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The Honorable Ben S. Bernanke

Chairman, Federal Reserve System

Questioners: Martin Feldstein
Professor of Economics at Harvard and
Former Chairman of the President's Council of
Economic Advisors

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INTRODUCTION

ANDREW TISCH

Good afternoon everyone. I am Andrew Tisch, the immediate Past Chairman of the Economic Club of New York. I would like to welcome you to the 426th meeting of the Economic Club of New York in our 105th year. The Economic Club of New York is the nations leading nonpartisan forum for economic policy speeches. More than 1000 guest speakers have appeared before this club, establishing a strong tradition of excellence. Today I have the pleasure of passing the gavel to our new Chairman, Roger Ferguson, President and CEO of TIAA-CREF and former Vice Chairman of the Federal Reserve. Roger, since I took over as Chairman two years ago, nominal GDP has grown by 8.3 percent. The S&P has grown by 21 percent. Unemployment has decreased from 9.7 to 7.9 percent and average core inflation has been about 1.8 percent. As for the deficit, well I am not going to go there. (Laughter). I hope in your tenure you do as well as I did. Roger congratulations. I hope that you find your stewardship of this great organization as rewarding as I have. Roger, congratulations.

ROGER FERGUSON

Moderator

Thank you Andrew. I think it is probably better for us not to engage in a debate about economic statistics until my term is up. But I take the challenge. It is really quite an honor for me to become the Chairman of this August institution. More importantly it is an honor and a personal pleasure for me in my first official act as chairman to introduce our speaker today. Ben

Bernanke, the Chairman of the Federal Reserve System. Dr. Bernanke joined the fed in 2006 and is now in his second term as chairman. He also serves as all of you know, as the chairman of the Open Market Committee which is the systems principal monetary policy making body. I think we would all agree that Dr. Bernanke has led the fed with great commitment through some of the most challenging times in our nations history attempting to help Andrew do well in his role here as Chairman. (Laughter) Before his appointment, Chairman Bernanke was the Chairman of the President's House of Economic Advisors and from 1985 to 2002 he was Professor of Economics and Public Affairs at Princeton University. He has also taught at Stanford's Graduate School of Business, New York University and M.I.T. Dr. Bernanke graduated summa cum laude from Harvard in 1975 with a B.A. in Economics. He earned a PhD in Economics from M.I.T. in 1979. Ladies and gentlemen it is now my pleasure to turn the podium over to Chairman Bernanke.

BEN BERNANKE

Chairman, Federal Reserve System

Thank you very much. Good afternoon. It is nice to join you for lunch in this intimate gathering. I do know that many of you and your friends and neighbors are still recovering from the affects of Hurricane Sandy. I want to let you know that your thoughts are with everyone who has suffered during the storm and its aftermath. It has been a very challenging time for New York City and I think you have shown quite a bit of fortitude in coming back and getting back to business.

My remarks today are going to focus on the reasons for the disappointingly slow pace of economic recovery in the United States and the policy actions that have been taken by the Federal Open Market Committee, the (FOMC) to support the economy.

In addition, I am going to discuss some important economic challenges that our country faces as we close out 2012 and move into 2013. In particular the challenge of putting federal government finances on a sustainable path in a longer run while avoiding actions that would endanger the economic recovery in the near term.

The economy has continued to recover from the financial crisis and the recession but the pace of the recovery has been slower than FOMC participants and many others had hoped or anticipated when I spoke here last, about three years ago. Indeed, since the recession trough in mid-2009 growth and real GDP has averaged only a little more than 2 percent per year.

Similarly the job market has improved over the past three years but at a slow pace. The unemployment rate which peaked at 10 percent in the fall of 2009, has since come down 2 percentage points to just below 8 percent. This decline is obviously a welcome one, but it has taken a long time to achieve that progress. The unemployment rate is still well above both its level prior to the onset of the recession and the level that my colleagues and I think can be sustained once a full recovery is achieved.

Moreover, many other features of the job market, including the historically high level of long-

term unemployment, the large number of people working part-time because they have not been able to find full-time jobs and the decline in labor force participation, reinforce the conclusion that we have some way to go before the labor market can be deemed healthy again.

Meanwhile, inflation has generally remained subdued. As is often the case, inflation has been pushed up and down in recent years by fluctuations in the price of crude oil and other globally traded commodities, including the increase in farm prices brought on by this summers drought. But with longer term inflation expectations remaining stable, the ebbs and flows of commodity prices have led to only transitory movements in inflation. Indeed since the recovery began about three years ago, consumer price inflation as measured by the Personal Consumption Expenditures Index, has averaged almost exactly 2 percent which is the FOMC longer run objective for inflation.

Because ongoing slack in labor and product markets should continue to restrain wage and price increases and with the public's expectations of inflation continuing to remain well anchored, inflation over the next few years is likely to remain close to or a little bit below the committees objective.

As background for our monetary policy decision making, we at the Federal Reserve have spent a good deal of effort attempting to understand why the economic recovery has not been stronger. Studies of previous financial crises provide one good place to start. This literature, as many of you know, has found that severe financial crises, particularly those associated with housing

booms and busts, have often been associated with many years of subsequent weak performance.

While this result allows for many interpretations one possibility is that financial crises or the deep recessions that typically accompany them, may reduce an economies potential growth rate, at least for a time. The accumulating evidence does appear consistent with the financial crisis and the associated recession, having reduced the potential growth rate of our economy somewhat at least, during the past few years. In particular, slower growth and potential output would explain why the unemployment rate has declined in the face of the relatively modest output gains we have seen during the recovery.

Output normally has to increase at about its longer term trend just to create enough jobs to absorb new entrants to the labor market and faster than trend growth is usually needed to reduce unemployment. So the fact that unemployment has declined in recent years despite economic growth at about 2 percent, suggests that the growth rate of potential output must have recently been lower than the roughly 2.5 percent rate that appeared to be in place before the crisis.

There are a number of ways in which the financial crisis could have slowed the rate of growth of the economies potential. For example, the extraordinarily severe job losses that followed the crisis especially in housing related industries, may have exacerbated for a time the extent of mismatch between the jobs available and the skills and the locations of the unemployed.

Meanwhile the very high level of long-term unemployment has probably led to some loss of

skills and labor force attachment among those workers. These factors may have pushed up to some degree the so called natural rate of unemployment–the rate of unemployment that can be sustained under normal conditions--and reduced labor force participation as well.

The pace of productivity gains, another key determinant of growth and potential output, may also have been restrained by the crisis, as business investment has declined sharply during the recession. And increases in risk aversion and uncertainty, together with tight credit conditions, may have impeded the commercial application of new technologies and slowed the pace of business formation.

Importantly, however, although the nations potential output may have grown more slowly than expected in recent years, this slowing seems at best a partial explanation of the disappointing pace of the economic recovery. In particular, even though the natural rate of unemployment may have increased somewhat, a variety of evidence suggests that any such increase has been modest and that substantial slack remains in the labor market.

For example the slow pace of employment growth has been widespread across industries and regions across the economy. That pattern suggests a broad base shortfall in demand rather than a substantial increase in mismatch between available jobs and workers, because greater mismatch would imply that the demand for workers will be strong in some regions and industries but not weak across the board. Likewise if a mismatch in jobs and workers is a predominant problem, we would expect to see wage pressures developing in those regions and industries where labor

demand is strong. In fact, wage gains have been quite subdued in most industries and parts of the country.

Indeed, as I indicated earlier the consensus among my colleagues on the FOMC is that the unemployment rate is still well above its longer run sustainable level, perhaps by 2 or 2.5 percentage points or so.

A critical question then is why the significant slack in the job market still remains after three years of recovery. A likely explanation which I will discuss further is that the economy has been faced with a variety of headwinds that have hindered what otherwise might have been a stronger cyclical rebound. If so, we may take some encouragement from the likelihood that there are potentially two sources of faster GDP growth in the future.

First the affects of the crisis on potential output should fade as the economy continues to heal. And second, if the headwinds continue to dissipate as I expect, the growth should pick up further as many who are currently unemployed are out of the labor force, find work.

So what are the headwinds that have been slowing the return of our economy to full employment. Some have come from the housing sector. Previous recoveries have often been associated with a vigorous rebound in housing. As rising incomes and confidence and often a decline in mortgage interest rates have led to sharp increases in the demand for homes. But the

housing bubble and its aftermath have made this episode quite different.

In the first half of the past decade both housing crisis and construction rose to what proved to be unsustainable levels, leading to a subsequent collapse. House prices declined almost one-third nationally from 2006 until early this year. Construction of single family homes fell by two-thirds and the number of construction jobs decreased by nearly one-third. And of course the associated surge in delinquencies on mortgages helped to trigger the broader financial crisis.

Recently the housing market has shown some clear signs of improvement as home sales, prices and construction has all moved up since early this year. These developments are encouraging. And it seems likely that, on net, residential investment will be a source of economic growth and new jobs over the next couple of years.

However, while historically low mortgage interest rates and the drop in home prices have made housing exceptionally?? affordable, a number of factors continue to prevent the sort of powerful housing recovery that has typically occurred in the past. Notably lenders have maintained tight terms and conditions on mortgage loans, even for potential borrowers with relatively good credit. Lenders cite a number of factors affecting their decision to extend credit, including ongoing uncertainties over the course of the economy, the housing market and the regulatory environment.

Unfortunately while some tightening of the terms of mortgage credit was certainly an appropriate

response to the developments of earlier excesses, the pendulum appears to have swung too far, restraining the pace of recovery in the housing sector.

Other factors slowing recovery in housing include the fact that many people remain unable to buy homes despite low mortgage rates. For example about 20 percent of existing mortgage borrowers owe more on their mortgages than their homes are worth. Making it more difficult for them to refinance or to sell their homes.

Also, a substantial overhang of vacant homes, either for sale or in the foreclosure pipeline, continues to hold down house prices and reduce the need for new construction. While these headwinds on both the supply and the demand sides of the housing market have clearly started to abate, the recovery in the housing sector is likely to remain moderate by historical standards.

A second set of headwinds stems from the financial conditions facing potential borrowers in credit and capital markets. After the financial system seized up, in late 2008 and early 2009, global economic activity contracted sharply and credit and capital markets suffered significant damage. Although dramatic actions by governments and central banks around the world helped these markets to stabilize and begin recovering, tight credit and a high degree of risk aversion have remained and have restrained economic growth in the United States and in other countries as well.

Now, measures of the conditions of U.S. financial markets and institutions do suggest gradual but significant progress achieved since the crisis. For example credit spreads and corporate

bonds and syndicated loans have narrowed considerably. And equity prices have recovered most of their losses.

In addition, indicators of market stress and illiquidity, such as spreads in short term funding markets, have generally returned to levels near those seen before the crisis. One gauge of the overall improvement in financial markets is the National Financial Conditions Index maintained by the Federal Reserve Bank of Chicago. This index shows that financial conditions viewed as a whole, are now about as accommodative as they were in the spring of 2007.

In spite of this broad improvement, the harm inflicted by the financial crisis has yet to be fully repaired in important segments of the financial sector. One example is the continued weakness in some categories of bank lending. Banks' capital positions and overall asset quality have improved substantially over the past several years. And over time these balance sheet improvements will position banks to extend considerably more credit to bank dependent borrowers.

Indeed, some types of bank credit such as commercial and industrial loans have expanded notably in recent quarters. Nonetheless, banks have been conservative in extending loans to many consumers and some businesses. Likely even beyond the restrictions on the supply of mortgage credit that I talked about earlier. This caution in lending by banks reflects among other factors their continued desire to guard against the risks posed by further economic weakness.

A prominent risk at present and a major source of financial headwinds over the past couple of years, is the fiscal and financial situation in Europe. This situation, of course, was not anticipated when the United States recovery began in 2009. The elevated levels of stress in European economies and uncertainty about how the problems there will be resolved are adding to the risks that U.S. financial institutions, businesses and households must consider when making lending and investment decisions. Negative sentiment regarding Europe appears to have weighed on U.S. equity prices and prevented U.S. credit spreads from narrowing even further. Weaker economic conditions in Europe and other parts of the world have also weighed on U.S. exports and corporate earnings. Policy makers in Europe have taken some important steps recently and in doing so have contributed to some welcome easing in financial conditions.

In particular the European Central Banks new Outright Monetary Transactions Program, under which it could purchase the sovereign debt of vulnerable euro-area countries who agreed to meet prescribed conditions has helped to ease market concerns about those countries. European governments have also taken steps to strengthen their financial firewalls and to move toward greater fiscal and banking union. Further improvement in global financial conditions will depend in part on the extent to which European policy makers follow through on these initiatives.

A third headwind to the recovery--and one that may intensify in force in the coming quarters--is U.S. fiscal policy. Although fiscal policy at the federal level was quite expansionary during the recession and early in the recovery, as the recovery proceeded the support provided for the

economy by federal fiscal actions was increasingly offset by the adverse effects of tight budget conditions for state and local governments. In response to a large and sustained decline in their tax revenues, state and local governments have cut about 600,000 jobs on net since the third quarter of 2008, while reducing real expenditures for infrastructure projects by about 20 percent.

More recently the situation has to some extent reversed. The drag on economic growth from state and local fiscal policy has diminished as revenues has improved and the pressures have eased for further spending cuts or tax increases. In contrast, the phasing-out of earlier stimulus programs and policy actions to reduce the federal budget deficit have led federal fiscal policy to begin restraining GDP growth. Indeed under almost any plausible scenario, next year, the drag from federal fiscal policy on GDP growth will outweigh the positive affects on growth from fiscal expansion at the state and local level.

However, the overall affect of federal fiscal policy on the economy, both in the near term, and in the longer run, remains quite uncertain and depends on how policy makers meet two daunting fiscal challenges–one, by the start of the new year and the other by no later than the spring.

So what are these looming challenges? First, the Congress and the administration will need to protect the economy from the full brunt of the severe fiscal tightening at the beginning of next year that is built into current law, the so called fiscal cliff. The realization of all of the automatic tax increases and spending cuts that make up the fiscal cliff, absent offsetting changes, would pose a substantial threat to the recovery. Indeed by the reckoning of the Congressional Budget

Office, the CBO, and that of many outside observers, a fiscal shock of that size would send the economy toppling back into recession.

And second, early in the new year it will be necessary to approve an increase in the federal debt limit to avoid any possibility of a catastrophic default on the nation's Treasury securities and other obligations. As you will recall the threat of default in the summer of 2011 fueled economic uncertainty and badly damaged confidence even though an agreement was ultimately reached. A failure to reach a timely agreement this time around can impose even heavier economic and financial costs.

As fiscal policymakers face these critical decisions, they should keep two objectives in mind. First, as I think is widely appreciated by now, the federal budget is on an unsustainable path. The budget deficit which peaked at about 10 percent of GDP in 2009, now stands at about 7 percent of GDP, is expected to narrow further in the coming years as the economy continues to recover.

However the CBO projects that under a plausible set of policy assumptions, the budget deficit would still be greater than 4 percent of GDP in 2018 assuming that the economy has returned to its potential by then. Moreover, under the CBP projection, the deficit and the ratio of federal debt to GDP would subsequently return to an upward trend. Of course we should all understand that long-term projections of ever increasing deficits will never actually come to pass because the willingness of lenders to continue to fund the government can only be sustained by

responsible fiscal plans and actions. A credible framework to set federal fiscal policy on a stable path, for example, one in which the ratio of federal debt to GDP eventually stabilizes or declines, is thus urgently needed to insure longer term economic growth and stability.

Even as fiscal policy makers address the urgent issue of longer run fiscal sustainability, they should not ignore a second key objective, to avoid unnecessarily adding to the headwinds that are already holding back the economic recovery. Fortunately these two objectives are fully compatible and mutually reinforcing.

Preventing a sudden and severe contraction in fiscal policy early next year will support the transition of the economy back to full employment. And a stronger economy will in turn reduce the deficit and contribute to achieving longer term fiscal sustainability.

At the same time, a credible plan to put the federal budget on a path that will be sustainable in the long run could help keep longer term interest rates low and boost household and business confidence, thereby supporting economic growth today.

Coming together to find fiscal solutions will not be easy but the stakes are high. Uncertainty about how the fiscal cliff, the raising of the debt limit and the longer term budget situation will be addressed, appears already to be affecting private spending and investment decisions and may be contributing to an increased sense of caution in financial markets with adverse effects on the economy.

Continuing to push off difficult policy choices will only prolong and intensify these uncertainties. Moreover, while the details of whatever agreement is reached to resolve the fiscal cliff are important, the economic confidence of both market participants and the general public likely will also be influenced by the extent to which our political system proves able to deliver a reasonable solution with a minimum of uncertainty and delay.

Finding long-term solutions that can win sufficient political support to be enacted may take some time, but meaningful progress toward this end can be achieved now if policy makers are willing to think creatively and work together constructively.

Let me know turn briefly to monetary policy. Monetary policy can do little to reverse the affects that the financial crisis may have had on the economies productive potential. However, it has been able to provide an important offset to the headwinds that have slowed the cyclical recovery.

As you know the federal reserve took strong easing measures during the financial crisis and the recession, cutting its target for the federal funds rate, the traditional tool of monetary policy, to nearly zero by the end of 2008. Since that time we have provided additional accommodations through two unconventional policy tools aimed at putting downward pressure on longer term interest rates; asset purchases that reduce the supply of longer term security outstanding in the market and communication about the future path of policy.

Most recently after the September FOMC meeting, we announced that the federal reserve would

purchase additional mortgage backed securities or MBS and would continue with the program to extend the maturity of our treasury holdings. These additional asset purchases should put downward pressure on longer term interest rates and make broader financial conditions more accommodative. Moreover, our purchases of MBS by bringing down mortgage rates, provides support directly to housing and thereby help mitigate some of the headwinds that are facing that sector.

In announcing this decision we also indicated that we would continue purchasing MBS, undertake additional purchase of longer term securities, and employ our other policy tools, until we judge that the outlook for the labor market has improved substantially in a context of price stability.

Although it is still too early to assess the effects of our most recent policy actions, yields on corporate bonds and agency MBS have fallen significantly on balance since the FOMC's announcement. More generally, research suggests that our previous asset purchases have eased overall financial conditions and provided meaningful support to the economic recovery in recent years.

In addition to announcing new purchases of MBS, at our September meeting we extended our guidance for how long we expect that exceptionally low levels of the federal funds rate will likely be warranted, at least through the middle of 2015. By pushing the expected period of low rates further into the future, we are not saying that we expect the economy to remain weak until mid 2015, rather we expect, as we indicated in our September statement, that a highly

accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.

In other words, we want to be sure that the recovery is established before we begin to normalize policy. We hope that such assurances will reduce uncertainty and increase confidence among households and businesses, thereby providing additional support for economic jobs, economic growth and job creation.

In sum, the U.S. economy continues to be hampered by the lingering effects of the financial crisis on its productive potential, and by a number of headwinds that have hindered the normal cyclical adjustment of the economy. The Federal Reserve is doing its part by providing accommodative monetary policy to promote a stronger economic recovery in a context of price stability.

As I have said before, however, while monetary policy can help to support economic recovery, it is by no means a panacea for our economic ills. Currently uncertainties about the situation in Europe and especially about the prospects for federal fiscal policy seem to be weighing on the spending decision of households and businesses as well as on financial conditions. Such uncertainties will only be increased by discord and delay.

In contrast, cooperation and creativity to deliver a fiscal clarity, in particular, a plan for resolving the nations longer-term budgetary issues without harming the recovery, could help make the new

year a very good one for the American economy.

Thank you very much. (Applause)

Question and Answer Session

ROGER FERGUSON: Thank you very much Chairman Bernanke. As is our custom, Chairman Bernanke has agreed to be questioned by two of our members. Today's questioners are Alan Blinder, Professor of Economics and Public Affairs at Princeton, and former Vice Chairman of the Federal Reserve. And Martin Feldstein, Professor of Economics at Harvard and former Chairman of the President's Council of Economic Advisors.

If you have questions, you can email them to questions@econclubny.org, and our President Jan Hopkins will read them. Alan, you have the first question.

ALAN BLINDER: Mr. Chairman, thank you for coming here and speaking to us today. You alluded briefly to the Federal Reserve's communication strategy, as an important method of monetary policy these days. As we all know the FOMC is struggling somewhat with its communications and in particular how to move away from a calendar based forward guidance such as through mid-2015 and toward a more economic conditions based sort of guidance. Could you explain to us why this is so hard. And in particular why we can't use suitable words

to replace the kind of threshold numbers that you find in formulations such as Charles Evans and others have advocated.

BEN BERNANKE: As you know, communication and forward guidance about our policy has been very important now for some time. As a general matter, when the short-term interest rate, our usual policy tool, goes to zero, where it is, one of the main tools we have for influencing overall financial conditions is providing guidance to the public about where we expect the rate to go in the future. That forward guidance has evolved over time. We use some qualitative language, even before my chairmanship, considerable periods and so on. More recently we have begun to talk about dates. We begin to give an assessment of when we expect the policy to become less accommodative. Where we expect to begin to raise the federal funds rate. Now, a difficulty with dates, besides the fact that it is not very transparent, is that it mixes together two issues. One issue is how long does the fed think that the economy is going to need life support, so to speak, how long is the economy going to be in a weak condition. But also, what is the feds response to that going to be. What is the so called reaction function. How is the fed going to respond to economic conditions. Those two things are conflated with the date. That is a problem with the date and we recognize that. We have tried to address that, and did, in our language that I mentioned in my remarks, going back to September when we said that our date where we expected the rate to begin to rise was at least mid-2015, but we also made clear that we anticipate raising rates only after the economic recovery has begun to strengthen. So clearly an important reason why we are looking to hold rates low for almost three years is that we want to be particularly sure not to take away accommodation before the economy has established upward

momentum, so to speak. Now, there are different ways to communicate that information and one possibility would be to provide some specific numbers on what economic conditions would prompt us, or at least make us consider the process of removing accommodation. Several people on the committee have made suggestions. You mentioned Charlie Evans, Janet Yellen has talked about it, and so on. This is something we are looking at very carefully. It does have the advantage that it would help to distinguish between our anticipation for how the economy is going to evolve and how we react to those conditions. And it would have another advantage which is that as economic conditions vary, as news comes in, that makes the markets think that unemployment is going to be low or high for longer, for example, that would automatically lead the markets to adjust rates appropriately. So there are some definite advantages. On the other side, and these are issues that a number of my other colleagues have raised, is that, monetary policy is a complex process, as you know. We have an enormous amount of material prepared for us at every meeting, forecasts, detailed data analyses and so on, and the question is, can we ... first of all, can we reasonably summarize those conditions under which we would begin to tighten policy, with just two numbers, or two or three numbers, and even if we could, can we get sufficient agreement on the committee to do that. So this is a very promising direction we are continuing to look at and we are continuing to try to improve our communication more generally, and that effort is going to continue to go on. But as the committee is still discussing this particular approach, I don't want to front-run those discussions which are still ongoing.

MARTIN FELDSTEIN: Ben, thanks very much. You spoke about housing and you explained to us that the level of mortgage lending and therefore home buying is being depressed by the

commercial banks overly tight lending standards. So my question is, what can the fed do to improve this, and therefore to increase mortgage lending beyond reducing mortgage interest rates?

BEN BERNANKE: So as I indicated in my remarks, the housing sector has been a major player in this drama. First with the boom and then the collapse and now playing a role in the recovery as we hoped. In terms of expanding mortgage lending expanding the growth of the housing sector, you said, beyond interest rate policy, but I do have to mention interest rate policy. I think one of the strongest things that we can do is maintain low mortgage interest rates, they are at historic lows as you know, and combined with a 30 percent decline in house prices across the country means that we have extensive affordability now for people who are interested in buying new homes. Now the reason I bring this up is that I think there are some positive dynamics that can occur here. In particular to the extent that the housing market appears to be now moving in the right direction and we are beginning to see increases in house prices, that in turn is going to feed back on mortgage lender decisions. Because one of the reasons that they have been keeping mortgage conditions tight is that they have been afraid of further house price declines, a weak economy, unemployment, those sorts of things that could lead to mortgage defaults in the future. So I think if we can get ourselves into a positive, virtuous circle here with rising house prices, rising construction, improving employment, I think that part of that process will be easing of mortgage lending conditions. Moreover as we keep rates low and as the profitability of mortgage lending goes up, we will see, and there is a lot of evidence now, that banks are beginning to expand their capacity and their interest in making mortgage loans. So I think the

monetary policy part is obviously a very big part of it. We have some other ways of addressing this. I guess I would summarize them as regulatory, supervisory, and would it be analytical. On the regulatory side, of course we are very much involved in the writing of the rules for implementing both Dodd-Frank and the Basel Accords. While, those rules are about broad financial stability, many aspects of those rules do affect the incentives for mortgage lending. For example, the capital weights on mortgages, rules for securitization and so on. While again, our objectives in writing these rules are of course the primary focus in Dodd-Frank and the Basel Accords is to achieve greater financial stability, we would like to think about taking into account the housing aspects there. On the supervisory side we have, as one of the banking supervisors, we have made an ongoing effort to promote mortgage lending by first encouraging banks to take an appropriate balance between prudence on the one hand and making loans to credit worthy borrowers on the other hand. We do not take the view that tighter is always better. I think there is an appropriate balance to be struck, and we have encouraged that. We have also done a variety of things to try to help on the margin. For example, we have encouraged banks rather than selling empty real estate owned, empty foreclosed homes into the market, to rent them for a period if that is appropriate. We were also part of the very large mortgage settlement, which you are aware of, which part of the outcome of that is that banks have been working hard to increase their modifications to reduce foreclosures, to assist homeowners who were unfairly treated in the past and so on. So from a supervisory, regulatory perspective, we are trying to help. But in that respect we are like other regulatory agencies who are addressing this issue. Finally, and I don't want to underestimate this part, analytically, the Federal Reserve as you know has many, many good economists. And we have devoted quite a few of them to studying housing issues, all the

way back to the beginning of the crisis and before. And we have been influential in talking to other agencies, talking to the Treasury, talking to the Congress, in providing ideas and approaches. For example, as you may know, about a year ago we put out a White Paper which describes some of the key issues and some of the approaches and provide us an analysis for things that could be done to improve mortgage lending. We also have been very supportive of steps like those taken by the financial ... the housing oversight, the GSC oversight body to take steps like to clarify the conditions under which mortgages would be put back to lenders, the so called put back risk. Or creating programs that again convert empty houses into rentals. So we have had a lot of influence I think from an analytical, intellectual point of view and we will continue to try to do that. But these are, I think, the bottom line here is that these are very challenging problems and the barriers to more mortgage lending and to more rapid growth in the housing sector are many and diverse. There is not a single magic bullet, as I know you appreciate. So we are trying to work on every margin that we can.

ALAN BLINDER: In discussions of unconventional monetary policies, of which you were discussing several, the question of lowering the interest rate on excess reserves often comes up and I am often asked, why doesn't the Federal Reserve do it. I usually fumble for some sort of an issue which I don't think is a very good answer but I think you could probably do better. What would be your answer?

BEN BERNANKE: Well I hope I can do better, I don't know. So here is the question. So the question is the following. The Federal Reserve is the repository so to speak of a very large

amount of reserves that the banks hold with the Federal Reserve and we currently pay interest on those reserves, the interest in excess reserves, of 25 basis points, which is one-fourth of 1 percent, a very, very low interest rate that we pay. Now, I say parenthetically that this ability that we have to pay interest on reserves is going to be very important in the future because when the time comes to raise interest rates, one of the tools that we have to do that, will be this interest on excess reserves which we can raise at the appropriate time. And this is in the power of the Board of Governors to raise. And by raising it, we will cause short term rates across the spectrum to rise because banks obviously are not going to lend into money markets at a price lower than they can get from the fed. So this is a very important instrument for us and we will be using that at some point, at the appropriate time, to begin the tightening of the monetary policy. Now you are talking about the other direction. Why don't we just cut it to zero, pay no interest on excess reserves and thereby get a little bit more accommodation. Well it is something we have considered repeatedly and we will continue to consider. I don't rule it out as an action in the future. The cost benefit analysis we have done in looking at it, starting from where we are at 25 basis points is the following. If we were to cut that interest rate from 25 basis points to zero, our estimate is that it would effect very short term interest rates like overnight rates by something on the order of 8 or 9 basis points. An extremely small amount. And that in turn would have even a smaller affect on the interest rates we care about, like the rates on auto loans or houses etc. So the stimulative affect of that action, while going in the right direction, we assess as being very, very small. On the other side, the concern we have, or at least some have had, is that if there is no return on overnight money that a variety of different institutions, money market funds, repo markets and so on, may become more liquid because there will be less... very

little incentive for participants to transact in those markets when interest pays zero. Why not just hold cash or hold ___ reserves. And so the concern is that perhaps the federal fund rate itself may become less informative because it is being determined in a less liquid market. So those are the kinds of concerns we have had. Now we have seen some interesting experiments and relatively recently we have seen in Europe for example, an analogous interest rate or a deposit interest rate has been cut to zero. And it is hard to judge what the affect of that really is because the interbank markets in Europe are not working very much anyway. So there is a bit of a question as to what affect that it has had. But those are the kinds of tradeoffs we are looking at. I think it is wrong to think of this as a major tool that is unused. I mean I think if it were used it would have some effects that would probably be at least marginally disruptive in terms of market functioning. On the other side, it would add just a few more basis points of accommodation. It is a relatively small cost benefit calculation. That is where we have come out to this point.

MARTIN FELDSTEIN: Ben you mentioned the fiscal cliff. I think everybody here and a lot of people who aren't here, are very worried about what happens if we go over the fiscal cliff with estimates that the combination of higher taxes and spending cuts would take some 4 percent out of an otherwise relatively weak GDP. But even if we don't and some deal is struck, the combination of eliminating the payroll tax reduction which seems to be something that the administration supports, that together with some base broadening would probably be at least 2 percent of GDP. If there is going to be a deal, it would involve spending cuts as well. So even if we avoid going over the cliff, it looks like there would be substantial fiscal contractionary impact next year. So in that environment, what can the fed do to try to offset that to make sure that it

doesn't take us to the edge of or over the edge of a recession.

BEN BERNANKE: So we will see what kind of deal comes out. I think there is still a range of possibilities. But you are correct that even if the most extreme scenarios are avoided, that some plausible scenarios still involve relatively contractionary fiscal policy overall. I made that point in my remarks, where I said, under most plausible scenarios, no matter what happens next year that the tightening of federal fiscal policy will outweigh the stronger, more expansionary state and local fiscal policy we are getting. So all of that is right. It is up to Congress and the president of course to figure out how they want to make the trade-offs between getting the budgetary improvement in the long run, and providing additional support for the economy in the short run. Then we are going to have to see how that goes. I think, again, my advice on this is sort of do no harm, and in that respect, what I am particularly concerned about is that we avoid full force of the cliff which would be quite substantial as you pointed out. So if there is some federal tightening at the federal level, offset to some extent by state and local government, then that would be an ongoing headwind along the lines of what I described in my remarks. But again, I think in that situation, the economy is still growing, albeit, not necessarily at a rapid pace. What the Federal Reserve can do and will do is continue its stated policy which is to do additional asset purchases by MBS and take whatever other actions are appropriate to try to ensure that the outlook for labor markets improve in a sustained way, and a substantial way. So we will continue to do our best to add monetary support to the recovery. A point that I have made though and I do want to reiterate this is that the ability of the fed to offset headwinds is not infinite. We have certain tools, we have obviously used our easiest tools. And we can certainly

have a meaningful contribution to supporting recovery, but in particular, in a worse case scenario where the economy goes off the broad fiscal cliff or the largest fiscal cliff, which according to CBO and to our own analysis, would throw the economy into a recession, I don't think the fed has the tools to offset that. That is why it is important for Congress to address these fiscal issues soon and in a bipartisan way, in a way that achieves the necessary long-term sustainability concerns that I know you have talked about frequently, but also takes into account exactly this issue of how much restraint we will be experiencing in the next six months to a year from the fiscal changes.

ROGER FERGUSON: Why don't we have Jan Hopkins ask a question from the audience. Jan.

JAN HOPKINS: You talked about the uncertainty of businesses because of all of the things that you also mentioned and that is impacting decisions on investment, etc. How much growth is being lost because of that, do you anticipate?

BEN BERNANKE: Well it is neither here nor there. But when I was a graduate student 30 years ago, I wrote my dissertation on the question of how uncertainty affects investment spending. And I concluded that it is not a good thing. (laughter) They gave me a PhD for that. So it seems pretty clear. One of the benefits of the way the Federal Reserve operates, you know, we have 12 reserve banks around the country. Bill Dudley who is here is President of the Federal Reserve Bank of New York, and at the FOMC we have folks therefore from all around the country with experiences in different backgrounds who in turn are talking to their boards, talking to local

citizens and other business people, bankers, trying to get a sense of the economy. So we hear an awful lot around the FOMC table of an anecdotal nature. And it is certainly true that businesses are very concerned about uncertainty and that it seems to be a drag on investment spending and hiring decisions. In fact, I think it is kind of striking that right now consumers seem to be actually doing a little better. Consumer sentiment has risen, consumer spending has been a bit stronger, but businesses, probably in part because they are more exposed to the global economy, in part because they may be more aware of some of these fiscal issues, and are more directly connected to these fiscal issues, business confidence has been pretty low and investment response to that has been quite weak. So I think uncertainty has been an important factor. I am sure that it is restraining particularly longer term investments. It is leading businesses to wait for the resolution of uncertainty before they make commitments to new hiring and to new projects and to new markets, and so in that respect, it is clearly a negative. Now what is difficult is a couple of things. First, you asked for how much. I think it is probably significant. But it is very, very hard to assess in any kind of rigorous way exactly how big the affects are, but again, I think they are meaningful because as we see businesses have been quite cautious and conservative, particularly lately. The other question that I think though is very important is uncertainty about what. There is a lot of uncertainties in the world now. There is uncertainties in Europe, there is uncertainties in the fiscal policy, there is uncertainties about the stability and strength of the recovery. And it is a little bit harder to separate all of those different factors when you ask business people what do they most worry about. So what we would like to do is attack that issue on all fronts. I think fiscal policy has a role to play. We hope our European colleagues will take necessary actions to create more stability on the continent. And as for the Federal

Reserve, we are going to do what we can to support ongoing recovery in growth and jobs and create the demand for output, the demand for the firms product, that will remove that uncertainty about the future and sustainability of the recovery. So if we work on all of these margins, I hope that we will help restore the kind of confidence that we need to see a strong recovery. I really have a sense that there is a lot of unused capability. Not just in terms of unemployed workers, but in terms of potential products, investments, new technologies, things that are just being on the shelf or not being utilized to the full extent because people are waiting to see how things will evolve. I do think there is important potential for the economy to strengthen significantly if there is a greater level of security and comfort about where we are going as a country. So I hope very much that is what is going to happen. Thank you very much. (Applause)

ROGER FERGUSON: So Chairman Bernanke, on behalf of all of us, thank you very much for that very insightful set of prepared remarks and questions and answers. I also want to thank Alan and Marty for the great questions. So before lunch is served let me announce that our next schedule event will be a lunch on December 10th with Sir Mervyn King, the Governor of the Bank of England. So thank you all for coming today and please enjoy your lunch. Thank you very much.