THE ECONOMIC CLUB

OF WASHINGTON, D.C.

Excerpts from the Signature Event featuring The Honorable Ben S. Bernanke, Chairman, United States Federal Reserve

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A year ago, our economy – indeed, all of the world's major economies – were reeling from the effects of a devastating financial crisis. Policymakers here and abroad had undertaken an extraordinary series of actions aimed at stabilizing the financial system and cushioning the economic effects of the crisis. Critically, these policy interventions succeeded in averting a global financial meltdown that could have plunged the world into a second Great Depression. But, although a global economic cataclysm was avoided, the crisis nevertheless had widespread and severe economic consequences, including deep recessions in most of the world's major economies.

By the middle of this year inventories have been sufficiently reduced to encourage firms in a wide range of industries to begin increasing output again, contributing to the recent upturn in the nation's GDP.

It is encouraging that we have begun to see some evidence of stronger demand for homes and for consumer goods and services. . . . Consumer spending also has been rising since midyear. Part of this increase reflected a temporary surge in auto purchases that resulted from the "cash for clunkers" program, but spending in categories other than motor vehicles has increased as well. In the business sector, outlays for new equipment and software are showing tentative signs of stabilizing, and improving economic conditions abroad have buoyed the demand for U.S. exports.

Though we have begun to see some improvement in economic activity, we still have some way to go before we can be assured that the recovery will be self-sustaining. Also at issue is whether the recovery will be strong enough to create the large numbers of jobs that will be needed to materially bring down the unemployment rate. Economic forecasts are subject to great uncertainty, but my best guess at this point is that we will continue to see modest growth next year – sufficient to bring down the unemployment rate, but at a pace slower than we would like.

The economy confronts some formidable headwinds that seem likely to keep the pace of expansion moderate. Despite the general improvement in financial conditions, credit remains tight for many borrowers, particularly bank dependent borrowers such as households and small businesses. And the job market, though no longer contracting at the pace we saw in 2008 and earlier this year, remains weak. Household spending is unlikely to grow rapidly when people remain worried about job security and have limited access to credit.

The Federal Reserve has been, and still is, doing a great deal to foster financial stability and to spur recovery in jobs and economic activity. Notably, we began the process of easing monetary policy in September 2007, shortly after the crisis began. By mid-December 2008, our target rate was effectively as low as it would go – within a range of zero to one-fourth percent, compared with 5-and-a-quarter percent just before the crisis. And we have maintained that very low rate for the past year.

Our efforts to support the economy have gone well beyond conventional monetary policy, however. I have already alluded to the Federal Reserve's close cooperation with the Treasury, the Federal Deposit Insurance Corporation, and other domestic and foreign authorities in a concerted and ultimately successful effort to stabilize the global banking system, which verged on collapse following the extraordinary events of September and October 2008. We subsequently took strong measures, independently or in conjunction with other agencies, to help normalize key financial institutions and credit markets disrupted by the crisis.

We also established and subsequently expanded special arrangements with other central banks to provide dollars to global funding markets, as we found that disruptions in dollar-based markets abroad were spilling over to our own markets. More recently, we played an important part in helping to re-start the markets for asset-backed securities that finance auto loans, credit card loans, small business loans, student loans, loans to finance commercial real estate and other types of credit. By working to revive these markets, which allow banks to tap the broader securities markets to finance their lending, we have helped banks make room on their balance sheets for new credit to households and businesses. In addition, we have supported the overall functioning of private credit markets and helped to lower interest rates on bonds, mortgages, and other loans by purchasing unprecedented volumes of mortgage related securities and Treasury debt.

This spring, we led a coordinated, comprehensive examination of 19 of the country's largest banks, an exercise formally known as the Supervisory Capital Assessment Program, or SCAP, but more informally as the "stress test." This assessment was designed to ensure that these banks, which collectively hold about two-thirds of the assets in the U.S. banking system, would remain well-capitalized and able to lend to creditworthy borrowers even if economic conditions turned out to be even worse than expected. The release of the assessment results in May provided sorely needed clarity about the banks' condition and marked a turning point in the restoration of confidence in our banking system.

The most difficult challenge for the Federal Open Market Committee will not be devising the technical means of unwinding monetary stimulus. Rather, it will be the challenge that faces central banks in every economic recovery, which is correctly judging the best time to tighten policy. Because monetary policy affects the economy with a lag, we will need to base our decision on our best forecast of how the economy will develop. As I said a few moments ago, we currently expect inflation to remain subdued for some time. It is also reassuring that longer-term inflation expectations appear stable. Nevertheless, we will keep a close eye on inflation risks and will do whatever is necessary to meet our mandate to foster both price stability and maximum employment.

Although the sources of the crisis were extraordinarily complex and numerous, a fundamental cause was that many financial firms simply did not appreciate the risks that they were taking. Their risk-management systems were inadequate, and their capital and liquidity buffers insufficient. Unfortunately, neither the firms nor the regulators identified and remedied many of the weaknesses soon enough. Thus, all financial regulators, including the Federal Reserve, must undertake unsparing self-assessments.

At the Federal Reserve, we have . . . moved to strengthen our oversight of banks. Working cooperatively with other agencies, we are toughening our banking regulations to help constrain excessive risk-taking and enhance the ability of banks to withstand financial stress. For example, we have been among the leaders of international efforts, through organizations such as the Basel Committee on Bank Supervision, to increase the quantities of capital and liquidity that banks must hold. At home, we are implementing standards that require banking organizations to adopt compensation policies that link pay to the institutions' long-term performance and avoid encouraging excessive risk-taking.

We are applying the lessons learned in *[SCAP, the stress test of banks]* to reorient our approach to the supervision of large, interconnected banking organizations that are critical to the stability of the financial system. In particular, we are taking a more "macroprudential" approach, one that goes beyond supervisors' traditional focus on the health of individual institutions and scrutinizes the interrelationships among firms and markets to better anticipate possible sources of financial contagion.

We are complementing our traditional onsite examinations with enhanced off-site surveillance programs, under which multidisciplinary teams will combine supervisory information, firm-specific data analysis, and market-based indicators to identify problems that may affect one or more banking institutions.

Congress also must act to fix gaps and weaknesses in the structure of the regulatory system and, in so doing, they must address the very serious problem posed by firms perceived as being "too big to fail." No firm, by virtue of its size and complexity, should be permitted to hold the financial system, the economy, or the American taxpayer hostage.

. . . in the fall of last year, the United States – indeed, the world – confronted a financial crisis of a magnitude unseen for generations. Concerted actions by the Federal Reserve and other policymakers here and abroad helped avoid the worst outcomes. Nevertheless, the turmoil dealt a severe blow to our economy from which we have only recently begun to recover. The improvement of financial conditions this year and the resumption of growth over the summer offer the hope and expectation of continued recovery in the new year. However, significant headwinds remain, including tight credit conditions and a weak job market.

What changed the Depression from a regular contraction into a Great Depression was the intense financial crisis, which gathered steam in 1931, particularly the collapse of large banks in Central Europe in May of 1931, which then spread around the world. The collapse of the financial system, which destroyed credit creation and created huge amounts of financial instability was the major factor that drove the world economy – not just the United States – into a deep depression between 1931 and 1933. It was the stabilization of the banking system with the bank holiday in 1933 and leaving the gold standard, which allowed monetary policy to become more supportive in 1933 – those were the measures that caused the U.S. economy to come back.