Fed Chairman Bernanke Assesses the Recovery So Far

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SOUND BITES FROM CHAIRMAN BERNANKE'S REMARKS

Question #1: Where is the economy headed? 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. A number of factors support the view that the recovery will continue next year. **Q #2:** What has the Federal Reserve been doing to support the economy and the financial system? A great deal. 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. Our efforts to support the economy have gone well beyond conventional monetary policy…. **Q #3:** Will the Federal Reserve's action to combat the crisis lead to higher inflation down the road? No, the Federal Reserve is committed to keeping inflation low and will be able to do so. **Q #4:** How can we avoid a similar crisis in the future? A fundamental cause was that many financial firms simply did not appreciate the risks that they were taking….At the Federal Reserve, we have extensively reviewed our performance and moved to strengthen our oversight of banks….In particular, we are taking a more "macroprudential" approach, one that goes well 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. **Avoiding "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. To eliminate that possibility, a number of steps are required. **Step #1:** All systemically important financial institutions, not only banks, should be subject to strong and comprehensive supervision on a consolidated, or firm-wide, basis…. **Step #2:** When a systemically important institution does approach failure, government policymakers must have an option other than bailout or a disorderly, confidence-shattering bankruptcy. **Step #3:** Our regulatory structure requires a better mechanism for monitoring and addressing emerging risks to the financial system as a whole. **Overview:** To close, I will again note that 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. **Outlook:** The Federal Reserve has been aggressive in its efforts to stabilize our financial system and to support economic activity. At some point, however, we will need to unwind our accommodative policies in order to avoid higher inflation in the future. I am confident that we have both the tools and the commitment to make that adjustment when it is needed and in a manner consistent with our mandate to foster employment and price stability. **Financial firms:** In the meantime, financial firms must do a better job of managing the risks of their business, and regulators – the Federal Reserve included – must complete a thoroughgoing overhaul of their approach to supervision. And the Congress should move forward in making needed changes to our system of financial regulation to avoid a similar crisis in the future. In particular – and importantly – we must solve the problem of "too big to fail."

DAVID RUBENSTEIN: Thank you all for coming today. I'm David Rubenstein, President of The Economic Club of Washington. Welcome to the fourth event of our 23rd season at the Economic Club. We're very pleased and of course honored to have the Chairman of the Federal Reserve Board of Governors with us today, Ben Bernanke. He has been such a draw that we now have the biggest single attendance of any Economic Club of Washington event in our 23 years. [Applause.]

Chairman Bernanke is the 14th person to serve in that position since the Federal Reserve was created in 1913. He came to the Federal Reserve chairmanship from two other positions in government. He had previously served for 3 years as a member of the Federal Reserve Board of Governors, appointed by President George W. Bush. After 3 years of service there, he was appointed by President Bush as Chairman of the Council of Economic Advisors. He assumed his position as chairman of the Federal Reserve Board of Governors on February 1, 2006, and has recently been renominated by President Obama for another 4-year term as Chairman, now subject to Senate confirmation.

Before he began his career in government, Ben Bernanke had a very distinguished academic career. In high school, he was valedictorian of his class, a person who got an almost perfect SAT score, 1590. [Laughter.] I've asked him what he got wrong; he doesn't know what the one answer he got wrong was, but he got 1590, the highest in the entire state of South Carolina.

He was accepted at Harvard, went to Harvard College, graduated *summa cum laude* in economics and was elected to Phi Beta Kappa, and went to MIT to get his Ph.D. He then went to Stanford Business School as an Assistant Professor and then Associate Professor of Economics. In 1985, Dr. Bernanke went to Princeton University as a Professor of Economics and rose to become Chairman of the Economics Department in 1996.

In his tenure as an academic, Dr. Bernanke became a leading expert on the Great Depression and the way that the Depression was handled by the Federal Reserve. He was one of the most well-known economists in that area and is one of the most published and quoted economists in that entire area.

So we're very honored to have him. Enormous respect has developed for him around the world in terms of his authority and in terms of his intellect. We're very pleased to hear his comments today on the economy. Thank you. [Applause.]

CHAIRMAN BERNANKE: Thank you very much. Well, it's very nice to be here again at The Economic Club of Washington. Having faced the most serious financial crisis and the worst recession since the Great Depression, our economy has made important progress during the past year. Although the economic stress faced by many families and businesses remains intense, with job openings scarce and credit still hard to come by, the financial system and the economy have moved back from the brink of collapse, economic growth has returned, and the signs of recovery have become more widespread.

Understandably, in a situation as complicated as this one, people have many questions about the current situation and the path forward. Accordingly, taking inspiration from the ubiquitous frequently-asked-questions lists, or FAQs, on Internet Web sites, in my remarks today I'd like to address four important FAQs about the economy and the Federal Reserve. They are: First, where is the economy headed? Second, what is the Federal Reserve doing to support the economy and the financial system? Third, will the Federal Reserve's actions lead to higher inflation down the road? And, fourth, what can we do to avoid a similar crisis in the future?

First, to understand where the economy might be headed, we should take a look at where it has been recently. 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. In the United States, for example, the unemployment rate, which was as low as 4.4% in March 2007, currently stands at 10%.

Recently we have seen some pickup in economic activity, reflecting, in part, the waning of some forces that had been restraining the economy during the preceding several quarters. The collapse of final demand that accelerated in the latter part of 2008 left many firms with excessive inventories of unsold goods, which in turn led them to cut production and employment aggressively. This phenomenon was especially evident in the motor vehicle industry, where automakers, a number of whom were facing severe financial pressures, temporarily suspended production at many plants. By the middle of this year, however, 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.

Although the working down of inventories has encouraged production, a sustainable recovery requires renewed growth in final sales. It is encouraging that we have begun to see some evidence of stronger demand for homes and for consumer goods and services. In the housing sector, sales of new and existing homes have moved up appreciably over the course of the year, and prices have firmed a bit. Meanwhile, the inventory of unsold new homes has been shrinking. Reflecting these developments, homebuilders have somewhat increased the rate of new construction – a marked change from the steep declines that have characterized the past few years.

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.

A number of factors support the view that the recovery will continue next year. Importantly, financial conditions continue to improve: Corporations are having relatively little difficulty raising funds in the bond and stock markets, stock prices and other asset values have recovered significantly from their lows, and a variety of indicators suggest that fears of systemic collapse have receded substantially. Monetary and fiscal policies are supportive. And I have already mentioned what appear to be improving conditions in housing, consumer expenditure, business investment, and global economic activity.

On the other hand, 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.

Inflation is affected by a number of crosscurrents. High rates of resource slack are contributing to a slowing in underlying wage and price pressures, and longer-run inflation expectations are stable. Commodities prices have risen lately, likely reflecting the pickup in global economic activity and the depreciation of the dollar. Although we will continue to monitor inflation closely, on net it appears likely to remain subdued for some time.

The discussion of where the economy is headed brings us to our second question: What has the Federal Reserve been doing to support the economy and the financial system? 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. Among these were the money market mutual fund industry, in which large numbers of American households, businesses, and municipalities make short-term investments; and the commercial paper market, which many firms tap to finance their day-to-day operations.

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.

In all of these efforts, our objective has not been to support specific financial institutions or markets for their own sake. Rather, recognizing that a healthy economy requires well-functioning financial markets, we have moved always with the single aim of promoting economic recovery and economic opportunity. In that respect, our means and goals have been fully consistent with the traditional functions of a central bank and with the mandate given to the Federal Reserve by the Congress to promote price stability and maximum employment.

In addition to easing monetary policy and acting to stabilize financial markets, we have also worked in our role as a bank supervisor to encourage bank lending. In November 2008 we joined with other banking regulators to urge banks to continue lending to creditworthy borrowers – to the benefit of both the economy and the banks – and we have recently provided guidelines to banks for working constructively with troubled commercial real estate loans.

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. In the months since then, and with the strong encouragement of the federal banking supervisors, many of these largest institutions have raised billions of dollars in new capital, improving their ability to withstand possible future losses and to extend loans as demand for credit recovers.

Meanwhile, we have also continued our efforts to ensure fair treatment for the customers of financial firms. During the past year-and-a-half, we have comprehensively overhauled the regulations protecting mortgage borrowers, credit card holders, and users of overdraft protection plans, among others.

In navigating through the crisis, the Federal Reserve has been greatly aided by the regional structure established by the Congress when it created the Federal Reserve in 1913. The more than 270 business people, bankers, nonprofit executives, academics, and community, agricultural, and labor leaders who serve on the boards of the 12 Reserve banks and their 24 branches provide valuable insights into current economic and financial conditions that statistics alone cannot.

Thus, the structure of the Federal Reserve ensures that our policymaking is informed not just by a Washington perspective, or a Wall Street perspective, but also a Main Street perspective. Indeed, our Reserve banks and branches have deep roots in the nation's communities and do much good work there. They have, to give just a couple of examples, assisted organizations specializing in foreclosure mitigation and worked with nonprofit groups to help stabilize neighborhoods hit by high rates of foreclosure.

They, as well as the Board, are also much involved in financial and economic education, helping people to make better financial decisions and to better understand how the economy works. All told, the Federal Reserve's actions – in combination with those of other policymakers here and abroad – have helped restore financial stability and pull the economy back from the brink.

Because of our programs, auto buyers have obtained loans they would not have otherwise obtained, college students are financing their educations through credit they otherwise likely would not have received, and home buyers have secured mortgages on more affordable and sustainable terms than they would have otherwise. These improvements in credit conditions in turn are supporting a broader economic recovery.

The scope and scale of our actions, however, while necessary and helpful in my view, have left some uneasy. In all, our asset purchases and lending have caused the Federal Reserve's balance sheet to more than double, from less than $900 billion before the crisis began to about $2.2 trillion today. Unprecedented balance sheet expansion and near-zero overnight interest rates raise our third frequently asked question: Will the Federal Reserve's actions to combat the crisis lead to higher inflation down the road?

The answer is no; the Federal Reserve is committed to keeping inflation low and will be able to do so. In the near term, elevated unemployment and stable inflation expectations should keep inflation subdued, and indeed, inflation could move lower from here. However, as the recovery strengthens, the time will come when it is appropriate to begin withdrawing the unprecedented monetary stimulus that is helping to support economic activity. For that reason, we have been giving careful thought to our exit strategy. We are confident that we have all the tools necessary to withdraw monetary stimulus in a timely and effective way.

Indeed, our balance sheet is already beginning to adjust, because improving financial conditions are leading to substantially reduced use of our lending facilities. Our balance sheet will also shrink over time as the mortgage-backed securities and other assets we hold mature or are prepaid. However, even if our balance sheet stays large for a while, we will be able to raise our target short-term interest rate – which is the rate at which banks lend to each other overnight – and thus tighten financial conditions appropriately.

Operationally, an important tool for adjusting the stance of monetary policy will be the authority, granted to us by the Congress last year, to pay banks interest on balances they hold at the Federal Reserve. When the time comes to raise short-term interest rates and thereby tighten policy, we can do so by raising the rate that we offer banks that hold balances with us. Banks will be unwilling to make overnight loans to each other at a rate lower than the rate that they can earn risk-free from the Fed, and so the interest rate we pay on banks' balances will tend to set a floor below our target overnight loan rate and other short-term interest rates.

Additional upward pressure on the short-term interest rates can be achieved by measures to reduce the supply of funds that banks have available to lend to each other. We have a number of tools to accomplish this. For example, through the use of a short-term funding method known as reverse repurchase agreements, we can act directly to reduce the quantity of reserves held by the banking system. By paying a slightly higher rate of interest, we can also induce banks to lock up their balances in longer-term accounts with us, making those balances unavailable for lending in the overnight market. And, if necessary, we always have the option of reducing the size of our balance sheet by selling some of our securities on the open market.

As always, 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.

As we at the Federal Reserve and others work to build on the progress already made toward securing a sustained economic recovery with price stability, we must also continue to address the weaknesses that led to the current crisis. Thus, our final question this afternoon is: How can we avoid a similar crisis in the future? 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 extensively reviewed our performance and 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.

I mentioned the SCAP, otherwise known as the stress tests. We are applying the lessons learned in that exercise 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.

To do that, we are expanding our use of the kind of simultaneous and comparative cross-firm examinations that we used to such good effect in the SCAP. The Federal Reserve's ability to draw on a range of disciplines – using economists, market experts, accountants, and lawyers, in addition to bank examiners – was essential to the success of the SCAP, and a multidisciplinary approach will be a central part of our supervision in the future.

For example, 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.

Although regulators can do a great deal on their own to improve financial oversight, the 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. To eliminate that possibility, a number of steps are required.

First, all systemically important financial institutions, not only banks, should be subject to strong and comprehensive supervision on a consolidated, or firm-wide, basis. Such institutions should be subject to tougher capital, liquidity, and risk-management requirements than other firms – both to reduce their chance of failing and to remove their incentive to grow simply in order to be perceived as too big to fail. Neither AIG, an insurance company, nor Bear Stearns, an investment firm, was subject to strong consolidated supervision.

The Federal Reserve, as the regulator of bank holding companies, already supervises many of the largest and most complex institutions in the world. That experience, together with our broad knowledge of the financial markets, makes us well-suited to serve as the consolidated supervisor for systemically important nonbank institutions as well. In addition, our involvement in supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions of promoting financial stability and of making monetary policy.

Second, when a systemically important institution does approach failure, government policymakers must have an option other than bailout or a disorderly, confidence-shattering bankruptcy.

The Congress should create a new resolution regime, analogous to the regime currently used by the FDIC for failing banks, that would permit the government to wind down a troubled systemically important firm in a way that protects financial stability, but that also imposes losses on shareholders and creditors of the failed firm without costs to the taxpayer.

Imposing losses on creditors of troubled, systemically critical firms would help address the too-big-to-fail problem by restoring market discipline and leveling the playing field for smaller firms, while minimizing the disruptive effects of a failure on the financial system and the economy.

And third, our regulatory structure requires a better mechanism for monitoring and addressing emerging risks to the financial system as a whole. Because of the size, diversity, and complexity of our financial system, that task may exceed the capacity of any individual agency. The Federal Reserve therefore supports the creation of a systemic oversight council made up of the principal financial regulators to identify developments that may pose systemic risks, to recommend approaches for dealing with them, and to coordinate the responses of its member agencies.

To close, I will again note that 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.

The Federal Reserve has been aggressive in its efforts to stabilize our financial system and to support economic activity. At some point, however, we will need to unwind our accommodative policies in order to avoid higher inflation in the future. I am confident that we have both the tools and the commitment to make that adjustment when it is needed and in a manner consistent with our mandate to foster employment and price stability.

In the meantime, financial firms must do a better job of managing the risks of their business, and regulators – the Federal Reserve included – must complete a thoroughgoing overhaul of their approach to supervision. And the Congress should move forward in making needed changes to our system of financial regulation to avoid a similar crisis in the future. In particular – and importantly – we must solve the problem of "too big to fail."

In sum, we have come a long way from the darkest period of the crisis, but we do have some distance to go. In the midst of some of the toughest days, in October 2008, I said in a speech that I was confident that the American economy, with its great intrinsic vitality, would emerge from this period with renewed vigor. I remain equally confident today. Thank you. [Applause.]

QUESTIONS AND ANSWERS

DAVID RUBENSTEIN: Thank you very much. We have time for a few questions. The first question would be, any hints – just between us – on where interest rates might go? [Laughter.]

CHAIRMAN BERNANKE: Well, they can't go much further down! [Laughter.] Obviously, the Federal Open Market Committee, which meets next week, will continue to look at the economy. We'll have to try to update our outlook, look at financial conditions, and move from there. But right now, we are still looking at the extended period, given that conditions remain – low rates of utilization, subdued inflation trends, and stable long-term inflation expectations. That remains where we are but we're going to have to continue to look at the economy. Obviously, there've been some signs of strength recently; we'll want to factor that in as we talk about this next week.

MR. RUBENSTEIN: Do you see any real prospect of a double-dip recession?

CHAIRMAN BERNANKE: Well, economic forecasting is very difficult, and obviously we can't get any guarantees either about that or, for that matter, for a stronger recovery next year. However, as I said in my remarks, I think the most likely outcome is a moderate pace of recovery.

There do seem to be enough forces in play to sustain a recovery going into next year. At the same time, there are headwinds like tight credit and high unemployment, which make a vigorous snapback seem somewhat less likely. But of course, again, we're going to have to keep following developments and adjusting policy appropriately.

MR. RUBENSTEIN: If your council recommendation had been in place at the time of Lehman Brothers, how would that have been resolved differently? Would you have handled Lehman Brothers differently if that council had been in place then?

CHAIRMAN BERNANKE: Well, I think first of all, as far as the council is concerned, the goal of the council would be to address systemic risks, emerging risks, before they become so critical. And so a systemic council with a macro-credential perspective would have done its good work, I hope, well before things came to that pass. So certainly by the time of the crisis in September and October of last year, we were well beyond the point of arresting the risks before they became apparent.

What would have made a great deal of difference last fall would have been having the resolution regime that I talked about. If we'd been able to wind down that firm and others in a way that would have allowed them to fail, would have avoided taxpayer intervention, avoided the Federal Reserve's intervention, but not have had all the adverse consequences on the financial system that we saw, that would have surely been a much better outcome than what we got.

MR. RUBENSTEIN: Do you have any views on the legislation by Congressman Paul about auditing the Federal Reserve? I assume you're not supportive – [laughter] – of that.

CHAIRMAN BERNANKE: Well, my views are known. [Laughter.] Let me make one point there which I think is very important, which is that the so-called "audit the Fed" bills – the word "audit" is used by most of the people in this room to have something to do with financial books; has to do with looking at numbers, looking at financial reports and statements.

That's not what this is about. The Federal Reserve fully agrees that the

Congress should have access to all aspects of our financial transactions, our financial operations, our financial controls. The Congress has every right to make sure that the Fed is using the taxpayer's money effectively and safely, as in fact, we are.

But in this particular context, the word "audit" means a policy review. If this bill were passed, it would repeal an exemption passed by the Congress in 1978, which protects monetary policy from an immediate review by the General Accountability Office to assess whether that policy was the right policy or not.

Every other aspect of our policymaking, our supervision, everything else, is subject to GAO review. Essentially, all of our financial books are open to the Congress and to the GAO. The thing that we're concerned about is the independence and the integrity of the monetary policymaking process.

Our concern would be that we would take some action on monetary policy that would be unpopular in some quarters, and that Congress, by ordering a GAO audit of that action, would be signaling strongly to the markets and the public that they disapproved and were putting pressure on the Fed not to take that action.

We believe that reducing the independence of the Fed to take actions in the medium-term, long-term interest of the U.S. economy would be bad for markets, bad for the Fed's credibility, bad for inflation expectations, and bad for the dollar.

MR. RUBENSTEIN: And do you expect the Federal Reserve will get all of the money back that it has injected into the system in terms of loans to corporations?

CHAIRMAN BERNANKE: Yes, I do. I think we're in very good shape. I think, in fact, certainly the actions we took were not from the perspective of profit maximization by any means, but in fact, I do believe we're going to get back all the money and, indeed, we are going to be showing, for the taxpayer, a fairly significant extra income.

MR. RUBENSTEIN: When you were minding your own business at Princeton, did you ever have any second thoughts about coming to Washington? [Laughter.]

CHAIRMAN BERNANKE: [Pause, laughter.] Well, let me say it's been a very interesting experience, overall. [Laughter.] And you know, Keynes once said that economics should aspire to be as useful as dentistry. [Laughter.] And what he meant by that was that economics is not a subject which should be studied in ivory towers; it's one that should be applied in a way to try to help the broader economy, to try to help the public, to try to make things better.

And it was my objective to bring my knowledge, my research on the Great Depression, on financial markets, on the economy to do the best I could to bring that to the actual policymaking arena. In that respect, I don't regret coming to Washington.

MR. RUBENSTEIN: From your academic research, is there anything that you have learned in Washington that would say that your academic research was wrong or right, or what would you say is the most important thing you've learned in Washington, in contradiction to what you wrote about?

CHAIRMAN BERNANKE: Well, as I mentioned, I studied the Great Depression of the 1930s, and the world is certainly much more complicated than the 1930s. Financial markets are much more complicated. We have many different institutions, financial instruments are much more complex. And so the whole structure and nature of our financial markets are different and more interconnected, more complex than was the case in the 1930s.

Nevertheless, the basic lessons of the 1930s still apply here, and they were, essentially, two. The first is that the Federal Reserve, in the 1930s, made the mistake of essentially being entirely passive on monetary policy. It took no action, and what happened was that, as the banks failed, the money supply contracted and the economy went through a severe – 10% a year – deflation, falling prices, which made it very unattractive to invest and gave people strong incentives to delay purchases.

So the first lesson was, don't let monetary policy become excessively tight. Provide support, through monetary policy, through the economy. I believe we took that lesson and we have been very aggressive, of course, in cutting interest rates and making sure that we stay away from deflationary cycles and that we are providing the necessary monetary support for the economy.

The second major lesson of the Great Depression was, don't let the financial system collapse. Many people think about the Depression as being the result of the 1929 stock market crash. Of course, that was a major event, but between 1929 and early 1931, the downturn in the economy – and in the stock market, for that matter – was not all that different from other recessions of the interwar period and earlier, and not that different from the beginning of this recession, for that matter.

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. In that respect, our actions to prevent a collapse of the financial system, including the entire global system, was, I believe, essential to avoiding a similar economic outcome in this decade.

Now, of course, a big problem was that we didn't really have all the tools we needed to wind down failing, systemically critical firms in a safe way that wouldn't affect the broader economy. And that's why it's so essential for Congress to give tools not to the Federal Reserve – I think it would be better managed by the FDIC and the Treasury – but to the government in general to avoid these kinds of situations in the future, while not creating moral hazard and other problems associated with preventing the failure of large firms.

MR. RUBENSTEIN: We have time for two questions from the audience. Let's see, we have one former member of the Federal Reserve here.

Q: Thank you. My name is Andrew Brimmer. Before I ask my questions, I want to assure the audience that I am not a dispassionate observer.

MR. RUBENSTEIN: One question.

Q: I have one question. As you know, this year the ASSA meetings – [inaudible] – in January next year. At that meeting, I have prepared a paper on the Federal Reserve and their fate of systemic risk in capital markets. I asked you to participate in that. You said you could not. Vice Chairman Donald Kohn is participating.

I plan to address, in that paper, several key questions related to the role of the Federal Reserve in combating the current financial crisis. These deal with Bear Stearns, Lehman, and AIG. My first question is, why did the Federal Reserve save Lehman, who made that decision, why was the decision made not to, first, Bear Stearns? Why was the decision made not to save Lehman? Who made that decision?

What were the respective roles of the Treasury – [laughter] – the Federal Reserve Bank of New York, and the Federal Reserve Board? Why did the Federal Reserve save AIG? Who made that decision? Why did the Federal Reserve invest so much money in the project? In my paper, I've also tried to describe the ways in which the sharp expansion in the Federal Reserve's balance sheet reflects the Federal Reserve's role as the lender of last resort.

MR. RUBENSTEIN: Can you repeat that question? [Laughter.]

CHAIRMAN BERNANKE: I bet when you thought that the former governor, Brimmer, was called on that he was some kind of plant, right? [Laughter.] Governor Brimmer, as you know, the Federal Reserve and the Treasury, in consultation – we always spoke to the President and we spoke with the Congress whenever possible – attempted to avoid the systemic collapse of our financial markets, our financial system.

And we were extremely concerned that the collapse of these large, interconnected firms in a disorderly way would have very adverse effects on the broader economy and the global economy. And I think the evidence is, as we saw following Lehman, that we were right – that the collapse of these firms is very destructive. We were very consistent. We did our best to save – "save" – protect the system from the collapse of these firms, all of them.

The reason we didn't save Lehman was not a conscious choice, but as I've said many times in public, that because, given the very limited powers that we had – essentially the only power we had was the Federal Reserve's lending authority against collateral – we just simply didn't have the tools. It was not a conscious choice. It was simply something we couldn't do within our legal authorities.

And that's why it is so essential, again, if we're going to avoid this kind of crisis in the future, if we're going to avoid the very unpopular – and deservedly so – bailouts that were associated with it, we have to have a better structure, better system. And the Congress is working on that, and I very much support that approach.

MR. RUBENSTEIN: Let me just ask one more question. "What is the best thing about being Chairman of the Federal Reserve Board?" [Laughter.]

CHAIRMAN BERNANKE: I get to go through the security lines at the airport – [laughter] – much more quickly – and I can take along even three ounces of fluid if I want to. [Laughter, applause.]

MR. RUBENSTEIN: On behalf of The Economic Club of Washington, we'd like to give you this antique map of the District of Columbia, and we know it might violate the $20 limit on gifts that you have, but not by much. [Laughter, applause.] We are adjourned. Thank you very much.

BEN S. BERNANKE

Ben S. Bernanke was sworn in on February 1, 2006, as Chairman and a member of the Board of Governors of the Federal Reserve System. Dr. Bernanke also serves as Chairman of the Federal Open Market Committee, the System's principal monetary policymaking body. He was appointed as a member of the Board to a full 14-year term, which expires January 31, 2020, and to a four-year term as Chairman, which expires January 31, 2010. Before his appointment as Chairman, Dr. Bernanke was Chairman of the President's Council of Economic Advisers, from June 2005 to January 2006.

Dr. Bernanke has already served the Federal Reserve System in several roles. He was a member of the Board of Governors of the Federal Reserve System from 2002 to 2005; a visiting scholar at the Federal Reserve Banks of Philadelphia [1987-89], Boston [1989-90], and New York [1990-91, 1994-96]; and a member of the Academic Advisory Panel at the Federal Reserve Bank of New York [1990-2002].

From 1994 to 1996, Dr. Bernanke was the Class of 1926 Professor of Economics and Public Affairs at Princeton University. He was the Howard Harrison and Gabrielle Snyder Beck Professor of Economics and Public Affairs and Chair of the Economics Department at the university from 1996 to 2002. Dr. Bernanke had been a Professor of Economics and Public Affairs at Princeton since 1985. Before arriving at

Princeton, Dr. Bernanke was an Associate Professor of Economics [1983-85] and an Assistant Professor of Economics [1979-83] at the Graduate School of Business at Stanford University. His teaching career also included serving as a Visiting Professor of Economics at New York University [1993] and at the Massachusetts Institute of Technology [1989-90].

Dr. Bernanke has published many articles on a wide variety of economic issues, including monetary policy and macroeconomics, and he is the author of several scholarly books and two textbooks. He has held a Guggenheim Fellowship and a Sloan Fellowship, and he is a Fellow of the Econometric Society and of the American Academy of Arts and Sciences. Dr. Bernanke served as the Director of the Monetary Economics Program of the National Bureau of Economic Research [NBER] and as a member of the NBER's Business Cycle Dating Committee. In July 2001, he was appointed Editor of the American Economic Review. Dr. Bernanke's work with civic and professional groups includes having served two terms as a member of the Montgomery Township, New Jersey, Board of Education.

Dr. Bernanke was born in December 1953 in Augusta, Georgia, and grew up in Dillon, South Carolina. He received a B.A. in economics in 1975 from Harvard University, *summa cum laude*, and a Ph.D. in economics in 1979 from the Massachusetts Institute of Technology. Dr. Bernanke is married and has two children.