before-tax profits of nonfinancial corporations as a percent of sector GDP, 1979–2006

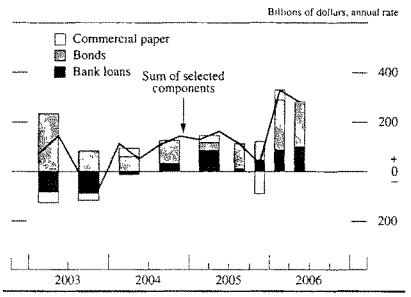


NOTE: The data are quarterly and extend through 2006 Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

appears to have remained strong in the second quarter as well. Commercial paper outstanding started rising again, on balance, after edging lower in 2005. Bank business loans outstanding expanded at an annual rate of 15½ percent in the first quarter. Businesses benefited from a more accommodative lending environment: For example, a significant net fraction of respondents to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in April 2006 noted that their institutions had eased both standards and terms on commercial and industrial loans in the first three months of the year. The most commonly cited reasons for the easing of lending policies were more-aggressive competition from other banks and nonbank lenders, increased liquidity in the secondary market for business loans, and increased tolerance for risk.

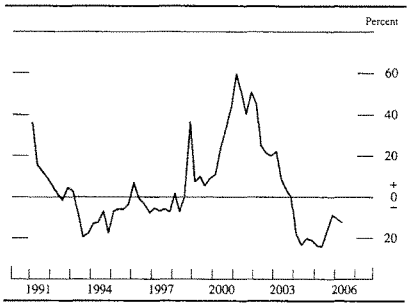
Gross equity issuance has remained moderate so far this year, while an elevated level of cash-financed merg-

Selected components of net financing for nonfinancial corporate businesses, 2003–06



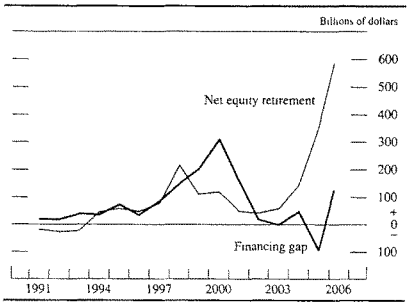
NOTE: The data for the components except bonds are seasonally adjusted. The data for the sum of selected components are quarterly. The data for 2006:Q2 are estimated.
SOURCE: Federal Reserve Board, Securities Data Company, and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized borrowers, 1991–2006



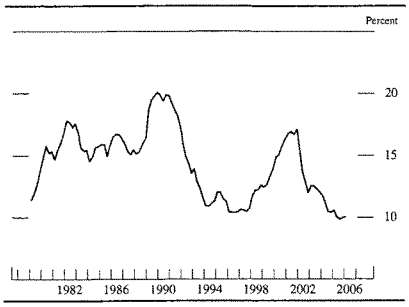
NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is from the April 2006 survey. Net percentage is the percentage of banks reporting a tightening of standards less the percentage reporting an easing. The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have sales of $50 million or more.
SOURCE: Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

Financing gap and net equity retirement at nonfinancial corporations, 1991–2006



NOTE: The data are annual through 2005, for 2006, they are as of Q1. The financing gap is the difference between capital expenditures and internally generated funds, adjusted for inventory valuation. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued by domestic companies in public or private markets. Equity issuance includes funds invested by venture capital partnerships and stock option proceeds.
SOURCE: Federal Reserve Board, flow of funds data.

Net interest payments of nonfinancial corporations as a percent of cash flow, 1979–2006



NOTE. The data are quarterly and extend through 2006 Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis

ers along with record share repurchases has produced further sizable net equity retirements. Taken together, net funds raised by nonfinancial corporations in the credit and equity markets have been slightly negative in 2006, an indication that nonfinancial corporations have financed their increased investment spending with internal funds.

With profitability strong and balance sheets flush with liquid assets, credit quality in the nonfinancial business sector generally has remained quite high. The six-month trailing default rate on corporate bonds dropped after some large firms in the troubled airline and automobile sectors defaulted during the past fall and winter. Delinquency rates on business loans have stayed near the bottom of their historical range.

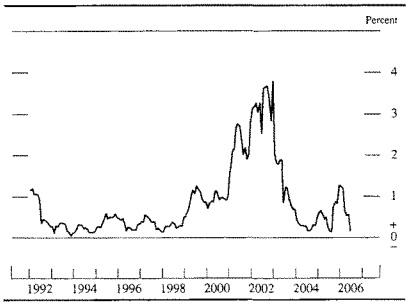
Commercial real estate debt expanded briskly in the first half of 2006, albeit not as quickly as during 2005. Spreads on BBB-rated commercial-mortgage-backed securities have fallen this year. The decline reversed an increase that took place at the end of last year, when issuance surged; these spreads are now back in line with those of comparable-quality corporate bonds. With rents climbing and vacancy rates falling, delinquency rates on commercial real estate loans have been low, and credit quality has remained generally good.

The Government Sector

Federal Government

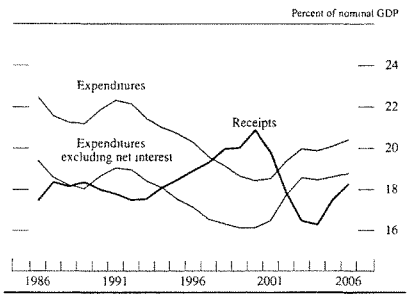
The deficit in the federal unified budget narrowed further during the past year. Over the twelve months ending in June, the unified budget recorded a deficit of $276 billion, about $60 billion less than during the comparable period last year. The federal deficit over the twelve months ending in June was approximately 2 percent of nominal GDP and was significantly lower than its recent fiscal year peak of 3.6 percent of GDP in 2004. Although outlays increased faster than nominal GDP over the past year, the rise in receipts was even larger. Thus, in its recent *Mid-Session Review* of the budget, the Administration estimated that the federal government will finish fiscal 2006 with a deficit of $296 billion; that figure marks a decline from the fiscal 2005 deficit of $318 billion and is much lower than most analysts had projected at the beginning of this year.

Default rate on outstanding corporate bonds, 1992–2006



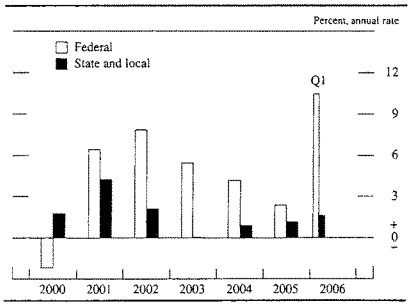
NOTE: The data are monthly and extend through June 2006. The rate for a given month is the face value of bonds that defaulted in the six months ending in that month, multiplied by two to annualize the defaults and then divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the six-month period.
SOURCE: Moody's Investors Service.

Federal receipts and expenditures, 1986–2006



NOTE: Through 2005, the receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September). GDP is for the four quarters ending in Q3. For 2006, the receipts and expenditures data are for the twelve months ending in June, and GDP is the average of 2005:Q4 and 2006:Q1.
SOURCE: Office of Management and Budget.

Change in real government expenditures on consumption and investment, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis

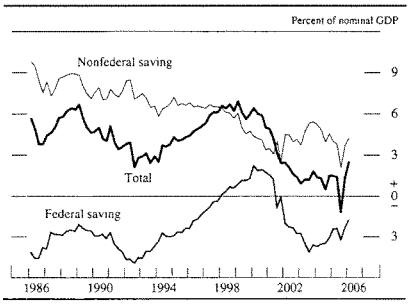
During the twelve months ending in June, federal receipts were 13¼ percent higher than over the same period a year earlier and equivalent to almost 18¼ percent of nominal GDP. Income tax receipts from individuals have outpaced the rise in nominal income; final tax payments on income from 2005 were especially strong in April and May. Corporate tax payments continued to rise at a robust rate, even faster than corporate profits.

Nominal federal outlays rose 9 percent between June 2005 and June 2006 and were about 20½ percent of nominal GDP. The rise in outlays was bolstered by increases in several components of federal spending. Net interest payments increased 20 percent over the year ending in June as federal debt continued to rise and interest rates increased. Medicare outlays were up 14½ percent; since the inception of the new Part D prescription drug program in January, outlays for benefits have added more than $20 billion to spending in this category. Legislative actions related to the hurricanes in the Gulf Coast region last autumn have added significantly to spending for disaster relief over the past ten months. Although defense spending has slowed from the annual double-digit rates of increase from 2002 to 2004, it still has increased about 8 percent per year in the past two years.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of real GDP—increased at an annual rate of 3¾ percent, on average, during the final calendar quarter of 2005 and the first calendar quarter of 2006 and contributed roughly 0.3 percentage point to the annualized change in real GDP over the period. Over these two quarters, real defense purchases were about constant, on average, while spending related to disaster relief from the hurricanes contributed importantly to a rise in real nondefense purchases.

The narrowing of the federal deficit recently has reduced its drain on national saving. However, net national saving excluding the federal government has remained low relative to historical norms. Although the saving rate for private business has moved up during the past two years, the improvement has been offset by the further decline in personal saving. Overall, national saving, net of depreciation, stood at 2½ percent of nominal GDP in the first quarter of 2006. Although the recent rate is a noticeable improvement from the lows of the preceding few years, it has been insufficient to avoid an increasing reliance on borrowing from abroad to finance the nation's capital spending.

Net saving, 1986–2006



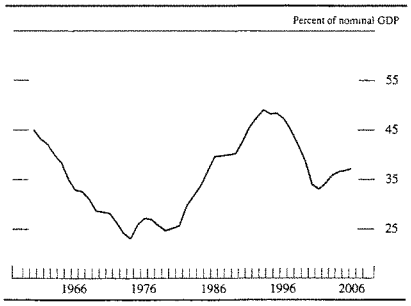
NOTE: The data are quarterly and extend through 2006 Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal Borrowing

Federal debt rose at an annual rate of 13 percent in the first quarter, a bit less than in the corresponding quarter of 2005. In February, federal debt subject to the statutory limit reached the ceiling of $8.184 trillion, and the Treasury resorted to accounting devices to avoid breaching the limit. The Congress subsequently increased the debt ceiling to $8.965 trillion in March. In the second quarter, federal debt likely declined temporarily because of a surge in tax receipts. On net, the Treasury has raised substantially less cash in the market so far this year than in the comparable period of 2005.

In February, the Treasury conducted an auction of thirty-year bonds for the first time since 2001. The issue generated strong interest, especially from investment funds; foreign investors were awarded only a small fraction of the total. In general, foreign demand for Treasury

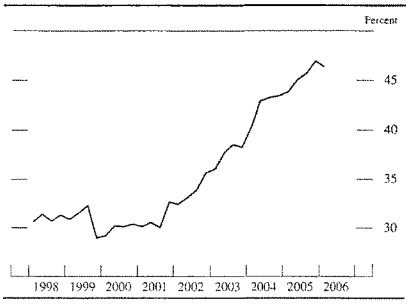
Federal government debt held by the public, 1960–2006



NOTE. The final observation is for 2006:Q1. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

securities appears to have eased somewhat in 2006. The proportion of nominal coupon securities bought at auction by foreign investors has continued to fall from its peak of 24 percent in 2004; it averaged about 14 percent in the first six months of 2006. Data from the Treasury International Capital system generally suggested subdued demand from both foreign private investors and foreign official institutions over this period. The amount of Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign official and international accounts has changed little since the end of 2005.

Treasury securities held by foreign investors as a share of total outstanding, 1998–2006



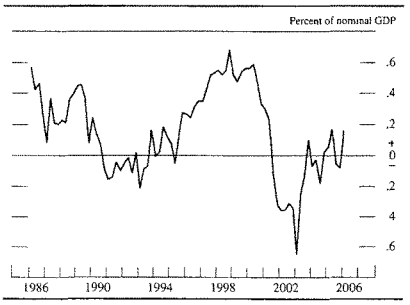
NOTE. The data are quarterly and extend through 2006:Q1.
SOURCE. Federal Reserve Board, flow of funds data.

State and Local Governments

The fiscal positions of states and localities continued to improve through early 2006. In particular, revenues are on track to post a relatively strong gain for a third consecutive year. Tax receipts from sales, property, and personal and corporate income were up 8¼ percent during the year ending in the first quarter of 2006, a rate similar to the increase in the preceding year. The sustained strength in revenues has enabled these jurisdictions to increase their nominal spending somewhat while rebuilding their reserve funds. On a NIPA basis, net saving by state and local governments—a measure that is broadly similar to the surplus in an operating budget—rose to an annual rate of $21½ billion in the first quarter of 2006 after having been close to zero in 2005. Although most states have seen improvement, a number of states are still struggling with structural imbalances in their budgets, and those in the Gulf Coast region are coping with demands related to damage from last year's hurricanes. In addition, local governments may face pressure to hold the line on property taxes after the sharp increases in the past several years, and governments at all levels will have to contend with the need to provide pensions and health benefits to a rising number of retirees in coming years.

Real expenditures by state and local governments on consumption and gross investment, as estimated in the NIPA, rose at an annual rate of 1½ percent in the first quarter of 2006 after having increased roughly 1 percent per year in 2004 and 2005. Real expenditures for investment turned up in the first quarter after having fallen during the second half of 2005. Real outlays for current consumption posted a moderate increase in the first quarter, and that trend appears to have continued into midyear.

State and local government net saving, 1986–2006



NOTE. The data, which are quarterly, are on a national income and product account basis and extend through 2006:Q1. Net saving excludes social insurance funds.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

Hiring by state and local governments was slow early in the year but appears to have firmed in the spring. Of the cumulative increase in employment of 100,000 between December and June, 40 percent of the jobs were in education.

State and Local Government Borrowing

Borrowing by state and local governments has slowed thus far in 2006. The deceleration likely reflects the general improvement in budget conditions and a decline in advance refundings, which have dropped below their 2005 pace amid rising interest rates and a dwindling pool of eligible securities. Credit quality in the state and local sector has continued to improve, and upgrades of credit ratings have far outnumbered downgrades. Consistent with the improvement in credit quality, yields on long-dated municipal bonds have increased substantially less than those on comparable-maturity Treasury securities, and the yield ratio has accordingly fallen sharply.

The External Sector

The U.S current account deficit narrowed in the first quarter of 2006 to $835 billion at an annual rate, or about 6½ percent of nominal GDP, from $892 billion in the fourth quarter of 2005. The narrowing resulted from three factors. Unilateral transfer payments to foreigners dropped, largely because of a decrease in government grants. The trade deficit narrowed, primarily because the value of imported oil and natural gas declined. In addition, higher direct investment receipts and lower direct investment payments produced an increase in the investment income balance.

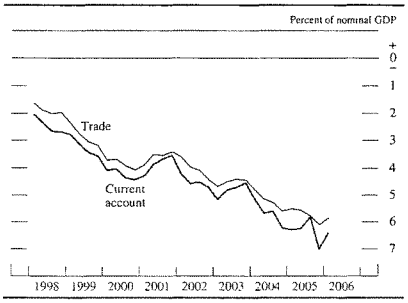
International Trade

Real exports of goods and services increased 14¾ percent at an annual rate in the first quarter of 2006, far faster than the 6½ percent rate recorded in 2005. The surge in export growth in the first quarter resulted in part from a recovery in exports of many types of industrial supplies following a period of hurricane-related disruptions late last year. Exports of capital goods also increased rapidly in the first quarter, with deliveries of aircraft to foreign carriers exhibiting particular strength. The first-quarter increase in exports was widespread across destinations, a sign of robust economic activity in many parts of the world, and exports to Mexico and Canada showed especially large increases. Real exports of services rose at an annual rate of about 6½ percent in the first quarter after increasing just 2¾ percent in 2005. Available data for nominal exports in April and May suggest that the increase in real exports was smaller in the second quarter, held down in part by a drop in aircraft exports after a strong first quarter.

Prices of exported goods increased at an annual rate of 2¾ percent in the first quarter of 2006, a pace somewhat faster than in the second half of 2005. Prices of nonagricultural industrial supplies continued to increase steadily in the first quarter, driven importantly by higher prices for oil and metals. An acceleration in prices for finished goods, especially for capital and consumer goods, contributed to the faster pace of export price inflation in the first quarter. The available data for the second quarter point to further increases in export prices on the strength of additional run-ups in the prices of nonagricultural industrial supplies, especially metals.

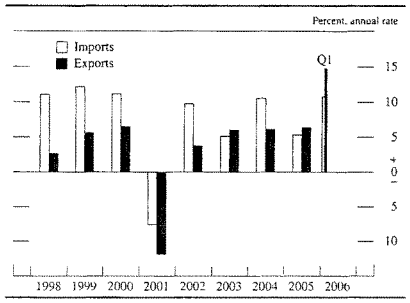
Real imports of goods and services rose at an annual rate of 10¾ percent in the first quarter, slightly slower

U.S. trade and current account balances, 1998–2006



NOTE The data are quarterly and extend through 2006 Q1.
SOURCE Department of Commerce

Change in real imports and exports of goods and services, 1998–2006

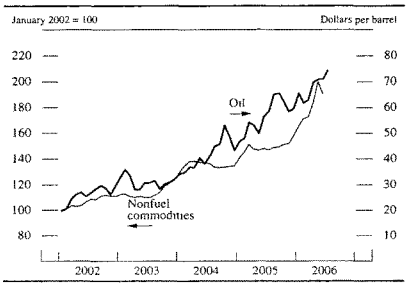


SOURCE Department of Commerce

than in the fourth quarter but still considerably faster than the 5¼ percent rate observed for 2005 as a whole. Robust growth of real GDP in the United States supported the first-quarter increase in imports. Among categories of goods, large increases in imports of consumer goods, automotive products, and capital goods, particularly computers, more than offset declines in imports of oil and some other industrial supplies. The rise in imports in the first quarter was widely distributed across countries, and the increases for China and Mexico were especially large. Real imports of services jumped at an annual rate of 8½ percent in the first quarter. Nominal imports in April and May point to an abrupt slowing of real imports in the second quarter from the first quarter's rapid pace.

Prices of imported goods excluding oil and natural gas rose at an annual rate of about 1 percent in the first quarter of 2006, ¾ percentage point faster than the pace in the second half of 2005. Prices of material-intensive goods, such as nonfuel industrial supplies and foods, increased steadily in the last quarter of 2005 and in the first quarter of 2006. Also in the first quarter, prices of finished goods, such as consumer goods and many kinds of capital goods, turned up slightly. Available data for the second quarter indicate that prices of finished goods kept rising at a subdued pace. However, prices of material-intensive goods continued to increase sharply, a development reflecting higher prices for metals. The International Monetary Fund's index of global metals prices rose 46 percent between December 2005 and May 2006, largely because of robust global demand. In June, metals prices retreated about 8 percent, although they remained well above the levels of earlier this year.

Prices of oil and of nonfuel commodities, 2002–06



NOTE The data are monthly. The last observation for the oil price is the average for July 3 through July 12, 2006. The prices of nonfuel commodities extend through June 2006. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.

SOURCE For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

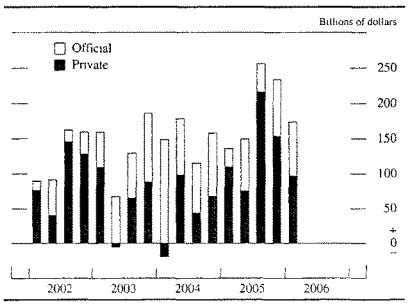
The spot price of West Texas intermediate crude oil increased from around $60 per barrel at the end of last year to more than $75 per barrel in July, higher than the peak that followed last year's hurricanes. Oil prices have been highly sensitive to news about both supply and demand, particularly in light of the narrow margin of worldwide spare production capacity. Global oil demand has continued to grow as the foreign economic expansion has spread, and developing countries have posted the largest increases in oil consumption. Recent events in the Middle East—including concerns over Iran's nuclear program, violence in Iraq, and the recent conflict in Lebanon—have put additional upward pressure on oil prices. In Nigeria, attacks against oil infrastructure have reduced oil production for most of this year. Government intervention in energy markets also raised concerns about supply from some countries: In recent months, Bolivia nationalized its natural gas reserves, and Venezuela and Russia continued to tighten governmental control of their energy industries.

The rise in the price of the far-dated NYMEX oil futures contract (currently for delivery in 2012) to more than $70 per barrel likely reflects a belief by oil market participants that the balance of supply and demand will remain tight over the next several years.

The Financial Account

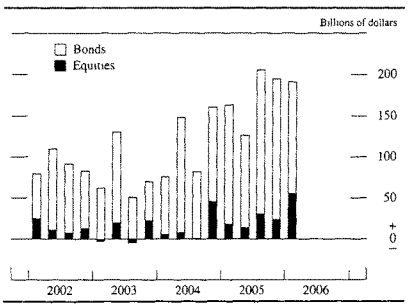
The U.S. current account deficit continues to be financed primarily by foreign purchases of U.S. debt securities. Foreign official inflows in the first quarter maintained the strength exhibited in 2005 but remained below the record levels of 2004. As in recent years, the majority of these official inflows were attributable to Asian central banks and have taken the form of purchases of U.S. government securities.

U.S. net financial inflows, 2002–06



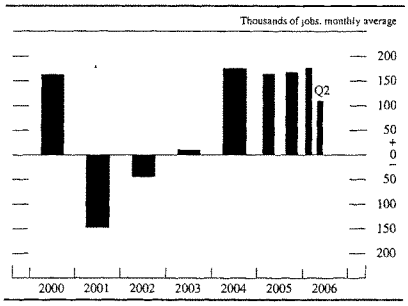
SOURCE Department of Commerce

Net private foreign purchases of long-term U.S. securities, 2002–06



SOURCE: Department of Commerce and the Treasury International Capital reporting system

Net change in payroll employment, 2000–06



NOTE Nonfarm business sector
SOURCE: Department of Labor, Bureau of Labor Statistics.

Foreign private purchases of U.S. securities continued in the first quarter at the extraordinary pace set in the second half of 2005. Although private flows into U.S. Treasury bonds were significantly smaller than in recent quarters, this slowing was more than offset by larger flows into agency bonds and equities. Preliminary data for April and May suggest a slowdown in foreign purchases of U.S. securities relative to the first quarter. Foreign direct investment flows into the United States continued in the first quarter near last year's average levels.

Net purchases of foreign securities by U.S. residents, which represent a financial outflow, strengthened slightly in the first quarter and continued at a solid pace in April and May. In addition, significant outflows were associated with U.S. direct investment abroad, a reversal of some unusual inflows in the second half of 2005. These second-half inflows were prompted by the partial tax holiday offered under the 2004 Homeland Investment Act (HIA), which induced the foreign affiliates of U.S. firms to repatriate a portion of earlier earnings that had been retained abroad. In the first quarter, the foreign affiliates partially unwound the HIA-induced flows by retaining an unusually large portion of their first-quarter earnings. Increased merger activity abroad also boosted direct investment outflows in the first quarter.

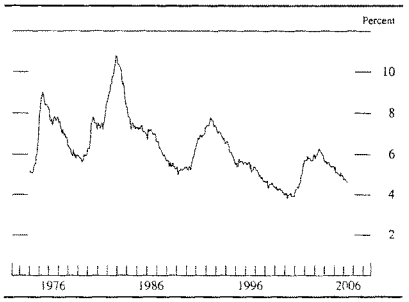
The Labor Market

Employment and Unemployment

Conditions in the labor market continued to improve in the first half of 2006, although the pace of hiring has slowed in recent months. Nonfarm payroll employment increased 176,000 per month during the first quarter, a rate roughly in line with the relatively brisk pace that prevailed during 2004 and 2005. During the second quarter, hiring slowed, and monthly gains in payrolls averaged 108,000 jobs per month. Over the two quarters, the civilian unemployment rate edged down further, to the lowest quarterly level of joblessness in five years.

In the first quarter, with homebuilding quite strong, hiring continued to be particularly robust at construction sites; part of this strength was the result of favorable weather, which allowed more construction activity than is typical during the winter months. Although nonresidential construction activity was firming by the spring, the pullback in housing starts slowed the demand for residential contractors and workers in the building trades. As a result, monthly additions to construction industry payrolls declined from more than 25,000 per month in the first quarter to just 3,000 per month in the second quarter. Cutbacks at retailers also were an important factor holding down the overall gain in employment in the

Civilian unemployment rate, 1974–2006



NOTE The data are monthly and extend through June 2006
SOURCE Department of Labor, Bureau of Labor Statistics

second quarter. After having been stable early in 2006, employment at retail outlets fell almost 30,000 per month between March and June; most of the cutbacks occurred at general merchandisers.

In other sectors, employment remained on a solid upward trend during the first half of the year. As has been the case since mid-2004, establishments providing education and health services, those offering professional and technical business services, and those involved in financial activities, taken together, added more than 60,000 jobs per month. Employment in manufacturing, which had turned up at the end of 2005, rose further over the first half of 2006. Expanding industrial production was also associated with further job gains in related industries, such as wholesale trade and transportation. In addition, the increase in energy production led to a sustained rise in employment in the natural resources and mining industry over the first half of the year.

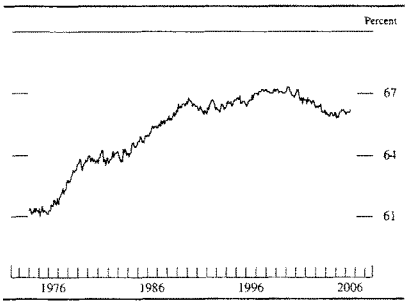
The increase in job opportunities so far in 2006 led to a further reduction in the civilian unemployment rate, from an average of 5.0 percent in the second half of 2005 to 4.7 percent in the second quarter of 2006. Although hiring moderated in the spring, layoffs remained low. New claims for unemployment insurance (UI) dipped below 300,000 per week in January and February and then fluctuated around a still-low level of about 315,000 per week for most of the period from March through early July. Over the first half of 2006, longer-term unemployment (fifteen weeks or more) also moved down, and the proportion of UI claimants who remained on the unemployment rolls until the exhaustion of their benefits continued to recede.

After having edged up during 2005, the labor force participation rate was relatively stable over the first half of 2006 despite the ongoing improvement in labor market conditions. Rates for most broad age groups were little changed from last year's levels. From a longer perspective, developments during the past decade highlight the importance of structural as well as cyclical influences on participation. The rise in the attachment of adult women to the workforce, which was a significant factor in the secular rise in participation over much of the post–World War II period, appears to have leveled off. And the aging of the population is increasing the proportion of the workforce that is 55 years and older; it rose from less than 12 percent in 1996 to 16¾ percent in recent months. Although older workers have tended in recent years to stay in the labor force longer, their participation rate, at 38 percent in the second quarter, was less than half the rate for workers who are age 25 to 54. Thus, the demographic shift to an older population has already begun to reduce the overall rate of labor force participation and has offset part of the rise in participation that has been associated with the cyclical upturn in job creation. The secular forces that are slowing the expansion of the labor force imply that the increase in employment that is consistent with a stable unemployment rate will, over time, be smaller than it was during the period when labor force participation was rising steadily.

Productivity and Labor Costs

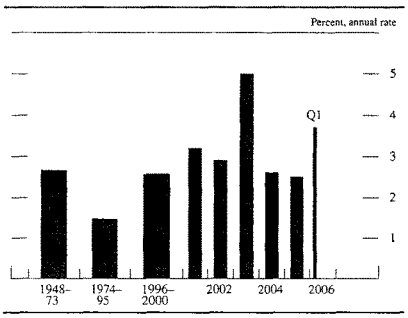
After having advanced at an unusually rapid rate from 2001 to mid-2004, labor productivity in the nonfarm business sector increased at a more moderate annual rate of 2½ percent from mid-2004 to early 2006. Nonetheless, by historical standards, productivity performance recently

Labor force participation rate, 1974–2006



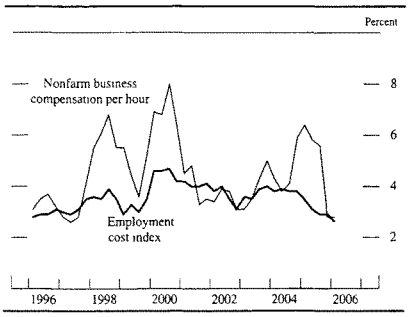
NOTE The data are monthly and extend through June 2006
SOURCE Department of Labor, Bureau of Labor Statistics

Change in output per hour, 1948–2006



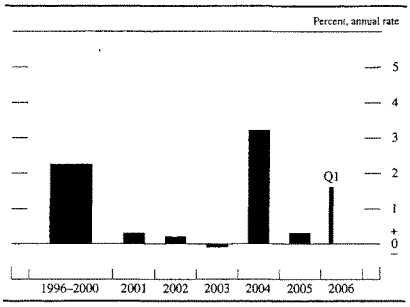
NOTE Nonfarm business sector Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period
SOURCE Department of Labor, Bureau of Labor Statistics

Measures of change in hourly compensation, 1996–2006



NOTE. The data are quarterly and extend through 2006:Q1. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. The nonfarm business sector excludes farms, government, nonprofit institutions, and households. The sector covered by the ECI used here is the same as the nonfarm business sector plus nonprofit institutions. A new ECI series was introduced for data as of 2001, but the new series is continuous with the old.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs, 1996–2006



NOTE: Nonfarm business sector. The change for 1996 to 2000 is measured from 1995:Q4 to 2000:Q4.
SOURCE. Department of Labor, Bureau of Labor Statistics.

has still been solid, with gains at a rate matching those during the second half of the 1990s. In an environment of a sustained expansion of aggregate demand, businesses have gradually adjusted their use of labor, capital, and services to achieve ongoing gains in efficiency. Productivity has continued to benefit importantly from investment in new technologies, organizational changes, and improvements in business processes, although the contribution from capital deepening has been smaller in recent years than it was during the capital investment boom of the late 1990s.

Broad measures of hourly labor compensation, which include both wages and the costs of benefits, posted moderate gains over the year ending in early 2006 despite the run-up in headline price inflation and the further tightening of labor markets. Both the employment cost index (ECI) and the estimate of compensation per hour that uses data from the national income and product accounts increased 2¾ percent between the first quarter of 2005 and the first quarter of 2006.[1] Both series had reported higher rates of change in hourly labor compensation a year earlier.

The deceleration in labor compensation appears to have been associated largely with smaller increases in employers' benefit costs. The benefits component of the ECI was up just 3 percent between March 2005 and March 2006, compared with an increase of 5.5 percent between March 2004 and March 2005. The cost of health insurance, which typically accounts for about one-fourth of overall benefit costs, rose just 4¾ percent during the year ending in March 2006; between 2000 and 2005, these costs increased, on average, 8¾ percent per year. Another likely contributor to the slower rise in benefit costs over the past year was smaller employer contributions to their defined-benefit pension plans; those costs dropped back somewhat after employers made sizable payments to bolster those pension assets in 2004.

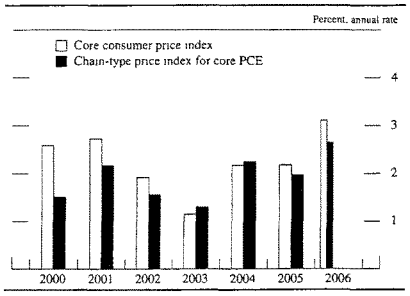
Indicators of the recent trend in the wage component of worker compensation have been providing mixed signals. As measured in the ECI, wages rose 2.4 percent between March 2005 and March 2006, slightly less than in the preceding two years. In contrast, the year-over-year change in average hourly earnings of production or nonsupervisory workers—which refers to a narrower group of private nonfarm employees and has tended to show greater cyclical variation than the ECI—has increased steadily over the past three years. Average hourly earnings rose 3.9 percent over the twelve months ending in June 2006, compared with an increase of 2.7 percent over the twelve months ending in June 2005.

Prices

Inflation pressures were elevated during the first half of 2006. The chain-type price index for personal consumption expenditures (PCE) rose at an annual rate of 4¼ percent between December 2005 and May 2006. Over the same period, core PCE prices increased at an annual rate of 2.6 percent, nearly 0.6 percentage point faster than over the twelve months of 2005.

1 The Bureau of Labor Statistics (BLS) developed a new ECI series and has provided data for the changes in that series beginning in 2001. The BLS considers the new ECI to be continuous with the old series.

Change in core consumer prices, 2000–06



NOTE: Through 2005, change is from December to December, for 2006, change is from December to May

SOURCE: For core consumer price index, Department of Labor, Bureau of Labor Statistics; for core PCE price index, Department of Commerce, Bureau of Economic Analysis

Although energy prices eased temporarily in February, they turned up sharply again from March to May; as a result, the PCE price index for energy increased 13 percent (not at an annual rate) over the first five months of 2006, a rise that marked a continuation of the steep climb in prices that began in 2004. This year, almost the entire rise in energy prices has been associated with higher prices for petroleum-based products. The PCE price index for gasoline and motor fuel, which increased more than 16½ percent last year, climbed another 24 percent (not at an annual rate) by May. Although recent data from the Department of Energy indicate that gasoline prices fell back in June, they moved up again in early July. Retail prices of gasoline this year have risen faster than the cost of crude oil in part because of the additional cost of producing and distributing reformulated product with ethanol. Also, the demand for fuel ethanol has been strong relative to the current capacity to produce it. In contrast, the consumer price of natural gas has turned down this year as inventories have remained relatively high; the price decline between January and May almost completely reversed the steep run-up that occurred last autumn.

Food price inflation remained moderate during the first five months of 2006; between December 2005 and May 2006, the PCE price index for food and beverages increased at an annual rate of 2¼ percent. Retail prices of meat and poultry have fallen so far this year. Domestic supplies of meat have been ample. Production has been expanding at a time when export demand for beef has been soft largely because of bans on imports of U.S. beef by Japan and Korea. Prices of processed food have continued to rise at only a moderate rate despite higher prices for grains; export demand for grains has been strong, and the price of corn has been boosted by demand from producers of ethanol. Prices for food consumed away from home, which typically are influenced heavily by labor and other business costs, have continued to increase relatively rapidly, rising at an annual rate of 3¾ percent over the first five months of the year.

The pickup in core inflation in the first half of 2006 was evident in the indexes for both goods and services. Prices of consumer goods excluding food and energy, which were unchanged in 2005, edged up at an annual rate of ¾ percent this year. Prices of consumer services also accelerated this spring; as a result, the PCE price index for non-energy services increased at an annual rate of 3½ percent between December 2005 and May 2006, compared with a rise of 2¾ percent in 2005. In the three months ending in May, increases in housing rents were especially steep; the rise may reflect, in part, a shift in demand toward rental units because home purchases have become less affordable. Another contributor to the higher inflation rate for consumer services has been the acceleration in the index for nonmarket services to an annual rate of 4 percent over the first five months of the year from 3 percent last year.[2] More broadly, the pickup in core consumer price inflation over the first five months of 2006 likely is the result of the pass-through of higher energy costs to a wide range of goods and services.

The cost pressures from the increase in energy costs during the past three years have been apparent in rising prices of inputs used in the production and sale of final goods and services. The producer price index for intermediate goods, excluding food and energy, rose at an annual rate of 7¼ percent between December 2005 and May 2006; this index rose 4¾ percent in 2005 and 8¼ percent in 2004. In particular, prices of industrial chemi-

2. These are services—such as foreign travel or the financial services provided by banks—for which no prices based on market transactions are available; the Bureau of Economic Analysis must impute or estimate these price indexes.

Alternative measures of price change

Percent

Price measure	2004 to 2005	2005 to 2006
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	2.8	3.1
Gross domestic purchases	3.1	3.5
Personal consumption expenditures (PCE)	2.7	3.0
Excluding food and energy	2.2	1.9
Market-based PCE excluding food and energy	1.8	1.5
Fixed-weight (Q2 to Q2)		
Consumer price index	3.0	4.0
Excluding food and energy	2.1	2.4

NOTE: Changes are based on quarterly averages of seasonally adjusted data. For the consumer price index, the 2006:Q2 value is calculated as the average for April and May compared with the average for the second quarter of 2005 and is expressed at an annual rate.

SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

cals, fertilizer, and stone and clay products, for which energy represents a relatively high share of the total costs of production, accelerated over the past several years. The costs of a number of important business services, particularly transportation by air, rail, and truck, have also been boosted by higher energy costs. The pass-through of the costs of energy to consumer prices is clear for a few items, such as airfares. For other components of core consumer price indexes, however, the extent of the pass-through is harder to trace. Quantifying the extent of the pass-through is difficult, in part because it is diffused through a wide range of retail goods and services. In addition, the cost of energy is a small share of overall costs—and that share has been declining over time as businesses adopt more energy-efficient technologies and households reduce their consumption of energy. Nonetheless, the cumulative rise in energy costs in recent years has been large enough to show through to pricing of final goods and services even as businesses have seen their labor costs, which represent roughly two-thirds of their costs, remain restrained.

Near-term inflation expectations were also influenced importantly over the first half of 2006 by movements in energy prices, but, as of midyear, they were only slightly higher than they were at the turn of the year. The Michigan SRC survey measure of the median expectation of households for inflation over the next twelve months held steady at 3 percent during the first three months of the year but then rose sharply to 4 percent in May as gasoline prices climbed. By early July, this measure of near-term inflation expectations dropped back to 3.1 percent. Longer-term inflation expectations remained within the ranges in which they have fluctuated in recent years. On average over the first half of 2006, the median respondent to the Michigan SRC survey continued to expect the rate of inflation during the next five to ten years to be just under 3 percent. In June, the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, reported expected inflation at a rate of 2½ percent over the next ten years, an expectation that has been roughly unchanged for the past eight years. Inflation compensation implied by the spread of yields on nominal Treasury securities over their inflation-protected counterparts rose slightly, on net, over the first half of the year; in early July it was just above 2½ percent.

TIPS-based inflation compensation, 2003–06

NOTE The data are daily and extend through July 12, 2006. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) with the nominal off-the-run Treasury yield curve

SOURCE Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays

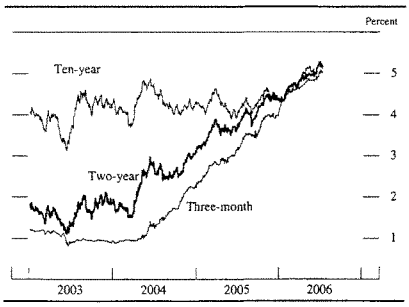
U.S. Financial Markets

U.S. financial markets functioned smoothly in the first half of 2006 against the backdrop of increased volatility in some asset prices. Yields on nominal Treasury coupon securities rose about 70 basis points, on net, through early July as investors came to appreciate that economic conditions and inflation pressures required more monetary policy tightening than they had expected at the end of 2005. Equity prices advanced until mid-May but then reversed those gains. Apparently, evidence of increased inflationary pressures and some softer-than-expected data on economic activity induced market participants to revise down their longer-term outlook for business profits and to perceive greater risks to that outlook. With corporate balance sheets remaining strong and liquid, risk spreads on corporate bonds stayed low, an indication that the revision to the outlook had not sparked broad concerns about credit quality. Firms had ample access to funds, and business-sector debt expanded rapidly in the first quarter. The need to finance brisk merger and acquisition activity was one factor that reportedly induced nonfinancial businesses to tap the credit markets heavily. Bond issuance picked up noticeably, and commercial and industrial loans increased robustly. Banks continued to ease terms and standards on such loans. Household debt expanded further in the first quarter amid rising house prices and brisk cash-out refinancing activity. As was the case in 2005, the M2 monetary aggregate has advanced moderately so far in 2006.

Interest Rates

The FOMC increased the target federal funds rate 25 basis points at each of its four meetings this year. These actions brought the rate to 5¼ percent, about 60 basis points above the rate expected at the end of last year for early July. In contrast to the situation earlier in the tightening cycle, when it was evident to investors that consid-

Interest rates on selected Treasury securities, 2003–06



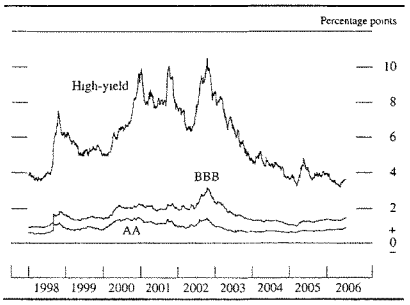
NOTE. The data are daily and extend through July 12, 2006
SOURCE Department of the Treasury

erable monetary policy accommodation was in place and had to be removed, market participants more recently have had to focus to a greater degree on economic data releases and their implications for the outlook for economic growth and inflation to form expectations about near-term policy. Although the information currently available suggests that growth of real output slowed appreciably in the second quarter, incoming price data have pointed to greater-than-expected inflationary pressures throughout the first half of the year. Investors anticipated that the FOMC would act to counter such pressures, and the expected policy path moved upward, on balance, over the first half of 2006. Nevertheless, market participants currently appear to expect the target federal funds rate to ease after the end of the year. Despite investors' apparent awareness that monetary policy decisions increasingly depend on the implications of incoming information for the economic outlook, the implied volatility on short-term Eurodollar rates calculated from option prices has remained near the low end of its historical range.

Yields on nominal Treasury coupon securities rose about 70 basis points across the maturity spectrum through early July, in part because of the expectations for firmer policy. In addition, it appears that a modest rebound in term premiums, including investor compensation for inflation risk, may have contributed to the rise in longer-term rates; still, estimated premiums remain low by historical standards. Yields on inflation-indexed Treasury securities rose less than those on their nominal counterparts, leaving inflation compensation at medium- and long-term horizons 20 to 30 basis points higher than at the turn of the year.

In the corporate bond market, yields on investment-grade securities moved about in line with those on comparable-maturity Treasury securities through early July. In contrast, those on speculative-grade securities rose only about 40 basis points; as a result, risk spreads were 30 basis points lower in that segment of the market. The narrowness of high-yield spreads was likely a reflection of investors' sanguine views about corporate credit quality over the medium term, given the strength of business balance sheets and the outlook for continued economic expansion.

Spreads of corporate bond yields over comparable off-the-run Treasury yields, 1998–2006

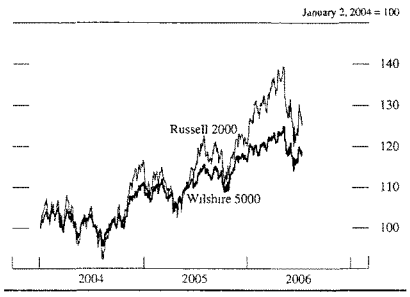


NOTE. The data are daily and extend through July 12, 2006 The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield
SOURCE Derived from smoothed corporate yield curves using Merrill Lynch bond data

Equity Markets

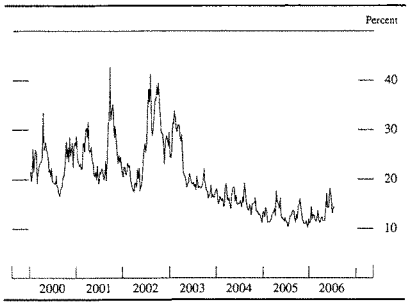
Broad equity indexes changed little, on net, through early July. Stock prices were boosted up to the first part of May

Stock price indexes, 2004–06



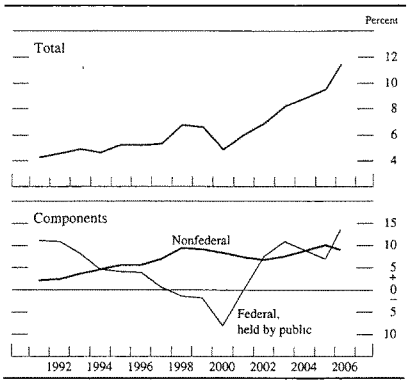
NOTE The data are daily and extend through July 12, 2006
SOURCE Frank Russell Company, Dow Jones Indexes

Implied S&P 500 volatility, 2000–06



NOTE: The data are weekly and extend through July 12, 2006. The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

Change in domestic nonfinancial debt, 1991–2006



NOTE: For 2006, change is from 2005.Q4 to 2006.Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of components shown. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts
SOURCE: Federal Reserve Board, flow of funds data.

by an upbeat economic outlook and by strong corporate earnings in the first quarter. However, those gains were subsequently reversed as incoming data clouded the prospects for economic growth and continued to point to upward pressures on inflation; the drop in share prices was led by stocks that had logged the largest gains in the previous months, including those of firms with small capitalizations and of firms in cyclically sensitive sectors. A measure of the equity risk premium—computed as the difference between the twelve-month forward earnings–price ratio for the S&P 500 and an estimate of the real long-term Treasury yield—has increased slightly so far this year and remains near the high end of its range of the past two decades. The implied volatility of the S&P 500 calculated from option prices spiked temporarily in late May and early June and remained somewhat elevated compared with its levels earlier in the year.

Net inflows to equity mutual funds were very strong through April, as investors were evidently attracted by the solid performance of the equity market up to that point. In May and June, however, investors withdrew funds as share prices began to sag.

Debt and Financial Intermediation

In the first quarter of 2006, the total debt of domestic nonfinancial sectors expanded at an annual rate of 11 percent. The household, business, and federal government components all increased at double-digit rates, while state and local government debt advanced at about a 6 percent pace. Preliminary data suggest somewhat slower growth of the debt of nonfinancial sectors in the second quarter. The slowdown is particularly noticeable in the federal and state and local government sectors, where strong tax receipts held down borrowing. The available data also point to somewhat reduced growth of nonfinancial business debt in the second quarter.

Commercial bank credit increased at an annual rate of about 11 percent in the first quarter of 2006, a little faster than in 2005, and picked up further to an almost 13 percent pace in the second quarter. A continued rapid increase in business loans was likely supported by brisk merger and acquisition activity, rising outlays for investment goods, ongoing inventory accumulation, and an accommodative lending environment. Growth in commercial mortgages was also strong, as fundamentals in that sector continued to improve. Despite a slowing of housing activity in recent months, residential mortgage holdings expanded robustly. However, higher short-term interest rates likely contributed to a runoff in loans drawn down under revolving home-equity lines of credit. Consumer loans adjusted for securitizations decelerated in the second quarter after rising at a solid pace in the first quarter.

Bank profitability remained solid, and asset quality continued to be excellent in the first quarter. Profits were supported by gains in non-interest income and reductions in loan-loss provisions that more than offset a rise in non-interest expenses. Delinquency and charge-off rates remained low across all loan types. Delinquency rates on residential mortgages on banks' books edged lower in the first quarter after moving up during 2005. Charge-off

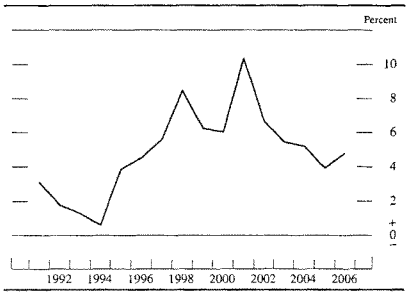
rates on consumer loans declined to the lowest level seen in recent years after a fourth-quarter surge in charge-offs on credit card loans that was associated with the implementation of the bankruptcy legislation in October of last year.

As the policy debate about the possibility of curbing the balance sheet growth of both Fannie Mae and Freddie Mac continued, the combined size of the mortgage investment portfolios at the two government-sponsored enterprises increased about 1 percent over the first five months of 2006.

The M2 Monetary Aggregate

In the first quarter of 2006, M2 increased at an annual rate of about 6½ percent, but its expansion moderated in the second quarter to a 2¾ percent pace, likely because of some slowing in the growth of nominal GDP. Rising short-term interest rates continued to push up the opportunity cost of holding M2 assets. Growth in liquid deposits, whose rates tend to adjust sluggishly to changes in market rates, was particularly slack. By contrast, the expansion in retail money market funds and, especially, small time deposits was brisk, as the yields on those instruments kept better pace with rising market interest rates. Despite apparently modest demand from abroad, currency growth was strong in the first quarter but has slowed since. The velocity of M2 rose at an annual rate of 2¼ percent in the first quarter and appears to have continued to rise in the second quarter.

M2 growth rate, 1991–2006



NOTE. Through 2005, the data are annual on a fourth-quarter over fourth-quarter basis, for 2006, change is calculated from 2005 Q4 to 2006:Q2 and annualized. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

SOURCE. Federal Reserve Board, Statistical Release H.6, "Money Stock Measures" (July 13, 2006).

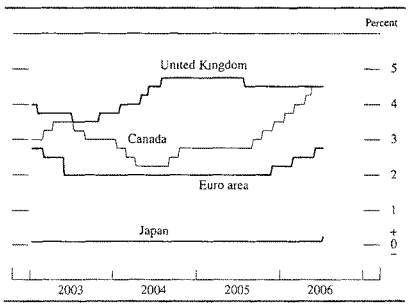
International Developments

Foreign economic growth was strong in the first quarter of 2006 as the expansion spread to all major regions of the world. Accelerating domestic demand boosted growth in the foreign industrial countries, especially Canada and the euro area. Emerging-market economies continued to benefit from rapid export growth, and Chinese economic activity was also spurred by a surge in investment spending. Data for the second quarter suggest continued strong growth abroad but with moderation in some countries. Rising energy prices have pushed up inflation in many countries this year, but upward pressure on core inflation has generally continued to be moderate.

Foreign monetary policy tightened in the first half of this year in the context of solid growth and some heightened inflation concerns. The European Central Bank (ECB) raised its policy rate ¼ percentage point in March and again in June, citing rapid credit growth and the ECB's expectation of above-target inflation. At its July policy meeting, the Bank of Canada kept its target for the overnight rate unchanged at 4¼ percent, but it had increased its target for the overnight rate ¼ percentage point at each of its previous seven policy meetings. On July 14, the Bank of Japan (BOJ) ended its zero-interest-rate policy by raising its target for the call money rate to ¼ percent for the first time since 2001. Earlier, on March 9, the BOJ, announcing an end to its five-year-old policy of quantitative easing, said that it would set policy in the future to control inflation over the medium to long run, defined as one to two years ahead.

Long-term bond yields abroad have risen along with U.S. bond yields on indications of robust global growth

Official or targeted interest rates in selected foreign industrial countries, 2003–06



NOTE. The data are weekly. The last observation for each series is July 14, 2006. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

SOURCE. The central bank of each area or country shown.

and expectations of additional tightening of monetary policy. Ten-year sovereign yields have risen roughly 70 basis points in the euro area since the end of last year, while the increases on similar securities in Canada and the United Kingdom have been about 50 basis points. Part of the rise in yields abroad has been increased compensation for possible future inflation as measured by the difference in yield between ten-year nominal and inflation-indexed bonds. Yield spreads of emerging-market bonds over U.S. Treasuries narrowed somewhat early in the year, but that narrowing was more than reversed in the second quarter as investors apparently demanded greater compensation for risk amid uncertainties about economic growth and inflation.

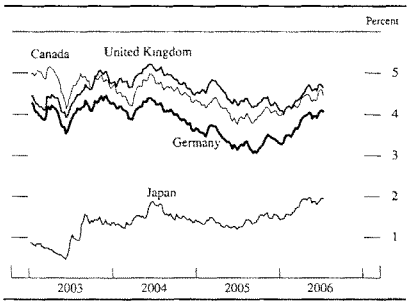
The foreign exchange value of the dollar has declined about 4½ percent, on net, this year against a basket of the currencies of the major industrial countries but is down only about 1 percent, on net, against the currencies of the other important trading partners of the United States. Much of the dollar's downward move occurred at times when the market was focused on concerns about global current account imbalances. The dollar has recovered some ground since early May, as investors reportedly have engaged in flight-to-safety transactions into dollar-denominated assets in conjunction with the volatility in global commodity and asset markets. On net, the dollar has depreciated since the turn of the year about 6½ percent against the euro and sterling, 3 percent against the Canadian dollar, and 1½ percent against the Japanese yen. In contrast, the dollar has risen roughly 4 percent, on balance, against the Mexican peso this year. During the first half of this year, several smaller countries experienced episodes of substantial financial volatility that in some cases involved sharp depreciations in the exchange value of their currencies.

Through the first four months of 2006, a favorable economic outlook and low interest rates supported gains in equity prices in all major foreign countries. During May and early June, however, equity prices registered widespread declines, as market participants grew more concerned about inflation, monetary policy, and global economic growth. More recently, developments in the Middle East have weighed further on stock prices. On net, equity price indexes are up between 1 percent and

U.S. dollar nominal exchange rate, broad index, 2003–06

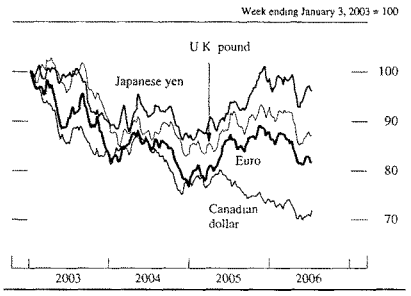
NOTE: The data are weekly and are in foreign currency units per dollar. The last observation is the average for July 10 through July 12, 2006. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board.

Yields on benchmark government bonds in selected foreign industrial countries, 2003–06



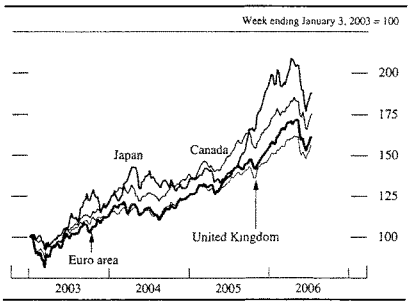
NOTE: The data are for ten-year bonds and are weekly. The last observation for each series is the average for July 10 through July 12, 2006.
SOURCE: Bloomberg L.P.

U.S. dollar exchange rate against selected major currencies, 2003–06



NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average for July 10 through July 12, 2006.
SOURCE: Bloomberg L.P.

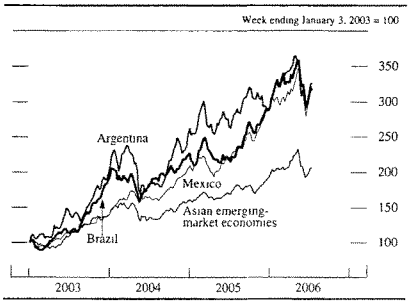
Equity indexes in selected foreign industrial countries, 2003–06



NOTE: The data are weekly. The last observation for each series is the average for July 10 through July 12, 2006
SOURCE. Bloomberg L.P.

4 percent so far in 2006 in Europe and Canada, but they have fallen roughly 8 percent since year-end in Japan. Latin American and Asian emerging-market equity indexes, which had generally gained more than industrial-country indexes early in the year, have fallen more sharply since early May. Equity indexes in Mexico, Brazil, and Argentina have dropped between 12 percent and 15 percent—leaving them still between 5 percent and 7 percent higher so far this year—while stock prices in Korea have fallen about 9 percent, on net, for the year.

Equity indexes in selected emerging-market economies, 2003–06



NOTE. The data are weekly The last observation for each series is the average for July 10 through July 12, 2006 The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand, each economy's index weight is its market capitalization as a share of the group's total
SOURCE For Asian emerging-market economies, Morgan Stanley Capital International (MSCI) index, for others, Bloomberg L P

Industrial Economies

The Japanese economy has continued to strengthen this year, although economic growth has stepped down a bit from the comparatively strong rate recorded in 2005. Household consumption maintained a solid rate of growth in the first quarter, and private investment spending rose 11 percent. However, net exports, which previously had been an additional source of strength, did not contribute to growth in the first quarter; the growth of imports increased while export growth remained firm. The labor market in Japan improved further in April and May: The unemployment rate fell to 4 percent, and the ratio of job offers to applicants reached a thirteen-year high. Although the GDP deflator has continued to decline, other signs indicate that deflation is ending. In the first quarter of 2006, land prices in Japan's six largest cities rose 3.8 percent over their year-ago level, the first increase since 1991. Core consumer prices have shown small twelve-month increases over the past several months.

Real GDP in the euro area accelerated in the first quarter, expanding 2½ percent, a rate of growth somewhat above its average in recent years. The acceleration was spurred by strength in domestic demand, especially private consumption spending, which increased in the first quarter at double its pace in 2005. Retail sales were also strong at the start of the second quarter. The revival in household spending has been supported by a small rise in the growth rate of employment and by an improvement in employer and consumer perceptions of employment prospects. Private investment spending has remained strong in the euro area, and business sentiment has continued to brighten in recent months. Energy price increases have pushed euro-area consumer price inflation to about 2½ percent recently, a level above the ECB's 2 percent ceiling, but core inflation has remained near 1½ percent.

In the United Kingdom, real GDP expanded at an annual rate of 3 percent in the first quarter after rising about 1¾ percent in 2005. Consumer spending grew about 1½ percent, the same moderate pace seen last year. House prices, which remained relatively flat during late 2004 and most of 2005, picked up in late 2005 and have continued to rise in the first half of this year. The twelve-month change in consumer prices was 2.2 percent in May. Consumer prices have been boosted importantly by increases in energy prices over the past several months.

In Canada, real GDP grew at an annual rate of nearly 4 percent in the first quarter, an increase led by a jump in spending on consumer durables and housing. Investment in residential structures grew at its fastest rate in more than two years, and business investment continued to exhibit the strength observed in the previous two quarters. Indicators for the second quarter point generally to a deceleration of GDP. Housing starts in the second quar-

ter were significantly below their elevated first-quarter levels; the merchandise trade balance declined, on balance, during the first five months of this year; and in the manufacturing sector, the volume of new orders and of shipments both fell in April. In contrast, in the second quarter, the labor market maintained its strength of the past year, and the unemployment rate has fallen to 6.2 percent, the lowest level in more than thirty years. Consumer prices rose 2.8 percent in the twelve months ending in May.

Emerging-Market Economies

In China, growth of real output was especially robust in the first half. Economic indicators suggest that fixed investment surged and that export growth continued to be strong. The rapid growth of investment prompted the Chinese government to impose a series of new measures to slow capital spending, including controls on credit and land use and stricter criteria for approving investment projects. In addition, to restrain credit, which has soared more than 15 percent over the past year, China's central bank raised the one-year bank lending rate in April and raised banks' reserve requirements ½ percentage point in June. The Chinese trade surplus widened in the first half of this year as exports accelerated. Chinese consumer price inflation is about 1½ percent, slightly above its pace in the second half of last year but well below the more than 5 percent rate seen in 2004.

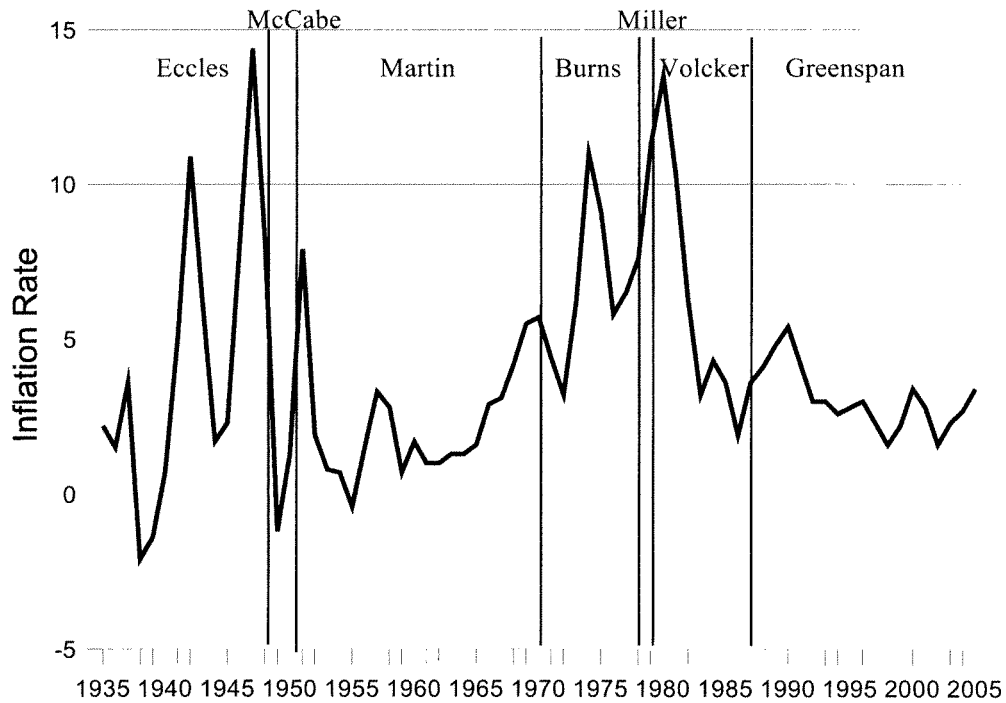
Economic growth in India, Malaysia, and Hong Kong also was quite strong in the first quarter, although the pace of activity of some of the other Asian emerging-market economies has moderated a bit from last year's rapid rate. Concerns about inflationary pressures have increased, largely because of rising energy prices. In response, monetary policy has been tightened in some countries, including Korea, India, and Thailand.

In Mexico, strong performance in the industrial sector, an expansion in services output, and a recovery in agricultural production propelled real GDP growth to more than 6 percent at an annual rate in the first quarter. In addition, a surge in manufacturing exports boosted Mexico's trade and current account balances noticeably. Industrial production continued to increase early in the second quarter. In June, Mexican inflation was 3.2 percent, just above the center of the Bank of Mexico's target range of 2 percent to 4 percent. After easing policy nine times between August and April, the Bank of Mexico signaled in April that it would leave its policy rate unchanged for a time.

Real GDP growth in Brazil also increased in the first quarter, rising to 5¾ percent, and was supported by very strong performances in manufacturing, mining, and construction. The rate of inflation has been declining from a high of 8 percent reached in April 2005; in June, the twelve-month change in prices edged down to 4 percent. In late May, the central bank reduced its target for the overnight interest rate 50 basis points, to 15¼ percent, bringing the cumulative decline to 450 basis points since the current easing phase began last September. In the minutes of its late-May meeting, the policymaking committee said that the onset of market volatility over the past month had increased its uncertainty about the prospects for inflation and had thus prompted it to ease less than it would have otherwise.

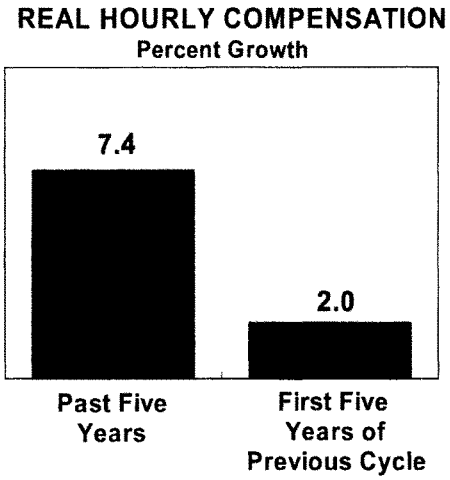
In Argentina, output growth slowed slightly in the first quarter. Amid emerging capacity constraints, inflation rose to about 11 percent, up from 6 percent in 2004. The Argentine government has tried to hold down inflation, with limited success, through voluntary price agreements in several sectors.

Inflation Under Different Fed Chairmen



Source: BLS, Federal Reserve

Compensation Growth is Better Than Comparable Point in Previous Cycle



- From the first quarter of 2001 to the first quarter of 2006, real compensation per hour has gone up 7.4 percent.
- During the same period in the previous business cycle (Q2.1990 to Q2.1995) real hourly compensation was up only 2 percent.
- Real compensation per hour is worker pay plus benefits adjusted for inflation and the number of hours worked.

June 19, 2006

Open Letter on Immigration

Dear President George W. Bush and All Members of Congress:

People from around the world are drawn to America for its promise of freedom and opportunity. That promise has been fulfilled for the tens of millions of immigrants who came here in the twentieth century.

Throughout our history as an immigrant nation, those who were already here have worried about the impact of newcomers. Yet, over time, immigrants have become part of a richer America, richer both economically and culturally. The current debate over immigration is a healthy part of a democratic society, but as economists and other social scientists we are concerned that some of the fundamental economics of immigration are too often obscured by misguided commentary.

Overall, immigration has been a net gain for American citizens, though a modest one in proportion to the size of our 13 trillion-dollar economy.

Immigrants do not take American jobs. The American economy can create as many jobs as there are workers willing to work so long as labor markets remain free, flexible and open to all workers on an equal basis.

In recent decades, immigration of low-skilled workers may have lowered the wages of domestic low-skilled workers, but the effect is likely to have been small, with estimates of wage reductions for high-school dropouts ranging from eight percent to as little as zero percent.

While a small percentage of native-born Americans may be harmed by immigration, vastly more Americans benefit from the contributions that immigrants make to our economy, including lower consumer prices. As with trade in goods and services, the gains from immigration outweigh the losses. The effect of all immigration on low-skilled workers is very likely positive as many immigrants bring skills, capital and entrepreneurship to the American economy.

Legitimate concerns about the impact of immigration on the poorest Americans should not be addressed by penalizing even poorer immigrants. Instead, we should promote policies, such as improving our education system, that enable Americans to be more productive with high-wage skills.

We must not forget that the gains to immigrants coming to the United States are immense. Immigration is the greatest anti-poverty program ever devised. The American dream is a reality for many immigrants who not only increase their own living standards but who also send billions of dollars of their money back to their families in their home countries—a form of truly effective foreign aid.

America is a generous and open country and these qualities make America a beacon to the world. We should not let exaggerated fears dim that beacon.

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LOOKING AHEAD

Enforcement Isn't Enough

Thirty-three signatories embrace Reagan's vision: Allow for sensible levels of open immigration.

Monday, July 10, 2006 12:01 a.m.

At this critical moment in the immigration debate, conservatives need to examine the role we are playing in this great national issue. In many respects, the way we position ourselves on immigration will determine whether we retain the mantle of majority leadership. What side of history do conservatives want to be on? Will we remain a movement that governs--that offers practical solutions to the problems facing the country?

Conservatives have always prided themselves on acknowledging, in the words of John Adams, that "Facts are stubborn things." Well, immigration--both the robust annual flow required to keep our economy growing and the 12 million illegal immigrants already in the country--is a fact of life in the U.S. today. And the only practical way to deal with these stubborn realities is with a comprehensive solution, one that includes border security, interior enforcement, a guest worker program and status for the illegal immigrants already here.

Some counsel that Congress should start with tougher enforcement and border security, but wait to create a guest worker program or address the illegal population. Only that way, it is said, can we avoid the mistakes of the failed 1986 immigration reform.

But in fact, the lesson of 1986 is that only a comprehensive solution will fix our broken immigration system.

The 1986 legislation combined amnesty for three million illegal immigrants with a promise of tougher enforcement, particularly in the workplace. But the law did not recognize the need for future immigration to meet the demands of a growing economy, and the new enforcement never materialized. The result? Twenty years later, illegal immigration is unabated. Why? Because while immigrants continue to be drawn to the jobs created by our economy, they have no legal way to enter the country.

What this history teaches is that the only way to control immigration is with a combination package--securing the border, enforcing the law in the workplace and creating legal channels for workers to enter the country.

Our past experience with guest worker programs bears this out. Illegal immigration reached a peak in the mid-'50s, and more than a million people were apprehended trying to cross the border in 1954. Then Congress expanded the Bracero work-visa program, creating a way for 300,000 immigrants to enter the U.S. legally each year.

The result? This new legal flow replaced the old illegal influx, and by 1964, INS apprehensions had dropped to fewer than 100,000. As the Congressional Research Service noted in 1980, "Without question, the Bracero program was . . . instrumental in ending the illegal alien problem of the mid-1940s and 1950s." The Bracero program and the 1986 failure point in the same direction: A comprehensive solution is the only real and lasting way to address immigration.

The American people intuitively understand this, which is why, in poll after poll, they choose a comprehensive approach over one that relies on enforcement alone. A recent NBC/Wall Street Journal poll found that Americans prefer a comprehensive plan to an enforcement-only proposal by 50% to 33%.

Of course, there are things in the Senate bill that need fixing--and conservatives must stand strong in favor of assimilation. New immigrants need to learn English, U.S. history and the values that have made this country great.

But let us remember the counsel of the great conservative standard-bearer, Ronald Reagan, who was in favor of strong borders--he once remarked that "a nation without borders is not really a nation"--but also constantly reminded us that America must remain a "beacon" and a "shining city on a hill" for immigrants who continually renew our great country with their energy and add to the nation's economic growth and prosperity. Reagan was right. We need to do both things--secure the borders and allow for sensible levels of safe, open, lawful immigration.

Americans and immigrants share the same values of work and opportunity. There is no reason to fear the newcomers arriving on our shores today--if anything, they will energize what is best about our country.

The best way--the only way--to realize President Reagan's vision is through comprehensive immigration reform legislation. We urge the House and Senate to work out their differences and meet the demand of the American people that we act on this critical issue in a comprehensive way.

Signed by:

Jack Kemp (former congressman from New York);
George P. Shultz (distinguished fellow, Hoover Institution);
Jeanne Kirkpatrick (former ambassador to the U.N.);
Tamar Jacoby (senior fellow, Manhattan Institute);
Cesar V. Conda (senior fellow, FreedomWorks);
Ken Weinstein (CEO, Hudson Institute);
Grover Norquist (president, Americans for Tax Reform);
Jeff Bell (board of directors, American Conservative Union);
Larry Cirignano (president, Catholic Alliance);
Bill Kristol (editor, The Weekly Standard);
Arthur B. Laffer (chairman, Laffer Investments);
Linda Chavez (chairman, Center for Equal Opportunity);
Elaine Dezenski (former acting assistant secretary for policy development, Department of Homeland Security);
Lawrence Kudlow (economics editor, National Review Online);
John Podhoretz (columnist, the New York Post);
John McWhorter (senior fellow, Manhattan Institute);
Joseph Bottum (editor, First Things);
Max Boot (senior fellow, Council on Foreign Relations);
Vin Weber (former congressman from Minnesota);

Richard Gilder (partner, Gilder Gagnon Howe & Co., LLC);
Ed Goeas (Republican strategist);
Martin Anderson (senior fellow, Hoover Institution);
J.C. Watts (former congressman from Oklahoma);
Ed Gillespie (former chairman, Republican National Committee);
C. Stewart Verdery, Jr. (former assistant secretary for border and transportation security policy, Department of Homeland Security);
Diana Furchtgott-Roth (senior fellow, Hudson Institute);
Robert de Posada (president, the Latino Coalition);
Clint Bolick (winner of 2006 Bradley Prize);
Steven Wagner (former director, human trafficking program, Department of Health and Human Services);
Steve Forbes (CEO, Forbes Inc.);
Gary Rosen (managing editor, Commentary);
Michael Petrucelli (former acting director, U.S. citizenship and immigration services, Department of Homeland Security);
And *John C. Weicher* (senior fellow, Hudson Institute).

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REVIEW & OUTLOOK

Reagan on Immigration

GOP nativists lose one for the Gipper.

Sunday, May 21, 2006 12:01 a.m.

One myth currently popular on the political right is that the immigration debate pits populist conservatives in the Ronald Reagan mold against Big Business "elites" who've hijacked the Republican Party. It's closer to the truth to say that what's really being hijacked here is the Gipper's reputation.

One of the Reagan Presidency's symbolic highlights was the July 3, 1986, celebration of a refurbished Statue of Liberty and Ellis Island, the gateway for immigrants a century ago. (Readers can find Reagan's entire speech that evening here.) To Reagan, the conservative optimist, immigration was a vital part of his vision of this country as "a shining city upon a Hill," in the John Winthrop phrase he quoted so often. It was proof that America remained a land of opportunity, a nation built on the idea of liberty rather than on the "blood and soil" conservatism of Old Europe.

This view was apparent in Reagan's public statements well before he became President. In one of his radio addresses, in November 1977, he wondered about what he called "the illegal alien fuss. Are great numbers of our unemployed really victims of the illegal alien invasion, or are those illegal tourists actually doing work our own people won't do? One thing is certain in this hungry world: No regulation or law should be allowed if it results in crops rotting in the fields for lack of harvesters." As a Californian, Reagan understood the role of immigrant labor in agriculture.

Ronald Reagan

In 1980, according to the book "Reagan: His Life in Letters" (page 511), the then-Presidential candidate wrote to one supporter that "I believe we must resolve the problem at our southern border with full regard to the problems and needs of Mexico. I have suggested legalizing the entry of Mexican labor into this country on much the same basis you proposed, although I have not put it into the sense of restoring the bracero program." The bracero program was a guest-worker program similar to the one now being proposed by President Bush. It was killed in the mid-1960s, largely due to opposition from unions.

During the same campaign, circa December 1979, the Gipper responded to criticism from conservative columnist Holmes Alexander with the following: "Please believe me when I tell you the idea of a North American accord has been mine for many, many years. I have seen presidents, both Democrat and Republican, approach our neighbors with pre-concocted plans in which their only input is to vote 'yes.'

"Some months before I declared, I asked for a meeting and crossed the border to meet with the president of Mexico. I did not go with a plan. I went, as I said in my announcement address, to ask him his ideas--how we could make the border something other than a locale for a nine-foot fence." So much for those conservatives who think the Gipper would have endorsed a 2,000-mile Tom Tancredo-Pat Buchanan wall.

It's true that in November 1986 Reagan signed the Immigration Reform and Control Act, which included more money for border police and employer sanctions. The Gipper was a practical politician who bowed that year to one of the periodic anti-immigration uprisings from the GOP's nativist wing. But even as he signed that bill, he also insisted on a provision for legalizing immigrants already in the U.S.--that is, he supported "amnesty."

In his signing statement, Reagan declared: "We have consistently supported a legalization program which is both generous to the alien and fair to the countless thousands of people throughout the world who seek legally to come to America. The legalization provisions in this act will go far to improve the lives of a class of individuals who now must hide in the shadows, without access to many of the benefits of a free and open society. Very soon many of these men and women will be able to step into the sunlight and, ultimately, if they choose, they may become Americans."

Yes, times change, and it's impossible to know what precisely the Gipper would do at the current moment. But judging from these quotes and so many others across his long career, we feel confident in asserting that Mr. Bush and those who support more open immigration are far closer to Reagan's views than today's restrictionists are.

The current immigration political panic is not unlike many in America's past, including a couple while Reagan was in public life. He always avoided the temptation to join them, no doubt realizing that they were short-sighted politically, and, more important, inconsistent with his vision of America as the last best hope of mankind.

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FLOOR REMARKS OF THE HONORABLE RUBEN HINOJOSA
IN DEFERENCE TO
DR. BEN BERNANKE, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE
AND
RICHARD W. FISHER, CEO AND PRESIDENT OF THE FEDERAL RESERVE BANK OF DALLAS
JUNE 27, 2006

Mr. Speaker,

Recently, I held my Fifth Regional Leaders Issues Conference in the Jefferson Building of the Library of Congress. Over 140 of my constituents attended the conference, including: elected officials, presidents of universities, educators, heads of Chambers of Commerce and other community leaders in the 15th district of Texas. On Tuesday, June 13, 2006, I was honored to have Dr. Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve, give remarks to the conferees. He referenced data from the Survey of Consumers Finances, which is a triennial survey sponsored by the Federal Reserve Board. The latest survey revealed some discouraging and alarming statistics: households whose income placed them in the bottom fifth of the population were less likely than the average respondent to maintain a checking or savings account; almost 25 percent of those families were "unbanked," compared to less than 10 percent of families in the other income levels. According to the survey, reasons given for not having an account varied: some respondents said they would not write enough checks to make having an account worthwhile, but others were dissuaded by minimum balance requirements or said that they did not have enough money to justify opening an account. Chairman Bernanke stated that, in some cases, a lack of knowledge about the services that banks offer including deposit insurance or even a misunderstanding of the important role banks play in our economy.

Chairman Bernanke went on to say that some of the general approaches to helping families of modest means build wealth and improve their economic well-being include community economic development, financial literacy, and other programs that encourage saving and investment. As co-founder and co-chair of the Financial and Economic Literacy Caucus, I was pleased by all the information he provided my constituents, and I am pleased with the efforts the Federal Reserve is undertaking to improve financial literacy rates across the United States. I want to take this opportunity to express my sincere appreciation for Chairman Bernanke taking time out of his very busy schedule to speak to my constituents. It is my hope that the media will focus more attention on what the Chairman and the Financial and Economic Literacy Caucus have to say with regard to financial education and literacy, instead of focusing solely on Chairman Bernanke's comments on the direction of interest rates. I find it odd that the media and some legislators have yet to realize that there is a correlation between the country's poor financial literacy rates and the actions the Federal Reserve has to take from time to time. Mr. Speaker, at this point, I ask unanimous consent to enter into the record the remarks Chairman Bernanke gave before my Fifth Regional Leaders Issues Conference.

I also want to take this opportunity to thank Richard W. Fisher, CEO and President of the Federal Reserve Bank of Dallas, for hosting me recently at the Federal Reserve Bank of Dallas. Richard W. Fisher assumed the office of president and CEO of the Federal Reserve Bank of Dallas on April 4, 2005. President Fisher serves as a member of the Federal Open Market Committee, the Federal Reserve's principal monetary policymaking group. He is former vice chairman of Kissinger McLarty Associates, a strategic advisory firm chaired by former Secretary of State Henry Kissinger. From 1997 to 2001, Fisher was deputy U.S. trade representative with the rank of ambassador. He oversaw the implementation of NAFTA, negotiations for the Free Trade Area of the Americas, and various agreements with Vietnam, Korea, Japan, Chile and Singapore. He was a senior member of the team that negotiated the bilateral accords for China's and Taiwan's accession to the World Trade Organization. Throughout his career, Fisher has served on numerous for-profit and not-for-profit boards. A first-generation American, Fisher is equally fluent in Spanish and English, having spent his formative years in Mexico. He attended the U.S. Naval Academy, graduated with honors from Harvard University in economics, read Latin American politics at Oxford and received an M.B.A. from Stanford University.

During my visit, President Fisher provided me with valuable economic information on the 15th district of Texas as well as insight into the Dallas Bank's efforts to improve financial literacy. I want to commend President Fisher and the Federal Reserve Bank of Dallas for publishing an excellent brochure entitled Building Wealth: A Beginner's Guide *to Securing Your Financial Future*, which is an introduction for individuals and families seeking to develop a plan for building personal wealth. It contains four sections: learn the language, budget to save, save and invest and take control of debt. The publication is available in both English and Spanish and is available in print and as an interactive version on the Dallas Fed's website. The Dallas Fed is an active partner in several asset-building initiatives throughout its district, including the Texas Asset Building Coalition, which promotes personal financial education, affordable homeownership opportunities, Individual Development Accounts/matched-savings programs, the Earned Income Tax Credit, and anti-predatory lending measures.

Again, I want to thank Chairman Bernanke for speaking at my Regional Leaders Issues Conference and President Fisher for hosting me at the Federal Reserve Bank of Dallas.

Mr. Speaker, I yield back the remainder of my time.

The Federal Reserve Board

Remarks by Chairman Ben S. Bernanke

At the Fifth Regional Issues Conference of the Fifteenth Congressional District of Texas, Washington, D.C.
June 13, 2006

Increasing Economic Opportunity: Challenges and Strategies

I am pleased to be here to discuss some strategies for helping families, particularly lower-income families, improve their economic and financial well-being. Families today face a financial marketplace that is increasingly complex, with numerous products and service providers from which to choose. Today I will touch on several approaches for helping people of modest means take advantage of these financial opportunities while managing the risks and avoiding possible pitfalls.

Today's Financial Marketplace

Technological advances have dramatically transformed the provision of financial products and services in recent years. To cite just one example, the expanded use of computerized credit-scoring models, by reducing the costs of making loans and by increasing the range of assets that lenders can sell on the secondary market, has made possible the extension of credit to a larger group of borrowers. Indeed, we have seen an increasingly wide array of products being offered to consumers across a range of incomes, leading to what has been called the democratization of credit. Likewise, technological innovation has enhanced financial services, such as banking services, and increased the variety of financial products available to savers.

The range of providers in consumer financial markets has also increased, with the number of nonbank entities offering credit and other financial services having risen particularly quickly. For example, a recent study of alternative providers of financial services found the number of nonbank check-cashing establishments doubled in the United States between 1996 and 2001.[1] Payday lending outlets, a source of credit that was almost non-existent a decade ago, now number more than 10,000. And data from the Survey of Consumers Finances, a triennial survey sponsored by the Federal Reserve Board, indicate that the share of households with a loan from a finance company increased from 13 percent in 1992 to 25 percent in 2004.

Financial Challenges of Lower-Income Families

Despite the increased complexity of financial products and the wider availability of credit in many forms, U.S. households overall have been managing their personal finances well. On average, debt burdens appear to be at manageable levels, and delinquency rates on consumer loans and home mortgages have been low. Measured relative to disposable income, household net worth is at a fairly high level, although still below the peak reached earlier this

decade.

Families with low to moderate incomes, however, face special financial challenges. These families generally have less of a cushion to absorb unanticipated expenses or to deal with adverse circumstances, such as the loss of employment or a serious health problem. Results from the Survey of Consumer Finances show that the median net worth for households in the lowest income quintile--those whose income placed them in the bottom fifth of the population--was only $7,500 in 2004, well below the median for all survey respondents of $93,000.[2] The Survey data also indicate that households in the lowest quintile were significantly less likely than the average respondent to maintain a checking or savings account; almost 25 percent of those families were "unbanked," compared to less than 10 percent of families in the other income quintiles. The reasons given for not having an account varied: Some respondents said they would not write enough checks to make having an account worthwhile, but others were dissuaded by minimum balance requirements or said that they did not have enough money to justify opening an account. In some cases, a lack of knowledge about the services that banks offer or even a distrust of banks is likely a factor.

The Survey also found that lower-income households are less able than others to manage their debts. A greater fraction of these households had debt-to-income ratios of 40 percent or more or had a payment past due at least sixty days. The data also reveal that only 40 percent of families in the lowest quintile own a home, compared with a homeownership rate of 69 percent among all families surveyed. Finally, the data on retirement account ownership show an even larger gap, with only 10 percent of lowest-quintile families holding a retirement account, whereas 50 percent of all families responding to the survey reported participation in some type of retirement savings plan.

How can these disparities be addressed? Some general approaches to helping families of modest means build assets and improve their economic well-being include community economic development, financial education, and programs that encourage saving and investment. In the remainder of my remarks, I will discuss each of these approaches briefly and offer some insights into their effectiveness based on research and experience.

Community Economic Development

In my time with the Federal Reserve, I have had a number of opportunities to meet with community economic development leaders--representatives of groups working to assist lower-income families become homeowners, start small businesses, better manage their finances, and save for the future. In fact, my first trip as a Federal Reserve Board member was to Brownsville, Texas, where I saw how a grassroots nonprofit organization is helping to build communities and to provide residents with the chance to build wealth through homeownership. The Community Development Corporation (CDC) of Brownsville works with multiple funding partners--governments at all levels, financial institutions, foundations, and corporations--to construct housing and to design innovative loan products that enable low-income families to qualify for mortgage credit. For example, because of the mix of funding sources, mortgage loans can be offered with features such as down-payment assistance or a below-market interest rate. The CDC of Brownsville also offers a program that allows prospective homeowners to acquire "sweat equity" in a property by working on

construction teams to help build their own new home and those of other participating families.

As in the case of many community development organizations, the Brownsville CDC has also made financial education a critical element of its efforts to help lower-income residents improve their financial status. For example, participation in financial counseling or in an education program is typically required for a borrower to obtain a loan through the CDC or through one of its lending partners. However, the broader aim of these programs is to improve borrowers' prospects for longer-term success in maintaining their credit and handling their overall finances. Since 1994, through this combination of leveraged financing arrangements and borrower education, the CDC of Brownsville has helped make homeownership possible for more than 2,500 low-income families. I cite the Brownsville example because of the opportunity that I had to learn about their work (and I recently had a similar opportunity to see some impressive community development efforts in the Anacostia neighborhood of the District of Columbia). But this localized approach to community development and wealth-building is playing out in neighborhoods throughout the country, in most cases through strategies tailored to the distinct needs of the particular community.

Financial Education and Financial Literacy

Financial education has not only been integral to community development but has also begun to play a larger role in the broader consumer market. Clearly, to choose wisely from the wide variety of financial products and providers available, consumers must have at least basic financial knowledge. People who understand the financial aspects of purchasing a home or starting a business, or who appreciate the importance of saving for children's education or retirement, will almost certainly be economically better off than those without that vital information. Financial literacy can be acquired through many channels: in school, on the job, through community programs and counseling, or through self-education and experience.

Studies generally find that people receiving financial education or counseling have better financial outcomes. For example, research that analyzed data on nearly 40,000 mortgage loans targeted to lower-income borrowers found that families that received individual financial counseling were less likely later to become delinquent on their mortgage payments.[3] Similarly, another study found that borrowers who sought and received assistance from a credit counseling agency improved their credit management, in particular, by reducing the number of credit accounts on which they carried positive balances, cutting overall debt, and reducing delinquency rates.[4] More broadly, the research shows that financial knowledge is correlated with good financial outcomes; for example, individuals familiar with basic financial concepts and products have been found to be more likely to balance their checkbook every month, budget for savings, and hold investment accounts.[5]

Studies that establish an association between financial knowledge and good financial outcomes are encouraging, but they do not necessarily prove that financial training and counseling are the *causes* of the better outcomes. It could be, for example, that counseling is associated with better financial outcomes because the consumers who choose to seek counseling are the ones who are already better informed or more motivated to make good

financial decisions. In medicine and other fields, researchers gain a better understanding of what causes what by doing controlled studies, in which some subjects are randomly assigned a particular treatment while others do not receive it. To translate this idea to the analysis of the effects of financial counseling, the Federal Reserve Board's Division of Consumer and Community Affairs is collaborating with the Department of Defense to conduct a three-year study of the effects of financial education. This study will evaluate the impact of various educational programs on the financial decisions of soldiers and their families. It includes a treatment group of those receiving financial education, with the programs each family receives and when they receive it being determined randomly, and a control group of similar soldiers and their families who have not received this formal financial education. Because assignments of individuals to programs will be random, any observed changes in behavior can be more reliably attributed to the type and amount of counseling received. Among other things, the results of this study should help us better understand whether financial education leads to changes in behavior for participants in general or only for those at critical teaching moments, such as the period before making a major financial decision such as choosing a mortgage.

I would like to say just a few words about the Federal Reserve's broader role in promoting consumers' understanding of financial products and services. Beyond conducting surveys of consumers and doing research, we work in a number of ways to support consumers in their financial decisionmaking. For example, through our consumer protection rule-writing authority, the Federal Reserve sets requirements that specify the information that must be disclosed to consumers about the terms and fees associated with credit and deposit accounts. These disclosures provide consumers with the essential information they need to assess the costs and benefits of financial services and compare products among different providers. We are currently reviewing many of our disclosures and plan to use focus groups and other methods to try to make these disclosures as clear and as user-friendly as possible.

The Federal Reserve System also works to promote financial education and financial literacy through various outreach and educational activities. We provide a great deal of substantive financial information, including interactive tools for economic education, on our education website www.federalreserveeducation.org. The website links to a wide variety of financial education resources at the local, regional, and national levels.

Additionally, the Federal Reserved Board collaborates with educational and community development organizations to support their efforts. Our national partners include the Jump$tart Coalition for Personal Financial Literacy, the Conference of Mayors' DollarWi$e Campaign, Operation HOPE, the American Savings Education Council, and America Saves, among others. At the regional level, the twelve Federal Reserve Banks work with organizations to support financial education and financial literacy. For example, the Federal Reserve Bank of Cleveland has worked with community financial educators to form regional networks that combine resources and share best practices. The Federal Reserve Bank of Chicago sponsors "MoneySmart Week," partnering with banks, businesses, government agencies, schools, community organizations, and libraries to host activities designed to help consumers learn how to manage money. The Federal Reserve Banks of San Francisco and Minneapolis have worked with leaders in the Native American community to develop

financial education materials. My recent testimony to Congress on financial literacy provided information on many other projects and programs.[6] The Federal Reserve will continue to make financial education a priority.

Strategies to Encourage Saving

Even if people know that they would be better off if they saved more or budgeted more wisely, we all know from personal experience that translating good intentions into action can be difficult. (Think about how hard it is to keep New Year's resolutions.) The field of behavioral economics, which studies economic and financial decisions from a psychological perspective, has cast new light on consumer behavior and led to recommendations about how to improve people's financial management. For example, studies of individual choices in 401(k) savings plans strongly suggest that workers do not pay adequate attention to their saving and investment decisions. Notably, despite the tax advantages of 401(k) contributions and, in some cases, a generous employer match, one-quarter of workers eligible for 401(k) plans do not participate. Studies have found, however, that if firms change the presentation of the plan from an "opt-in" choice to an "opt-out" choice, in which workers are automatically enrolled unless they actively choose to remain out of the plan, participation rates increase substantially.[7] The impact of changing from "opt-in" to "opt-out" is particularly evident for younger and lower-income workers, who may have less financial expertise.

In addition, participants in savings plans evidently do not understand the various investment options that are offered. A survey by the investment management firm, The Vanguard Group, found that many plan participants cannot assess the risk inherent in different types of financial assets; for example, many did not appreciate that a diversified equity mutual fund is generally less risky than keeping most of one's wealth in the form of the employer's stock.[8] Indeed, employees appear to invest heavily in their company's stock despite the fact that their income is already tied to the fortunes of their employer. More than one-quarter of 401(k) balances are held in company stock, and this high share arises not only from an employer match but from voluntary purchases as well.[9]

These insights into consumer behavior have prompted some changes in the design of retirement plans and in education programs focused on saving for retirement. More employers now feature automatic enrollment in their 401(k) plans in an effort to boost participation. Also, some have set the default investment option to a diversified portfolio that is rebalanced automatically as the worker ages or have set contribution rates to rise automatically over time in line with salary increases.

However, although these changes in program design may boost saving and improve investment choices, they are not a substitute for continued financial education. Employers, including the Federal Reserve Board, offer financial education at the workplace to help their workers gain a better understanding of retirement savings options. Helping people appreciate the importance of saving and giving them the tools they need to translate that knowledge into action remain major challenges.

Conclusion

Let me close by observing that many factors influence consumer financial behavior. Financial education is clearly central to helping consumers make better decisions for themselves and their families, but policymakers, regulators, nonprofit organizations, and financial service providers must all help ensure that consumers have the tools and the information they need to make better decisions. Success can only come through collaborative efforts. I see much interest today in increased collaboration toward these objectives, both in Washington and around the country.

Thank you for the opportunity to speak with you today. I encourage you to continue working together to help provide increased economic opportunity in your communities, and I wish you the best of luck in your efforts.

Footnotes

1. Kenneth Temkin and Noah Sawyer (2004), "Analysis of Alternative Financial Service Providers (781 KB PDF)," report prepared for the Fannie Mae Foundation by the Urban Institute Metropolitan Housing and Communities Policy Center. Return to text

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3. Abdighani Hirad and Peter M. Zorn (2001), "A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling (466 KB PDF)," paper presented at "Seeds of Growth - Sustainable CommunityDevelopment: What Works, What Doesn't and Why?" Return to text

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8. The Vanguard Group (2002), "Expecting Lower Market Returns in the Near Term," *Vanguard Participant Monitor*. Return to text

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2006 Speeches

BOARD OF GOVERNORS
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WASHINGTON, D. C 20551

BEN S BERNANKE
CHAIRMAN

September 5, 2006

The Honorable Spencer Bachus
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the July 20 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to a written question received from Congressman Spencer Bachus in connection with the July 20, 2006, hearing before the Committee on Financial Services:

Q.1. In a recent letter to a Member of this Committee about the proposed regulatory guidance on commercial real estate, the Fed indicated that concentrations of commercial real estate loans deserved special monitoring. Wouldn't this be true of concentrations of any kind of loans? After all, in the same letter the Fed acknowledged that commercial and industrial (C&I) loans had shown that this type of lending resulted in as much or more risk as multifamily CRE lending, for example.

A.1. Concentrations of any type of asset class may raise safety and soundness concerns and the federal banking agencies have long standing supervisory guidance addressing the need for banking institutions to effectively manage concentration risk.

However, the agencies also have a responsibility to be alert to trends that could cause instability in the banking system and respond appropriately. Experience has shown us that it is better to address potential concerns earlier rather than later to avoid bigger problems. Our observations of recent trends in commercial real estate lending are a good example of that. Supervisory monitoring systems have shown that CRE concentrations have risen significantly over the last several years, particularly among small- to medium-sized institutions that are facing an increasingly competitive market.

CRE concentrations are a concern because CRE has historically been a volatile asset class prone to boom and bust cycles. This volatility was most recently evidenced in the late 1980s and early 1990s, when weak CRE loan underwriting and depressed CRE markets contributed to significant bank failures and instability in the banking system. Along with this rise in CRE concentration levels, supervisory reviews have found that portfolio risk management practices have not always kept pace with the growth in institutions' CRE activities. Due to a very strong competitive market, there has also been a slippage in underwriting standards over the last several years evidenced by lengthening maturities, increasing lending policy exceptions, loosening covenants, and narrowing credit spreads.

The agencies recognize that CRE lending is an important business activity for banks and the intent of the guidance is not to discourage institutions from making CRE loans. Rather, the proposed guidance reminds institutions with CRE concentrations of the need to have risk management systems and capital levels commensurate with the level and nature of an institution's concentration risk. The basic message in the proposed guidance is not new; the proposed guidance essentially reinforces and builds upon interagency guidance for CRE lending issued in 1993. The purpose of the proposed guidance is to remind banks that concentrations in CRE lending, or any high asset concentration for that matter, expose

banks to higher credit risk and warrant increased management attention and strong risk management practices.

Q.2. The Basel Accord that was agreed to at the international level is designed to make capital more risk sensitive. The riskier the assets and activities, the more capital required, and conversely, the more conservative the investments, the less required capital. The proposed U.S. regulation implementing the Basel Accord has been criticized by some as not being appropriately risk sensitive and disincenting low risk, safer portfolios and institutions. Do you agree with these concerns? If so, do you envision refinements to the proposed regulation to address these issues?

A.2. Making minimum risk-based regulatory capital requirements more risk sensitive is indeed an important goal of Basel II, a goal to which the Federal Reserve subscribes. At the same time, the Federal Reserve and the other federal banking agencies must ensure that the U.S. bank regulatory capital framework establishes a strong base of capital in the U.S. banking system overall and for each of our largest banking organizations, adequate to maintain a safe and sound financial system.

When the banking agencies were preparing the U.S. Basel II NPR, the results of the Fourth Quantitative Impact Study (QIS4) suggested there was considerable uncertainty about the levels of minimum required and actual capital that would accompany full implementation of Basel II. Given these uncertainties, the agencies agreed that the U.S. implementation should include additional safeguards and conservatism through the transition periods, until the implications of the new framework could be better understood. The agencies also agreed that during the parallel run and transition years they would undertake periodic careful analysis of changes in capital relative to Basel I, and if appropriate, make adjustments before the end of the transition periods. To be sure, the additional safeguards and conservatism likely reduce somewhat the framework's overall risk-sensitivity, at least during the transition years. However, given the attendant uncertainties of the new framework, we believe these decisions were both prudent and necessary.

During the formal NPR comment period, we expect to receive considerable feedback on all aspects of the proposal, including the proposed transitional safeguards. I cannot pre-judge what specific comments may come forward, or what specific actions the agencies might take in response. However, I can assure you that prior to putting out a final rule, we will review and evaluate carefully all comments on the Basel II NPR, including any suggested alternative approaches to dealing with the above uncertainties.

Q.3. The Basel Accord recognizes several methods for determining required capital, including the advanced and standardized approaches. My understanding is that foreign countries permit their institutions to choose among these approaches. In the U.S. regulatory proposal large banks are only permitted to use the advanced approaches. In your testimony, you indicated that large foreign banks will elect the advanced approach. However, the standardized approach would still be an *option* for foreign banks. What is the policy rationale for not allowing U.S. banks the same options as foreign banks?

A.3. While in a technical sense the standardized approach for credit risk is an "option" that could be elected by large foreign banks, in practice it is likely that both their supervisors and financial markets are pushing these institutions to adopt the more advanced credit risk approaches.

This observation is supported by the following table, which is taken from the Basel Committee's report on "Results of the Fifth Quantitative Impact Study." It shows that although the standardized approach is an available option in most G10 countries except the United States, no bank in the Group 1 category (i.e., the largest internationally active banks) indicated that they are likely to adopt that approach. All of the eighty-two banks in the sample said they are most likely to adopt either the foundation or advanced internal ratings-based approaches.[1] Thus, there is a difference between having an "option" and meeting a regulator's and the marketplace's "expectations." These banks have indicated that they likely would elect to be on the more advanced credit risk approaches rather than the standardized approach for a variety of reasons, including those expectations.

The U.S. agencies decided not to propose the standardized option for credit risk because we do not believe it would stimulate the types of ongoing improvements in risk measurement and management practices that we believe are needed at our largest, most complex institutions. Moreover, I am concerned that the Basel II standardized approach for credit risk would not accommodate the risks that the large, complex, internationally active banks take, both on and off their balance sheets. In my judgment, elements of the Basel II standardized approach for credit risk would be more appropriately applied to smaller, less complex, and primarily domestic U.S. banking organizations. That is how it was designed and that is how it appears it will be implemented in other countries.

The U.S. agencies have supported Basel II advanced approaches for our largest banks in order to make their regulatory capital framework much more risk sensitive; better align regulatory and supervisory practices with the way the best run banks measure

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[1] Note that the sample of eighty-two large internationally active banks includes the twenty-six U.S. institutions from the fourth Quantitative Impact Study (QIS-4) conducted in the United States, all of which would have indicated they would adopt the advanced IRB approach since it was the only available approach.

economic capital and manage their risks; improve bank risk measurement and management; improve the ability of supervisors and participants in financial markets to assess bank capital adequacy; and produce a framework that can adapt over time to innovations in banking and financial markets. None of these objectives would be advanced by allowing our largest banks to operate under the standardized approach.

QIS5 Comparison of Approaches

Number of institutions according to the approach they are "most likely" to adopt	Standardized Approach	FIRB approach	AIRB approach	Percentage most likely adopting AIRB
G10 Group 1	0	23	59	72.0%
G10 Group 2	33	102	11	7.5%

Source: Basel Committee on Banking Supervision, "Results of the Fifth Quantitative Impact Study (QIS5)," Table 3. Bank for International Settlements, Basel, Switzerland, 2006.

Notes: FIRB is foundation internal ratings-based approach. AIRB is advanced internal ratings-based approach. G10 Group 1 banks are large, diversified, and internationally active. G10 Group 2 banks are smaller and domestic. Of the fifty-nine G10 Group 1 banks that are most likely to adopt the AIRB approach, twenty-six are U.S. institutions that participated in the QIS-4.

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

September 5, 2006

The Honorable J. Gresham Barrett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the July 20 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congressman Barrett in connection with the July 20, 2006, hearing before the Committee on Financial Services:

Future "bankruptcy" of the U.S.

Q.1. According to recent research by Professor Laurence Kotlikoff for the Federal Reserve Bank of St. Louis, "the U.S. government is, indeed, bankrupt, insofar as it will be unable to pay its creditors, who, in this context, are current and future generations to whom it has explicitly or implicitly promised future net payments of various kinds."

a. Is it reasonable, in your opinion, for the Congress to reduce mandatory spending each year to get our books in order for future generations?

A.1.a. Reducing the federal budget deficit is very important, especially in light of the need to prepare for the retirement of the baby-boom generation, and I urge the Congress to proceed on that effort in a timely manner. As your question suggests, one of the major issues that will have to be addressed is the rapid growth in the major entitlement programs. That growth is projected to occur as the U.S. population ages and as spending on health care continues to climb. Substantial reform of the entitlement programs doubtless will be an important part of any serious plan to reduce the deficit over the longer haul. However, I believe that in my role as Chairman of the Federal Reserve, I should not make specific proposals to the Congress regarding fiscal policy. Those decisions are best made by elected officials.

b. Should Social Security reform be a top priority for the next Congress?

A.1.b. Social Security should certainly be considered by the Congress in coming years as part of an evaluation of mandatory spending. However, as my response to the previous question suggests, it would not be appropriate for me to comment on either specific proposals or a timetable for reform.

Future monetary decisions

Q.1. In your opening statements, you stated monetary policy makers "have imperfect knowledge about the effects of our own policy actions as well as of the many other factors that will shape economic developments during the forecast period."

a. What have you learned from previous policy actions that may be influencing future monetary decisions from the Reserve?

A.1.a. Experience with policy suggests that the full effects of policy actions on the economy take some time to unfold. The fact that monetary policy operates with a lag implies that policymakers must base their actions on the longer-term economic outlook, taking into account the possible future effects of earlier policy actions. Unfortunately, history also shows that economic forecasting is far from a precise science, in part because there will always be unanticipated developments that affect the course of the economy. Consequently, policymakers must consider not only the economic outlook but also the risks to the outlook.

As you may be aware, at its meeting on August 8, 2006, the Federal Open Market Committee decided to leave the stance of monetary policy unchanged after increasing the target federal funds rate by 25 basis points at each of seventeen consecutive meetings. In reaching that decision, the Committee noted that inflation pressures seem likely to moderate over time, reflecting the cumulative effects of previous monetary policy actions among other factors. However, the Committee also judged that "some inflation risks remain" and stated that any additional firming that may be needed to address those risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Personal savings by Americans

Q.2. In 2005 Americans had a negative savings rate of 0.5 percent. The last year Americans had a negative savings rate was 1932, during some of the worst years of economic activity in our nation's history.

a. What are your thoughts on the effect rising inflation has on people's savings, both immediate and long term?

A.2.a. Economists believe that household saving decisions depend, in the long run, on key fundamentals, including the age of household members, levels of real income and wealth, and the return that households can get on their savings. Over a shorter time horizon, the evidence suggests that households are somewhat slow to adjust their spending in response to changes in real income. As a result, under certain circumstances higher price inflation can lead to a lower saving rate in the short run. For example, last year's run-up in oil prices crimped consumers' purchasing power and appears to have lowered the saving rate as many households adjusted their purchases by less than the slowdown in real incomes at least for a time. Eventually, as households more fully adjust their spending patterns, the saving rate is likely to return to the level implied by longer-run fundamentals.

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BEN S. BERNANKE
CHAIRMAN

August 18, 2006

The Honorable Ginny Brown-Waite
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am pleased to enclose my responses to your additional questions following the July 20 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congresswoman Ginny Brown-Waite in connection with the July 20, 2006, hearing before the Committee on Financial Services:

Q.1. You mention in your statement that homeowners are no longer experiencing the increases in home equity they have been used to over the past decade. This is troubling to me because the Fed has previously commented that Americans have one of the lowest savings rates in the world. Many have basically been living off the equity in their home. As the baby boomers begin to retire in the coming years, what kind of effect will this loss of home equity and lack of savings have on your economy?

A.1. Indeed, the Commerce Department reported recently that the personal saving rate declined in the second quarter to -1.5 percent, a level that is well below the readings of a few years ago and a source of concern to many analysts.

I would mention first that smaller increases in home equity are likely, all else equal, to push up the personal saving rate a little during the next few years. When households experience capital gains in their houses, equities, or other assets, they naturally feel somewhat less need to save out of their current income--which is the definition of saving used to calculate the saving rate in the national income accounts. Therefore, the rapid pace of house price appreciation in recent years likely contributed to the decline in the saving rate. Similarly, the cooling of the housing market and associated reduction in capital gains on housing will probably provide some upward impetus to the saving rate. Even so, as I said in my testimony, rising disposable incomes should enable household spending to expand at a moderate pace and provide continued support for the overall economic expansion.

Over the longer term, as you note, a low level of saving may mean that our families and our nation are not preparing adequately for the aging of the population. For individual families, saving too little means that future retirees may need to cut back their consumption significantly or become a heavy burden on their children. For the nation as a whole, the relevant measure of saving is broad and includes personal saving, saving by businesses, and saving or dis-saving by the federal government and by state and local governments. The logic is similar, though: Saving too little now means that we may be unable to sustain ongoing improvements in the standard of living for our retirees as well as our working-age population and children. Of course, judging the optimal level of saving for a family or a country is quite difficult. However, I think it is appropriate for policymakers to consider ways to raise government saving and to encourage additional private saving.

Q.2. You mentioned in your testimony that inflation was higher than what you had predicted, and you name rising energy costs as the main culprit. Rising energy costs contribute to the overall increase in the price of goods derived from petroleum-based

products. You also note that labor costs are by far the largest component of business costs, which are rising more quickly than expected because of the strong labor market, thus also increasing the price of goods. My question then is as gas prices historically increase during the summer months, what kind of effect would a congressionally mandated increase in minimum wage have on inflation?

A.2. As I noted at a Congressional hearing in February, the effects of raising the minimum wage are controversial among economists. Clearly, increases in the minimum wage will raise the incomes of people who retain their jobs. However, economists disagree about whether increases in the minimum wage are well-targeted toward lower-income people and whether increases in the minimum wage reduce employment of low-wage workers. These debates have focused on the impact of changes in the minimum wage on the individuals directly affected by those changes.

Your specific inquiry turns to the effect of changes in the minimum wage on the aggregate economy, and specifically on aggregate inflation--especially in the context of rising energy prices and rising labor costs in a strong labor market. Of course, the Federal Reserve is alert to the inflationary forces that you describe. As the FOMC noted in its statement on August 8, "high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures." Indeed, an increase in the minimum wage would push up labor costs in companies and industries employing the affected workers. However, the Bureau of Labor Statistics reports that fewer than two percent of wage and salary workers were paid at or below the federal minimum wage last year. Thus, a modest increase in the minimum wage would likely have only a small effect on labor costs for the economy as a whole and therefore a small effect on overall inflation.

Q.3. In Florida, we are facing a property and homeowners' insurance crisis, as I am sure you are aware. I continue to hear anecdotal evidence that potential buyers are walking away from the negotiating table when they get their insurance assessment. And other coastal states such as Mississippi and Louisiana are facing availability issues as well. At what point does this insurance crisis begin to affect the housing market nationally?

A.3. As you know, insured property catastrophe losses for the nation as a whole reached a new record in 2004 and again in 2005, and insured losses in Florida were extremely high in both years. Given those losses, it is not surprising that insurers are raising rates and, in some cases, managing their exposure to natural catastrophe risk by limiting their renewal of existing policies and issuance of new policies in certain locations. Unfortunately, these responses are reducing the availability of private insurance and driving up insurance costs for homeowners in the affected places. These problems in turn are putting tremendous pressure on companies created to serve the needs of homeowners in high-risk areas, such as the Citizens Property Insurance Corporation in Florida.

The rising cost of insuring property in Florida and other coastal states undoubtedly has damped the demand for housing in those locations. Some people who live in those areas may choose smaller houses in order to reduce their insurance costs, and other people may end up living in different locations. However, the effect of these factors on the national housing market is probably limited, because most people in the country live in places that experience less hurricane damage and because the people who are deterred from living in coastal areas likely augment housing demand in other parts of the country. Accordingly, the cooling of the national housing market now underway owes primarily to forces apart from insurance. In particular, as I mentioned in my testimony, increases in mortgage rates and the sustained run-up in housing prices have reduced housing affordability and thus the demand for new homes.

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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

September 25, 2006

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congressman:

In response to your recent request, the enclosed tables present data on total employee compensation and the relative size of its components for the past five years. All data are from the Bureau of Labor Statistics' "Employer Costs for Employee Compensation" release, which is based on the same survey underlying the employment cost index but which provides additional detail on the components of compensation. The top panel in the first table presents the data in average dollars per hour, while the bottom panel shows the percentage of compensation accounted for by each of the major components. The second table shows the percent change in each component over the twelve months ending in March of each year. As was noted on page 18 of the latest semi-annual Monetary Policy Report to the Congress, increases in employer costs for health insurance and retirement plans slowed during the March 2005 to March 2006 period.

Sincerely,

Enclosures

Employer Costs for Employee Compensation
(Private industry workers)

	March						
	2000	2001	2002	2003	2004	2005	2006
Cost levels (dollars per hour)							
Total Compensation	19.85	20.81	21.71	22.37	23.29	24.17	25.09
Wages and Salaries	14.49	15.18	15.80	16.15	16.64	17.15	17.73
Total Benefits	5.36	5.63	5.90	6.22	6.65	7.02	7.36
Paid Leave	1.28	1.37	1.44	1.47	1.50	1.54	1.71
Supplemental Pay	.60	.61	.62	.64	.66	.68	.73
Health Insurance	1.09	1.16	1.29	1.41	1.53	1.64	1.72
Life Insurance	.04	.05	.04	.04	.04	.04	.04
Short and Long-term Disability Insurance	.07	.07	.07	.07	.08	.08	.09
Retirement and Savings Plans	.59	.62	.63	.67	.80	.90	.91
Social Security and Medicare	1.20	1.26	1.32	1.35	1.39	1.43	1.49
Other Legally Required Benefits	.47	.47	.48	.54	.62	.67	.66
Shares of total compensation (percent)							
Total Compensation	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Wages and Salaries	73.0	72.9	72.8	72.2	71.4	71.0	70.7
Total Benefits	27.0	27.1	27.2	27.8	28.6	29.0	29.3
Paid Leave	6.4	6.6	6.6	6.6	6.4	6.4	6.8
Supplemental Pay	3.0	2.9	2.9	2.9	2.8	2.8	2.9
Health Insurance	5.5	5.6	5.9	6.3	6.6	6.8	6.9
Life Insurance	.2	.2	.2	.2	.2	.2	.2
Short and Long-term Disability Insurance	.4	.3	.3	.3	.3	.3	.4
Retirement and Savings Plans	3.0	3.0	2.9	3.0	3.4	3.7	3.6
Social Security and Medicare	6.0	6.1	6.1	6.0	6.0	5.9	5.9
Other Legally Required Benefits	2.4	2.3	2.2	2.4	2.7	2.8	2.6

Employer Costs for Employee Compensation
(Private industry workers)

	March						
	2000	2001	2002	2003	2004	2005	2006
Percent change from previous year							
Total Compensation	4.5	4.8	4.3	3.0	4.1	3.8	3.8
Wages and Salaries	4.5	4.8	4.1	2.2	3.0	3.1	3.4
Total Benefits	4.5	5.0	4.8	5.4	6.9	5.6	4.8
Paid Leave	6.7	7.0	5.1	2.1	2.0	2.7	11.0
Supplemental Pay	9.1	1.7	1.6	3.2	3.1	3.0	7.4
Health Insurance	5.8	6.4	11.2	9.3	8.5	7.2	4.9
Life Insurance	.0	25.0	-20.0	.0	.0	.0	.0
Short and Long-term Disability Insurance	16.7	.0	.0	.0	14.3	.0	12.5
Retirement and Savings Plans	3.5	5.1	1.6	6.3	19.4	12.5	1.1
Social Security and Medicare	3.4	5.0	4.8	2.3	3.0	2.9	4.2
Other Legally Required Benefits	-4.1	.0	2.1	12.5	14.8	8.1	-1.5

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

BEN S. BERNANKE
CHAIRMAN

August 16, 2006

The Honorable Rubén Hinojosa
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the July 20 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congressman Rubén Hinojosa in connection with the July 20, 2006, hearing before the Committee on Financial Services:

Q.1. Chairman Bernanke, in terms of oil prices, you and I discussed the important and ever-increasing role China is playing in the demand for, and the price of, oil when you last appeared before this Committee.

In light of the fact that China's next Five Year Plan calls for them to build an additional 5,000 to 8,000 skyscrapers, what impact will this plan, if realized, have on the overall global marketplace and particularly on the price of oil, steel, concrete and other raw materials as well as competition between China and the United States for said materials?

A.1. China's demand for many raw materials such as oil, as well as more processed materials such as steel and cement, has been rising rapidly in recent years. During the 2003-2005 period, for example, China accounted for about one-quarter of the growth in world oil consumption and large fractions of the growth in global demand for many other raw materials as well. Along with increasing demand from other economies, including the United States, China's growing appetite for such products has helped to push up the prices of many primary commodities and intermediate materials. With many of these commodities, the supply is relatively fixed in the near term. Thus, there is often a period when prices stay high before new supply comes on line. Anecdotal evidence suggests suppliers have begun to respond to the higher prices (and the greater profits they reap from them) by, for example, opening new mines and building new factories in order to bring greater supply to the market. Quotes from futures markets indicate that market participants expect prices of oil and many other primary commodities to remain elevated for the next several years. However, futures markets are not calling for further run-ups in commodity prices such as occurred in the past several years.

It should also be kept in mind that in addition to adding to global demand, China is a significant producer of many materials. China's production and production capacity in some products, such as steel and cement, have grown enormously in recent years. In fact, at various points over the past several years, China has been a net exporter of steel, indicating that they produce quantities of some steel products in excess of domestic consumption. Therefore, whereas Chinese demand likely has boosted prices of some primary commodities, its effect on prices of other materials may be more ambiguous.

Q.2. Mr. Chairman, I imagine that you or your staff are closely following the rapid evolution of China's financial markets, and likely that of its neighbors and similar

markets that are growing as quickly as China's, likely with a population above one billion people.

If this is the case, are you or your staff or anyone in the Federal Reserve System aware of, and, if so, do you follow, financial transactions and possibly market collaboration between China and India?

If such transactions occur, do you, your staff or anyone in the Federal Reserve System know the approximate dollar amount of those financial transactions?

A.2. Federal Reserve Board staff follows financial market developments in many economies, both for the sake of analyzing global economic developments and to monitor potential sources of financial market instability. As the economies of China and India modernize and develop, they are increasingly engaging in a multiplicity of financial interactions with other economies, including each other. These financial interactions can derive from trade in goods and services, from trading in a wide array of financial claims and securities (including, but not limited to, foreign exchange, equities, and bonds), from direct investment and portfolio investment flows, and from direct interactions between financial institutions, such as the making and taking of deposits. While the Federal Reserve's staff generally does not monitor financial interactions between foreign countries on a bilateral basis, it would do so should those interactions come to have systematic effects on the global and the U.S. financial system.

Trade flows between China and India have grown over the past few years, but in 2005 only about 1 percent of total Chinese merchandise imports and exports were with India, and only about 8 percent of total Indian merchandise imports and exports were with China. Data on financial flows between developing countries such as these two are very incomplete. One category for which data are available is direct investment flows. However, recent data indicate that direct investment flows between China and India remain very small indeed. In 2004 and 2005, less than 1 percent of all direct investment flows into China originated in India, and a similarly small fraction of direct investment flows into India originated in China.

Q.3. Chairman Bernanke, does China have a trade deficit with any nation in the world? If so, which one(s), how large is it/are they, and is that offset by its trade surplus with the United States? If not, what is China's overall trade deficit or surplus?

A.3. Last year China reported an overall trade surplus of $102 billion. China also reported a trade surplus with the United States in 2005 of $114 billion, implying that China ran a deficit of a little over $10 billion with the rest of the world.

In 2005, China reported large trade deficits with the following economies: Taiwan ($58 billion), Korea ($42 billion), Japan ($16 billion), Malaysia ($9 billion), Saudi Arabia ($8 billion), Philippines ($8 billion), Thailand ($6 billion), Australia ($5 billion), Russia ($3 billion), Switzerland ($2 billion), India ($1 billion). Notice that most of these countries export large quantities of either electronic components or raw materials to China.

It should be borne in mind that, for various reasons, trading partners often report different bilateral trade balances with each other. Such discrepancies are especially large for trade between China and its trading partners, because much of this trade is transshipped through Hong Kong. Accordingly, a good deal of bilateral trade between China and its trading partners is often misreported as trade with Hong Kong. Thus, China's trade surplus with the United States is reported as $202 billion in the data reported by the United States, considerably larger than the surplus reported by China noted above.

Q.4. Last year, 24 of the largest 25 initial public stock offerings were done offshore; only one was in the U.S. Do we have a competitiveness problem in our capital markets, and if so, what should be done about it and what is the marketplace doing to address it on its own? Do you approve of the markets' actions taken to address the competitiveness problem if you deem it to exist?

A.4. Broadly speaking, U.S. capital markets are the largest and most liquid in the world, with roughly $19 trillion of public equities, $5 trillion of corporate bonds, and $2 trillion of commercial paper. With respect to the IPO market, some of the largest IPOs last year were by foreign-owned companies, including privatizations of foreign state-owned enterprises, and so would not have been expected to take place in the United States. Nevertheless, the number of IPOs each year in the United States since 2000 has been well below the pace in the mid-to-late 1990s. The number of IPOs typically is greater when equity prices rise relative to earnings--as was the case with many firms in the mid-to-late 1990s--and fewer when equity prices fall relative to earnings--as has been the case over the past several years. Even so, about 90 IPOs were completed in the United States in the first half of this year, and they raised nearly $25 billion in proceeds.

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

BEN S. BERNANKE
CHAIRMAN

August 15, 2006

The Honorable Deborah Pryce
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am pleased to enclose my responses to your additional questions following the July 20 hearing before the Committee on Financial Services. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congresswoman Deborah Pryce in connection with the July 20, 2006, hearing before the Committee on Financial Services:

Q.1. Mr. Chairman, clear and transparent information is an essential aspect of a market based society. As you are aware, the Fed ceased publishing the M3 Money Supply statistics earlier this spring. While I understand that the decision to drop M3 statistics was largely as a result of the diminished relationship of M3 and economic activity, many people expected the Fed to redefine the aggregate and provide an alternative. Without an alternative, it is my fear that the fiat currency is poised to increase without transparency. What are the Fed's plans regarding reporting in this area?

A.1. As the nation's central bank, the Federal Reserve recognizes the importance of carefully monitoring as well as releasing to the public data on useful concepts of the money supply. Although the Board has discontinued publishing the M3 monetary aggregate, it will continue to publish timely data on the monetary aggregate M2. Of the various monetary and debt aggregates, in our view M2 has exhibited the most stable, explicable, and useful relationship with measures of nominal spending and interest rates. In addition, the Board will continue to publish the monetary aggregate M1, which is a component of M2, as well as the other components of M2.

There are a number of statistical sources for monitoring the issuance of currency by the Federal Reserve as well as our monetary policy activities more broadly. Each week, as required by the Federal Reserve Act, the Board publishes Federal Reserve notes outstanding on its H.4.1 statistical release entitled "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks." In addition, this release also provides data on currency in circulation, which is comprised principally of Federal Reserve notes and Treasury coin. This measure of currency in circulation measures currency held outside the Federal Reserve Banks and U.S. Treasury. The release also includes information on the factors that affect bank reserves. (The Federal Reserve implements monetary policy by affecting the availability and cost of bank reserves.) The Board also publishes the amount of currency in circulation that is held by the public (excluding the banking sector) on its H.6 statistical release entitled "Money Stock Measures." This measure of currency in circulation, sometimes called money stock currency, is a component of both M1 and M2. Both the H.4.1 and H.6 statistical releases are published each Thursday at 4:30 p.m.

Q.2. On a related topic, I have come to understand that the CFTC is preparing to end the publication of the Commitment of Traders Reports in futures markets across the board, leaving market participants blind. What is your position regarding the publication of COT data?

A.2. The CFTC is doing a broad review of its Commitments of Traders reports. As part of that review, the Commission has asked about restructuring various categories in the report in addition to inquiring whether the information is useful to market participants and whether the reports should continue to be published. This request for comment has generated hundreds of responses posted on the Commission's web site. Whenever a government agency collects data, the process generates benefits for the uses of the data, but those benefits must be weighted against the costs imposed on market participants in the collection process. The Commission is best placed to weigh these benefits and costs.

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

August 16, 2006

BEN S BERNANKE
CHAIRMAN

The Honorable Barbara Lee
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Thank you for your letter of July 12 regarding home ownership among minority populations. I share your conviction that increasing home ownership among all Americans, and particularly among minorities, is an important national goal. While substantial progress toward that end has been achieved in recent years, home-ownership rates for both blacks and Hispanics still remain below those of whites. We as a nation should continue to strive to improve minority home-ownership rates.

You point out that the Community Reinvestment Act (CRA) does not focus on lending to minorities, and you ask whether it should. The statute does not focus on race or ethnicity, but requires the federal banking agencies to evaluate institutions' records of helping to meet the credit needs of their entire communities, including low- and moderate-income areas. Amending the statute to change or expand its focus to lending to minorities would change or expand the purposes and objectives of the statute, raising policy questions that I believe are best left to the Congress to address.

Also on the topic of CRA, during the July 20 hearing on monetary policy, you asked me about the effect of fair lending violations on a bank's CRA rating. The CRA regulations provide that evidence of discriminatory practices by a bank or, in certain circumstances, by the bank's affiliate, adversely affects the examiners' evaluation of the bank's CRA performance. Examiners may reduce the bank's CRA rating, depending on such factors as the nature, extent, and strength of the evidence of a violation.

Your letter also asks whether the benefits of increasing available data about home loans to minorities would outweigh the costs of collecting, reporting, and disclosing additional data. As you are aware, pursuant to the Home Mortgage Disclosure Act (HMDA), the Federal Reserve Board's Regulation C requires lenders to report the race and ethnicity of each applicant. Regulation C also requires that lenders report substantial additional information about loan applications and originations, including--pursuant to a rule the Board adopted on its own initiative--price information about certain higher-priced loans. You express concern about the racial and ethnic disparities in the incidence of higher-priced mortgage lending that these new data illustrate, and an interest in making available more data that might help explain the causes of these disparities.

I agree that it is critical that we seek to better understand the pricing disparities in mortgage lending, and that, in general, expanding available information about mortgage lending has the potential to improve our understanding. I also believe, however, that proposals to expand data reporting requirements under HMDA warrant a careful, and realistic, weighing of all of the relevant costs and benefits. That is the approach the Board has taken when it has considered revising Regulation C. This approach led the Board to determine that the benefits of reporting data on higher-priced loans outweighed the costs.

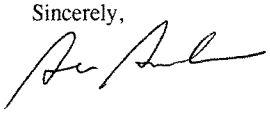
While the benefits of HMDA data cannot always easily be quantified, they are nonetheless apparent. Evident benefits from the data include: helping to improve the public's ability to evaluate lending patterns, spurring lenders to focus attention on fair lending compliance and community outreach--including outreach to minority populations--and enhancing the ability of supervisory and enforcement agencies to use their resources efficiently. A realistic evaluation of the data's benefits, however, recognizes practical limitations on data utility. The practices and products of lenders are so varied that it is unlikely that enough data could be collected through HMDA to permit definitive conclusions by the public or the agencies about the causes of racial or ethnic disparities in the lending of particular institutions, or of institutions in the aggregate. Thus, while expanding available HMDA data could augment the data's benefits, practical limitations of the data should also be considered.

On the cost side, as you point out, the costs of expanding data collection include compliance costs that fall directly on lenders as well as on other persons in the supply chain for mortgage funds. Some part of that cost is passed on to consumers, and that cost dimension should also be considered. As the HMDA data are public data about specific transactions by individual consumers, any potential effect on consumer privacy of expanding available data also warrants consideration.

This is only the second year in which price data on higher-priced mortgage loans will be publicly available under the Board's Regulation C. The Board continues to monitor the effects of the regulation in an effort to understand both its benefits and its costs.

I appreciate the opportunity to discuss these important issues with you.

Sincerely,



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

BEN S. BERNANKE
CHAIRMAN

July 28, 2006

The Honorable Maxine Waters
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am writing in response to your inquiry at the monetary policy hearing regarding opportunities for minorities in high-level positions at the Federal Reserve System.

As shown in the enclosure, the Board of Governors and the Federal Reserve Banks have become more diverse since the early 1990s. The number of minority officers at the Board increased from 11 officers (10.6 percent of officers) in 1992 to 18 officers (13.5 percent) at the end of 2005. Those figures include two African American female division directors and one Hispanic male division director. Over the same time period, the number of minority officers at the Reserve Banks increased from 69 officers (8.0 percent) in 1992 to 137 officers (13.6 percent) at the end of 2005.

Increasing employment opportunities for women is also important in promoting a diverse workforce, and here too, progress has been made. The number of female officers at the Board increased from 21 officers (20.2 percent) in 1992 to 49 officers (36.8 percent) at the end of 2005. At the Reserve Banks, the number of female officers increased from 185 officers (21.4 percent) in 1992 to 356 officers (35.3 percent) at the end of 2005.

Equality of opportunity in attracting, developing, promoting, and retaining the most qualified workforce is an important strategic objective for the Federal Reserve System and we have a number of activities and policies designed to promote and support this objective. These include: (1) an annual Equal Employment Opportunity (EEO) review of the Board and each Reserve Bank; (2) processes to address EEO complaints; (3) development of annual outreach plans and activities designed to inform minorities about employment opportunities with the Federal Reserve and to build a diverse pool of candidates for positions; and (4) mandatory EEO and diversity training for all employees. The Board's EEO Programs Director serves as a resource to Board officers and employees by providing direction and guidance, and monitoring of policies, practices and key

activities in pursuit of a diverse workplace without barriers to equal opportunity. The Board's EEO Programs Director also provides similar oversight and direction to the EEO programs and activities of the Reserve Banks.

In closing, I want to reaffirm the Federal Reserve's commitment to the principles of equal employment opportunity and non-discrimination. Achieving and promoting workplace diversity, and developing the leaders needed to support the System's missions, are of fundamental importance and will have my strong support in the years ahead.

Sincerely,

Enclosure

Federal Reserve System Officers as of December 31, 1992 and 2005

Location and Date	Total	Women		Minorities	
		Number	Percent	Number	Percent
Board					
1992	104	21	20.2	11	10.6
2005	133	49	36.8	18	13.5
Banks					
1992	866	185	21.4	69	8.0
2005	1,008	356	35.3	137	13.6
Total					
1992	970	206	21.2	80	8.2
2005	1,141	405	35.5	155	13.6

[Note: Board data does not include Members of the Board of Governors.]

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

BEN S. BERNANKE
CHAIRMAN

July 24, 2006

The Honorable Maxine Waters
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

During my recent appearance at the House Financial Services Committee, I mentioned in response to a question you asked that I have given speeches on community development and financial asset building by low- and moderate-income families. Enclosed are three recent speeches I have given on these matters. I hope you will find them of interest.

I look forward to our breakfast on July 31, and to the opportunity to work on these matters, and other matters of mutual concern, in the years ahead.

Sincerely,

Enclosures

cc: Nathaniel Thomas, Senior Policy Advisor
Office of The Honorable Maxine Waters

For release on delivery
11:00 a.m. EDT
June 13, 2006

Increasing Economic Opportunity: Challenges and Strategies

Remarks

By

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Fifteenth Congressional District of Texas'

Fifth Regional Issues Conference

Washington, D.C.

June 13, 2006

I am pleased to be here to discuss some strategies for helping families, particularly lower-income families, improve their economic and financial well-being. Families today face a financial marketplace that is increasingly complex, with numerous products and service providers from which to choose. Today I will touch on several approaches for helping people of modest means take advantage of these financial opportunities while managing the risks and avoiding possible pitfalls.

Today's Financial Marketplace

Technological advances have dramatically transformed the provision of financial products and services in recent years. To cite just one example, the expanded use of computerized credit-scoring models, by reducing the costs of making loans and by increasing the range of assets that lenders can sell on the secondary market, has made possible the extension of credit to a larger group of borrowers. Indeed, we have seen an increasingly wide array of products being offered to consumers across a range of incomes, leading to what has been called the democratization of credit. Likewise, technological innovation has enhanced financial services, such as banking services, and increased the variety of financial products available to savers.

The range of providers in consumer financial markets has also increased, with the number of nonbank entities offering credit and other financial services having risen particularly quickly. For example, a recent study of alternative providers of financial services found the number of nonbank check-cashing establishments doubled in the United States between 1996 and 2001.[1] Payday lending outlets, a source of credit that was almost non-existent a decade ago, now number more than 10,000. And data from the Survey of Consumers Finances, a triennial survey sponsored by the Federal Reserve

Board, indicate that the share of households with a loan from a finance company increased from 13 percent in 1992 to 25 percent in 2004.

Financial Challenges of Lower-Income Families

Despite the increased complexity of financial products and the wider availability of credit in many forms, U.S. households overall have been managing their personal finances well. On average, debt burdens appear to be at manageable levels, and delinquency rates on consumer loans and home mortgages have been low. Measured relative to disposable income, household net worth is at a fairly high level, although still below the peak reached earlier this decade.

Families with low to moderate incomes, however, face special financial challenges. These families generally have less of a cushion to absorb unanticipated expenses or to deal with adverse circumstances, such as the loss of employment or a serious health problem. Results from the Survey of Consumer Finances show that the median net worth for households in the lowest income quintile--those whose income placed them in the bottom fifth of the population--was only $7,500 in 2004, well below the median for all survey respondents of $93,000.[2] The Survey data also indicate that households in the lowest quintile were significantly less likely than the average respondent to maintain a checking or savings account; almost 25 percent of those families were "unbanked," compared to less than 10 percent of families in the other income quintiles. The reasons given for not having an account varied: Some respondents said they would not write enough checks to make having an account worthwhile, but others were dissuaded by minimum balance requirements or said that they did not have enough

money to justify opening an account. In some cases, a lack of knowledge about the services that banks offer or even a distrust of banks is likely a factor.

The Survey also found that lower-income households are less able than others to manage their debts. A greater fraction of these households had debt-to-income ratios of 40 percent or more or had a payment past due at least sixty days. The data also reveal that only 40 percent of families in the lowest quintile own a home, compared with a homeownership rate of 69 percent among all families surveyed. Finally, the data on retirement account ownership show an even larger gap, with only 10 percent of lowest-quintile families holding a retirement account, whereas 50 percent of all families responding to the survey reported participation in some type of retirement savings plan.

How can these disparities be addressed? Some general approaches to helping families of modest means build assets and improve their economic well-being include community economic development, financial education, and programs that encourage saving and investment. In the remainder of my remarks, I will discuss each of these approaches briefly and offer some insights into their effectiveness based on research and experience.

Community Economic Development

In my time with the Federal Reserve, I have had a number of opportunities to meet with community economic development leaders--representatives of groups working to assist lower-income families become homeowners, start small businesses, better manage their finances, and save for the future. In fact, my first trip as a Federal Reserve Board member was to Brownsville, Texas, where I saw how a grassroots nonprofit organization is helping to build communities and to provide residents with the chance to

build wealth through homeownership. The Community Development Corporation (CDC) of Brownsville works with multiple funding partners--governments at all levels, financial institutions, foundations, and corporations--to construct housing and to design innovative loan products that enable low-income families to qualify for mortgage credit. For example, because of the mix of funding sources, mortgage loans can be offered with features such as down-payment assistance or a below-market interest rate. The CDC of Brownsville also offers a program that allows prospective homeowners to acquire "sweat equity" in a property by working on construction teams to help build their own new home and those of other participating families.

As in the case of many community development organizations, the Brownsville CDC has also made financial education a critical element of its efforts to help lower-income residents improve their financial status. For example, participation in financial counseling or in an education program is typically required for a borrower to obtain a loan through the CDC or through one of its lending partners. However, the broader aim of these programs is to improve borrowers' prospects for longer-term success in maintaining their credit and handling their overall finances. Since 1994, through this combination of leveraged financing arrangements and borrower education, the CDC of Brownsville has helped make homeownership possible for more than 2,500 low-income families. I cite the Brownsville example because of the opportunity that I had to learn about their work (and I recently had a similar opportunity to see some impressive community development efforts in the Anacostia neighborhood of the District of Columbia). But this localized approach to community development and wealth-building

is playing out in neighborhoods throughout the country, in most cases through strategies tailored to the distinct needs of the particular community.

Financial Education and Financial Literacy

Financial education has not only been integral to community development but has also begun to play a larger role in the broader consumer market. Clearly, to choose wisely from the wide variety of financial products and providers available, consumers must have at least basic financial knowledge. People who understand the financial aspects of purchasing a home or starting a business, or who appreciate the importance of saving for children's education or retirement, will almost certainly be economically better off than those without that vital information. Financial literacy can be acquired through many channels: in school, on the job, through community programs and counseling, or through self-education and experience.

Studies generally find that people receiving financial education or counseling have better financial outcomes. For example, research that analyzed data on nearly 40,000 mortgage loans targeted to lower-income borrowers found that families that received individual financial counseling were less likely later to become delinquent on their mortgage payments.[3] Similarly, another study found that borrowers who sought and received assistance from a credit counseling agency improved their credit management, in particular, by reducing the number of credit accounts on which they carried positive balances, cutting overall debt, and reducing delinquency rates.[4] More broadly, the research shows that financial knowledge is correlated with good financial outcomes; for example, individuals familiar with basic financial concepts and products have been found

to be more likely to balance their checkbook every month, budget for savings, and hold investment accounts.[5]

Studies that establish an association between financial knowledge and good financial outcomes are encouraging, but they do not necessarily prove that financial training and counseling are the *causes* of the better outcomes. It could be, for example, that counseling is associated with better financial outcomes because the consumers who choose to seek counseling are the ones who are already better informed or more motivated to make good financial decisions. In medicine and other fields, researchers gain a better understanding of what causes what by doing controlled studies, in which some subjects are randomly assigned a particular treatment while others do not receive it. To translate this idea to the analysis of the effects of financial counseling, the Federal Reserve Board's Division of Consumer and Community Affairs is collaborating with the Department of Defense to conduct a three-year study of the effects of financial education. This study will evaluate the impact of various educational programs on the financial decisions of soldiers and their families. It includes a treatment group of those receiving financial education, with the programs each family receives and when they receive it being determined randomly, and a control group of similar soldiers and their families who have not received this formal financial education. Because assignments of individuals to programs will be random, any observed changes in behavior can be more reliably attributed to the type and amount of counseling received. Among other things, the results of this study should help us better understand whether financial education leads to changes in behavior for participants in general or only for those at critical

teaching moments, such as the period before making a major financial decision such as choosing a mortgage.

I would like to say just a few words about the Federal Reserve's broader role in promoting consumers' understanding of financial products and services. Beyond conducting surveys of consumers and doing research, we work in a number of ways to support consumers in their financial decisionmaking. For example, through our consumer protection rule-writing authority, the Federal Reserve sets requirements that specify the information that must be disclosed to consumers about the terms and fees associated with credit and deposit accounts. These disclosures provide consumers with the essential information they need to assess the costs and benefits of financial services and compare products among different providers. We are currently reviewing many of our disclosures and plan to use focus groups and other methods to try to make these disclosures as clear and as user-friendly as possible.

The Federal Reserve System also works to promote financial education and financial literacy through various outreach and educational activities. We provide a great deal of substantive financial information, including interactive tools for economic education, on our education website www.federalreserveeducation.org. The website links to a wide variety of financial education resources at the local, regional, and national levels.

Additionally, the Federal Reserved Board collaborates with educational and community development organizations to support their efforts. Our national partners include the Jump$tart Coalition for Personal Financial Literacy, the Conference of Mayors' DollarWi$e Campaign, Operation HOPE, the American Savings Education

Council, and America Saves, among others. At the regional level, the twelve Federal Reserve Banks work with organizations to support financial education and financial literacy. For example, the Federal Reserve Bank of Cleveland has worked with community financial educators to form regional networks that combine resources and share best practices. The Federal Reserve Bank of Chicago sponsors "MoneySmart Week," partnering with banks, businesses, government agencies, schools, community organizations, and libraries to host activities designed to help consumers learn how to manage money. The Federal Reserve Banks of San Francisco and Minneapolis have worked with leaders in the Native American community to develop financial education materials. My recent testimony to Congress on financial literacy provided information on many other projects and programs.[6] The Federal Reserve will continue to make financial education a priority.

Strategies to Encourage Saving

Even if people know that they would be better off if they saved more or budgeted more wisely, we all know from personal experience that translating good intentions into action can be difficult. (Think about how hard it is to keep New Year's resolutions.) The field of behavioral economics, which studies economic and financial decisions from a psychological perspective, has cast new light on consumer behavior and led to recommendations about how to improve people's financial management. For example, studies of individual choices in 401(k) savings plans strongly suggest that workers do not pay adequate attention to their saving and investment decisions. Notably, despite the tax advantages of 401(k) contributions and, in some cases, a generous employer match, one-quarter of workers eligible for 401(k) plans do not participate. Studies have found,

however, that if firms change the presentation of the plan from an "opt-in" choice to an "opt-out" choice, in which workers are automatically enrolled unless they actively choose to remain out of the plan, participation rates increase substantially.[7] The impact of changing from "opt-in" to "opt-out" is particularly evident for younger and lower-income workers, who may have less financial expertise.

In addition, participants in savings plans evidently do not understand the various investment options that are offered. A survey by the investment management firm, The Vanguard Group, found that many plan participants cannot assess the risk inherent in different types of financial assets; for example, many did not appreciate that a diversified equity mutual fund is generally less risky than keeping most of one's wealth in the form of the employer's stock.[8] Indeed, employees appear to invest heavily in their company's stock despite the fact that their income is already tied to the fortunes of their employer. More than one-quarter of 401(k) balances are held in company stock, and this high share arises not only from an employer match but from voluntary purchases as well.[9]

These insights into consumer behavior have prompted some changes in the design of retirement plans and in education programs focused on saving for retirement. More employers now feature automatic enrollment in their 401(k) plans in an effort to boost participation. Also, some have set the default investment option to a diversified portfolio that is rebalanced automatically as the worker ages or have set contribution rates to rise automatically over time in line with salary increases.

However, although these changes in program design may boost saving and improve investment choices, they are not a substitute for continued financial education. Employers, including the Federal Reserve Board, offer financial education at the

workplace to help their workers gain a better understanding of retirement savings options. Helping people appreciate the importance of saving and giving them the tools they need to translate that knowledge into action remain major challenges.

Conclusion

Let me close by observing that many factors influence consumer financial behavior. Financial education is clearly central to helping consumers make better decisions for themselves and their families, but policymakers, regulators, nonprofit organizations, and financial service providers must all help ensure that consumers have the tools and the information they need to make better decisions. Success can only come through collaborative efforts. I see much interest today in increased collaboration toward these objectives, both in Washington and around the country.

Thank you for the opportunity to speak with you today. I encourage you to continue working together to help provide increased economic opportunity in your communities, and I wish you the best of luck in your efforts.

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By the Numbers: Data and Measurement in Community Economic Development

Remarks

by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

via satellite

to the

Greenlining's Thirteenth Annual Economic Development Summit

"Building for the Future"

Los Angeles, California

April 20, 2006

I would like to thank Greenlining for the opportunity to participate in today's conference. In my time at the Federal Reserve, I have had a number of opportunities to meet with community economic development leaders to discuss issues of mutual concern and learn about the valuable role that community development organizations play in economically distressed areas across the country. I have been particularly impressed, and heartened, by the increasingly high degree of professionalism in the field. In this area, as in social policy generally, good intentions are not enough. Successful community development requires knowledge--knowledge about the particular community in question and about what has worked in similar communities in the past--and community development organizations are working assiduously and with sophisticated tools to help develop that knowledge.

Of course, knowledge bearing on community economic development has both qualitative and quantitative aspects, and it can be gained through diverse channels, from talking to people in a neighborhood to performing a regression analysis. Today, I will focus on the progress that is being made on the quantitative side--in particular, the remarkable strides that have been made in developing and analyzing social and economic data at the community level. The information that can be extracted from detailed data profiles of individual communities supports economic development in several distinct ways. First, by making companies, entrepreneurs, and investors aware of new opportunities and by promoting competition in underserved areas, such information helps put market forces in the service of community development. Second, both government policymakers and community development organizations need the reality check that only

hard data can provide. To know whether our policies and programs are delivering the desired results, we need to be able to measure inputs and outcomes, program by program and community by community. Better information increases accountability and promotes good governance in both the public and the nonprofit sectors. Third, the increased availability of community-level data facilitates independent research, which is vital to informing the public policy debate and to developing further community development efforts, both public and private.

Historically, government agencies have been the source of the most-comprehensive social and economic data bearing on community development. An important example is the data collected by the Federal Reserve under the Home Mortgage Disclosure Act (HMDA). The HMDA data set provides extensive information on home mortgage applications to virtually all U.S. lenders, including approval rates, the socioeconomic characteristics of applicants, and most recently, mortgage pricing information. As all good social scientists know, the data never "speak for themselves," and the HMDA information, like any data set, must be interpreted with care and insight. Still, for nearly three decades, the HMDA data have provided valuable information about mortgage lending patterns, contributed to significant changes in mortgage credit practices, informed regulatory policies, and supported fair-lending enforcement.

Although government agencies continue to be an important source of data on community development, data collection and data analysis in this area is increasingly becoming the province of the private and nonprofit sectors, notably including community development organizations themselves. In recent years, we have seen a series of data-collection initiatives outside the public sector, with objectives that include the

improvement of development strategies, the identification of new opportunities, the quantification of risk, and the exertion of influence on the direction of public policy. Many of these efforts have already had significant payoffs.

In the rest of my remarks, I will discuss some specific ways data and quantitative measurement have been used in community development. To be clear, I do not believe that all aspects of economic development can or should be quantified; and, as I have already noted, the data never speak for themselves but must be interpreted with care. Still, improving the measurement of inputs and outcomes is critical to better development policy. In this regard, it is interesting to observe that we have seen some convergence between best practices in community economic development and in economic development policy at the international level. I will conclude by noting a few of those parallels and their implications.

Discovering Market Potential

Good data support community growth and development by helping to identify previously unrecognized market opportunities. Free markets can be a powerful source of economic development, but markets work less effectively when information about potential opportunities is absent or costly for private actors to obtain. Several noteworthy initiatives have helped to provide better information about the economic potential of lower-income and underserved communities. For example, the Local Initiative Support Corporation's (LISC) MetroEdge initiative seeks to demonstrate the market potential of diverse communities through customized data analyses of each community's demographics and buying power. Such analysis can provide investors with a different perspective when they assess a neighborhood's viability for investment. In one instance,

a national home-improvement retailer used MetroEdge data as the basis for its decision to establish a store in inner-city Chicago, even though the retailer's own site-selection model presented discouraging indications of profit potential for that neighborhood. With access to new market data, the company could justify its investment in the community, and sales performance was triple what was expected within the first six months of operation.[1]

Similarly, Social Compact's Neighborhood Market DrillDown methodology uses a multilayered research process to provide profiles of the market potential of high-density, lower-income communities. This approach focuses on business indicators--buying power, market size, unmet needs, and market risks--rather than on the deficiency statistics typically used to describe inner-city neighborhoods, such as rates of poverty, crime, and overcrowding. Social Compact, a coalition of business leaders, has applied its DrillDown approach to 101 neighborhoods over the past five years, beginning with Chicago neighborhoods and, most recently, in Santa Ana, California. By tapping existing public records and conducting intensive economic and demographic surveys, the DrillDown analyses of these 101 neighborhoods in eight cities have, in the aggregate, revealed additional income and buying power averaging nearly $6,000 per household, which is not captured by traditional sources of community-level data.[2] Such information may attract private-sector investors to areas that had once been deemed untenable for investment. For example, following Social Compact's study of neighborhoods in Jacksonville, Florida, a developer announced plans to invest $45 million in a multi-use entertainment complex there. A DrillDown study in inner-city Houston revealed a population that was 25 percent larger than Census estimates, resulting in the

redevelopment of a 750,000 square foot retail center that brought 2,000 jobs to a neighborhood that had not had new construction in fifty years. This shopping center is now one of the busiest retail centers in the city.[3]

Work to improve the measurement of market potential in inner-city communities is continuing. In one such project, Social Compact and the Brookings Institution's Urban Markets Initiative group are collaborating in reviewing methods for measuring the size and composition of economies in urban areas around the world. The objectives of the review are to develop new tools for measuring economic activity at the local level and to identify areas for future research.

Informing Investors in Community Development

The growth and maturation of community development financial institutions (CDFIs) provide another impetus for data development and analysis at the community level. CDFIs are private-sector financial intermediaries with community development as their primary mission. Like banks and other more-conventional financial intermediaries, CDFIs are in the business of attracting funds and putting those funds to work in productive ways. Also like conventional intermediaries, CDFIs depend heavily on the production of accurate information both to guide investment decisions and to provide a basis for attracting new funding. It is difficult to overstate the importance of adequate and accurate information for attracting capital. Managers of pools of capital have many choices, and they tend to be extremely wary when they cannot fully assess the level of risk presented.

With an appreciation for the need for such information, managers and others with an interest in the CDFI industry have invested substantial effort in designing tools for

data collection and analysis that focus on measuring the financial performance--the risks and returns--of CDFI portfolios. An important motivation for these efforts is the need to diversify funding sources for community development, which has relied heretofore largely on grants from government and foundations. To attract more return-oriented investors, including both conventional investors and those with social as well as financial goals, CDFIs must demonstrate financial viability as well as the ability to fulfill the broader development mission.

For example, the Opportunity Finance Network's CDFI Assessment and Rating System (CARS) gathers data to evaluate a CDFI's overall creditworthiness and its effectiveness in using its financial resources to achieve its development objectives. A CDFI is rated for its financial strength and performance in the areas of capital, assets, management, earnings, and liquidity, in a manner broadly analogous to the way a supervisory agency would rate a commercial bank. The financial analysis is supplemented by an evaluation of how well the CDFI is fulfilling its mission, including an assessment of its procedures for tracking the outcomes of its work. To date, more than forty CDFIs have chosen to be evaluated under the CARS, and thirty-one analyses have been completed. Thus far, fifteen potential investors have subscribed to the CARS database, including socially responsible investment funds, brokerage houses, large financial institutions, and national foundations.[4] Although still in its early stages, this initiative, if successful, will have the double benefit of attracting more funds into community development and helping to ensure that those funds are effectively used.

More generally, the movement toward quantifying the performance, risk, and community impact of CDFIs is essential to the growth and sustainability of the field, in

my view. By demonstrating both financial viability and social impact through hard data, CDFIs are better positioned to obtain the funding necessary to maintain their operations and to respond to emerging needs and opportunities. Indeed, progress has been made in recent years in the rating and securitization of community development portfolios, a development that should provide CDFIs with increased access to the capital markets and to new sources of liquidity. If the new data and evaluation methods of CDFI performance bear scrutiny, investors will gain confidence in using this information for matching their investment choices with their priorities and risk tolerances. In the community development field, to be sure, financial returns and social returns are not necessarily the same, which is why measurement should include both financial and social indicators. Potential investors, including public-sector and foundation sources of funds, will naturally differ on the weights they put on financial and social returns. To attract the widest range of funding, both types of information should be provided.

Evaluating Policy and Practice

Quantitative information plays yet another important role: increasing the effectiveness of policies and programs. The systematic collection and analysis of data on program inputs and outputs is an increasingly important part of learning about what works. For policymakers, data on program results help guide policy development and improve the allocation of scarce public funds. For community development organizations, participation in broad-based data-gathering serves at least two goals. First, in the long run, their analyses of the activities and the associated outcomes in diverse communities will help them achieve the greatest impact for resources expended. Second,

such analyses help community development organizations demonstrate their effectiveness to public and private funders.

A number of methods for evaluating community development projects are currently in use, with more in development. The NeighborWorks America's® Success Measures Data System documents the effect of community development programs throughout the country. Using forty-four indicators and a range of data-collection tools, the system quantifies the effects of housing, economic development, and community building programs at the individual, organization, and community levels. By sharing this knowledge, practitioners, funders, and policymakers can identify programs that achieve the best outcomes and gain insights into the reasons they work. Broad access to this information promotes replication of the most effective programs and may diminish the costs associated with trial-and-error learning.[5]

Another tool available to CDFIs is the Community Investment Impact System developed by the Department of Treasury's CDFI Fund. This system collects detailed information on institutions and transactions, allowing the CDFI Fund to measure community effects and to associate those effects with institutions working in that area. These results can help inform funding decisions, develop programs, establish performance benchmarks, and communicate societal benefits attributable to specific policy. For example, using data from the system, the CDFI Fund found that in a recent year, CDFIs leveraged financial program awards by the fund at a ratio of 20 to 1, using multiple sources of debt and equity financing from banks, local and state governments, private investors, and borrower equity to structure project financing. [6]

Each of these data-driven initiatives share the goal of increasing understanding of opaque markets to support investment, policy, and research. The need for data and tools is the driving force behind the Brookings Institution's Urban Markets Initiative. In establishing this policy center, Brookings acknowledged that limited access to data that captures the viability of urban communities constrains investment in these markets. The think tank is focusing on initiatives that can demonstrate untapped market potential.[7] One such effort is the National Infrastructure for Community Statistics. It will include a central web-based repository that integrates data from federal, state, and local governments and from commercial sources. The ultimate goal of this project, which is under development in collaboration with more than 100 participants from government, nonprofits, and private-sector industries, is to aggregate and to make accessible the data needed to inform decisions about economic development activities.[8]

Parallels to International Economic Development

The usefulness of microeconomic data in community development raises an interesting parallel to recent analyses of international economic development. Although the U.S. context is obviously different in important respects from that of developing countries, domestic community organizations and providers of international aid both face the challenge of fostering economic development in low-income areas. In the United States, our experience in community development over the past thirty years has resulted in an evolution from a centralized, federal-government-driven approach to a heavy reliance on the involvement of community-based organizations and agencies for project development and implementation. In light of this experience, it is quite interesting that some new thinking on international development has rejected the traditional approach to

aid, with its emphasis on large-scale projects and top-down planning, in favor of micro-level, bottom-up approaches that use local information and systematic analyses of inputs and outcomes.

Critics of traditional development aid programs, such as New York University economist William Easterly, argue that such programs have not succeeded because those implementing the programs do not have the information necessary to make effective use of resources.[9] For example, a World Bank report describes an irrigation project that was being designed by technical staff for an area of Nepal that was thought to be unirrigated. A delay in the project led to the discovery that, in fact, eighty-five fully functioning farmer-managed irrigation systems existed in the "unirrigated" area. Further, another irrigation program actually reduced productivity because it undermined pre-existing arrangements among farmers.[10] Quite obviously, those planning these projects needed local input to make better use of the project resources.

Easterly advocates a more decentralized, grass-roots approach that involves local groups and emphasizes feedback and accountability. Illustrative of this point, a World Bank study of rural water supply projects found that, of those projects with a high level of participation by local beneficiaries, more than two-thirds were successful whereas, among those projects with little local beneficiary participation, only 12 percent were successful.[11] Both feedback and accountability depend, of course, on accurate measurement of results. In practice, measuring results is easier at the local level, in part because comparisons can be drawn to other localities that have not received aid. Incentives also matter; and smaller, more-tailored projects for which responsibilities are well defined are likely to provide better incentives to the people who carry them out than

those that large, diffuse projects will provide. Follow-up is important as well. Easterly criticizes, for instance, situations in which foreign aid has been used to build highly visible projects, such as new roads, without providing resources or incentives to do the less-glamorous work of maintaining them.

The themes emphasized by Easterly and other analysts of international aid programs are useful, I think, in the context of domestic community development. Although national initiatives have their place, often the most effective programs take place at the level of the individual community, using local information and local participation. Accountability and feedback, facilitated by data development and quantitative analysis as well as by more-qualitative information, are critical for success. Goals should be modest at first; but knowledge is cumulative, and sometimes good results can be replicated at larger scales. Research, both quantitative and qualitative, furthers learning. None of this is easy, particularly since the data have a way of challenging our views about what works and what doesn't. But a great deal is at stake both internationally and domestically and serious empirical analysis has no substitute. The development of more and better data on economically distressed communities, together with sophisticated tools for analyzing those data, is essential for continued progress in community economic development.

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Community Revitalization: Lessons from Anacostia

Remarks

by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before

Operation HOPE's Anacostia Economic Summit

May 3, 2006

I would like to thank Operation HOPE and the host committee for inviting me to participate in today's summit. I would also like to congratulate John Bryant and the staff of the Anacostia HOPE Center on this anniversary and on your many contributions to this community over the past year. I recently visited the HOPE Center and saw some of the services it offers in financial education, small business development, job training, and computer literacy. These activities contribute to the revitalization of this community by helping residents gain access to resources they can use to improve their economic situations and prospects. Institutions such as the HOPE Center and THEARC (Town Hall Education, Arts, and Recreation Campus) bring people together and give them a sense of being part of a larger community.

Today, I will share some thoughts on economic revitalization, highlighting two general themes. The first theme is the importance in community economic development of strategic collaboration among public, private, and nonprofit organizations. Working together, these three groups of actors can achieve much more than they could on their own. The second theme is the need for a comprehensive approach to revitalizing communities, one that focuses on the economic and cultural viability of the community as a whole, not only on the construction or rehabilitation of individual homes and businesses. In my remarks I will focus on the experience of the Anacostia neighborhood in the District of Columbia, which offers useful illustrations of both themes.

Anacostia: Looking Back

To think about Anacostia's future it helps first to recall its past. I recently toured some of the neighborhoods southeast of the Anacostia River and gained an appreciation for both the rich history of the area and its great promise. Many of the buildings in this

area are architectural treasures. The older houses date from the late 1800s, when Anacostia was home to a large working-class community. The residents included, of course, Frederick Douglass, known as the Sage of Anacostia, a man whose dedication to lifelong learning and to the battle for racial equality still has the capacity to inspire.

In the early to middle twentieth century, Anacostia offered affordable homes and wide open spaces--at that time, it had only 5 percent of the District's total population but 40 percent of the District's vacant land. In the 1920s, Anacostia had a higher percentage of homeowners than other sections of the District, with apartments accounting for less than 1 percent of its dwellings. Indeed, during a six-year period of rapid expansion following World War I, when Anacostia's population surged 56 percent, more than 1,800 detached and row houses were constructed in the area, but only four apartment buildings.[1]

However, the pattern of residential construction and homeownership in Anacostia changed dramatically over the following decades. During the 1920s, 1930s, and 1940s, policies designed to eradicate tenements in central D.C. resulted in Anacostia, with its relatively large tracts of undeveloped land, becoming home to large numbers of lower-income families displaced from other parts of the city. In the 1950s and 1960s, the growth of the city's population, the expansion of the central business district to accommodate the burgeoning federal government, and urban renewal projects led to substantial increases in the demand for new housing in the city, particularly for lower-income residents. By 1967, the need for affordable housing in the District led the

[1] American Studies at the University of Virginia, "The Changing Face of Anacostia: Public Housing and Urban Renewal," http://xroads.virginia.edu/~CAP/ANACOSTIA/public.html.

planning commission to call for the construction of 65,000 units of new housing, with 30,000 of those units to be located in Anacostia.

The result of these developments was an apartment-construction boom that ultimately changed the character of the area. As the community's stock of public and rental housing increased, Anacostia shifted from being a community of homeowners to one of renters, with a high concentration of lower-income households. As we have seen in other cities, large-scale public housing projects have often become liabilities to the community. Anacostia struggled as public housing complexes fell into disrepair, many homes were abandoned, crime rates increased, and poverty rates climbed. The economic vitality of this historic community was undermined, and previously healthy neighborhoods were destabilized.

Anacostia Today

Today, however, Anacostia looks to be on the way back. Leaders in the public, private, and nonprofit sectors have a new vision for the area--one of mixed-income neighborhoods, vibrant commercial and retail centers, expanded neighborhood amenities, and strong community institutions. These partners are playing different but complementary roles, bringing both capital and expertise and ushering in a new wave of economic development in the area.

In the public sector, both the federal and city governments are supporting development in Anacostia through their investments, often leveraged with private money. On the federal side, for example, the Department of Homeland Security's new communications center and other planned development on the St. Elizabeth's property will bring jobs and economic activity to the neighborhood. The city of Washington is

making a number of important investments here as well. For example, the Anacostia Gateway project will include two buildings, one that will house offices of the D.C. government, the other (which will be a joint venture of the Anacostia Economic Development Corporation and the National Capital Revitalization Corporation) providing commercial office space. The city has also made a major commitment for the construction of a baseball stadium, as you know. In the sphere of housing, an entirely new community is rising up at Henson Ridge, bringing residents with a range of incomes. The city took a leadership role in this project, demolishing the public housing previously on the site and then arranging the financing of the new construction through a combination of public bond issuance, private equity, and a successful competitive proposal to the U.S. Department of Housing and Urban Development.

The promise of these investments for Anacostia's future is supported by recent research, which has highlighted how carefully targeted public investment can help to jump-start urban revitalization.[2] An illustration not too far from here can be found in Richmond, where the city played a lead role in finding the funds to develop mixed-income housing in seven distressed neighborhoods. After five years, the housing values in those communities increased nearly 10 percent per year faster than in the city of Richmond as a whole.[3]

But public investments alone are generally not sufficient to re-establish the economic viability of a community. For development to be truly sustainable, private

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[2] Bruce Katz, Brookings Institution, "Transformative Investments: Unleashing the Potential of American Cities, April 5, 2006, http://www.brookings.edu/metro/speeches/20060405_TransformativeInvestments.pdf

[3] John Accordino, George Galster, Peter Tatian, "The Impacts of Targeted Public and Nonprofit Investment on Neighborhood Development: Research based on Richmond, Virginia's Neighborhoods in Bloom Program," July 2005, http://www.richmondfed.org/community_affairs/topical_essays_and_resources/pdf/nib_research.pdf.

capital is also needed. Successful private investment in economically challenged areas can be rewarding, but it requires substantial expertise, local knowledge, and a vision of what the community can become. In this community, several innovative private developers have shown what is possible by collaborating with the city, financial institutions, and nonprofit organizations to rehabilitate and construct thousands of new mixed-income housing units for both renters and owners.

A key element in the success of much of this private-led development is the insight that, to achieve economically viable communities, building housing units is not enough. For people to find an area an attractive place to live, they need a range of services, community institutions, and places to shop and work. Accordingly, developers building in Anacostia have included in their plans community amenities such as day care centers, shuttle services, and recreation programs for resident children. Developments like Asheford Court, a new mixed-use, mixed-income community, will include a supermarket, restaurants, and shops. Even as they make communities more attractive, these amenities create new jobs and provide opportunities for small business development.

Together with actors in the public and private sectors, leaders in the nonprofit community have an important role in the redevelopment of Anacostia as well, particularly in creating the social infrastructure that improves the quality of life. I have already alluded to Operation HOPE and the important work that it does in helping residents become more financially literate, which paves the way for more people to own homes and to start small businesses. Nonprofit community development organizations, such as East of the River Community Development Corporation, the Anacostia Economic

Development Corporation, and the Marshall Heights Community Development Organization have supported retail development. With the support of the Local Initiatives Support Corporation, over the past twenty years these organizations have worked to bring projects such as the Good Hope Marketplace and the future Shops at Park Village to the area. Guided by leaders who have a personal commitment to the success of their communities, these nonprofit organizations have led the way in meeting the needs of residents for affordable housing and in helping to attract private investment and development.

Nonprofit educational and cultural organizations are also at the heart of this community's revitalization. The network of nonprofits that worked together to create THEARC--the Washington Ballet, the Corcoran Gallery of Art, the Levine School of Music, and the Boys and Girls Club--is a model for strategic partnerships. THEARC also provides vital services, such as the Children's Hospital family wellness center, a significant resource in a community that previously had no health-care facilities.

Again, the development philosophy that we see at work in Anacostia is one that focuses not only on the construction of individual homes and businesses but on the broader social and economic environment in the community. As every successful developer knows, real estate markets are driven not only by the characteristics of the physical structures, though those are important, but also by the accessibility of goods and services that current and future residents want, such as schools, shops, and transportation.

Data on business patterns offer some insight into the positive changes in Anacostia, as well as the remaining challenges. In the communities which I had the opportunity to visit, the number of business establishments increased by about 7 percent

between 1998 and 2003.[4] In light of the public and private investments in this community, it is not surprising that some of the most rapid growth was in the number of firms in construction (64%) and in the finance and insurance industries (47%). Industry data for these communities reveal significant increases in the number of establishments in educational services, such as academic and arts schools and training centers (a 118% gain); professional, scientific, and technical services such as offices of lawyers and engineers (a 35% increase); and health care and social assistance including medical care and daycare centers (a 15% gain).[5] Although the rate of homeownership in Ward 8 is still only about half the average for the city as a whole, progress has been made on that count as well. From 1990 to 2000, the homeownership rate in Ward 8 increased by 22 percent, and I have little doubt that further improvement has occurred since 2000, given the completion of 765 owner-occupied housing units since 2001 and an additional 210 under construction due to be completed by 2006.[6]

Beyond Anacostia

What does Anacostia's experience offer for other communities confronting economic decline, given the reality of limited resources and the financial risks associated with redeveloping distressed areas? One lesson is that public, private, and nonprofit development partners must be increasingly innovative in their work. First, they must identify the strategic investments that have the potential to transform neighborhoods and stimulate ongoing private investment and economic activity. As I have noted today,

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[4] U.S. Census Bureau, North American Industry Classification System, zip codes 20020 and 20032, http://censtats.census.gov/cbpnaic/cbpnaic.shtml.

[5] Ibid.

[6] D.C. Office of Planning and NeighborhoodInfo DC, Neighborhood Profiles, http://www.neighborhoodinfodc.org/wards/nbr_prof_wrd8.html.

success in community development requires a comprehensive approach--one based on the recognition that vibrant communities offer their residents not only a place to live, but also access to services, to community institutions, and to places to shop, work, and enjoy recreation as well. Many of the development initiatives that have taken place in Anacostia have made good use of this insight, combining housing development with other amenities such as recreational areas, retail outlets, or cultural institutions like THEARC.

Second, the community leaders, government officials, lenders, and developers now involved in helping to rebuild communities must keep working to find new partners and new sources of capital. In this respect, it is encouraging to see how much more professional the whole field of community development finance has become. For example, over the past twenty-five years, innovative lenders at banks and at community development financial institutions have demonstrated that investments in community economic development can be rewarding in the financial sense as well as in the social sense. With that demonstration, new financing structures may continue to emerge that can help mitigate decreases in government funding. The expansion of secondary markets for affordable housing and community development loans will, I hope, provide increasing liquidity that allows the redeployment of capital for new development efforts. What we see today in Southeast D.C. demonstrates that smart public and private investment can create a virtuous circle of economic growth and opportunity. I am optimistic that the positive changes that we see in Anacostia can be replicated in economically challenged communities throughout the country.

My optimism also stems from the commitment demonstrated by the participation today of leaders from all levels of government, banking, the corporate sector, and nonprofit institutions. Today's summit underscores your commitment to increasing opportunity for lower-income individuals and communities. I join you in celebrating the ongoing revitalization of Anacostia and the potential for similar communities throughout our nation. I commend you for your leadership and look forward to your continued success.

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