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Federal Reserve Policies in the Financial Crisis

Remarks by

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It is a privilege for me to be here in Texas, and I would like to thank the Austin Chamber for hosting this luncheon. The Texas economy is strong and diversified, accounting for more than a trillion dollars of output last year. However, our nation, and Texas too, is being tested by economic and financial challenges. Those challenges and the Federal Reserve's policy responses are the topic of my remarks today.

Federal Reserve Policies during the Crisis

As you know, this extraordinary period of financial turbulence is now well into its second year. Triggered by the contraction of the U.S. housing market that began in 2006 and the associated rise in delinquencies on subprime mortgages, the crisis has become global and is now affecting a wide range of financial institutions, asset classes, and markets. Constraints on credit availability and slumping asset values have in turn helped to generate a substantial slowing in economic activity.

The Federal Reserve's strategy for dealing with the financial crisis and its economic consequences has had three components. First, to offset to the extent possible the effects of the crisis on credit conditions and the broader economy, the Federal Open Market Committee (FOMC) has aggressively eased monetary policy. The easing campaign began in September 2007, shortly after the turbulence began, with a cut of 50 basis points in the target for the federal funds rate. The cumulative reductions in the target rate reached 100 basis points--that is, a full percentage point--by the end of 2007. As indications of economic weakness proliferated, the Committee continued to respond, reducing the target rate by an additional 225 basis points by the spring of this year. By way of historical comparison, this policy response stands out as exceptionally rapid and proactive. In taking these actions, we aimed not only to cushion the direct effects of the

financial turbulence on the economy, but also to reduce the risk of a so-called adverse feedback loop in which economic weakness exacerbates financial stress, which, in turn, leads to further economic damage. Unfortunately, despite the support provided by monetary policy, the intensification of the financial turbulence this fall has led to a further deterioration in the economic outlook. The Committee again responded by cutting the target for the federal funds rate an additional 100 basis points in October. Half of that reduction came as part of an unprecedented coordinated interest rate cut by six major central banks on October 8.

The Committee's rapid monetary easing was not without risks. Some observers expressed concern at the time that these policies would stoke inflation, and, indeed, inflation reached high levels earlier this year, mostly as the result of a surge in the prices of oil and other commodities. Throughout this period, the Committee remained closely attuned to inflation developments. Because control of inflation requires that the public's longer-term inflation expectations remain well anchored, we paid particularly close attention to indicators of those expectations, as inferred, for example, from financial markets and from surveys of households and businesses. However, the Committee maintained the view that the rapid rise in commodity prices primarily reflected sharply increased demand for raw materials in emerging market economies, in combination with constraints on the supply of these materials, rather than general inflationary pressures. We expected that, at some point, global economic growth and the associated growth in the demand for commodities would moderate, which would result in a leveling out of commodity prices, consistent with the predictions of futures markets. As you know, commodity prices peaked during the summer and, rather than leveling out, have actually

fallen dramatically with the weakening in global economic activity. As a consequence, overall inflation appears set to decline significantly over the next year toward levels consistent with price stability.

Although monetary easing likely offset some part of the economic effects of the financial turmoil, that offset has been incomplete, as widening credit spreads and more restrictive lending standards have contributed to tight overall financial conditions. In particular, many traditional funding sources for financial institutions and markets have dried up, and banks and other lenders have found their ability to securitize mortgages, auto loans, credit card receivables, student loans, and other forms of credit greatly curtailed. Consequently, the second component of the Federal Reserve's strategy has been to support the functioning of credit markets and to reduce financial strains by providing liquidity to the private sector--that is, by lending cash or its equivalent secured with relatively illiquid assets.

To ensure that adequate liquidity is available, consistent with the central bank's traditional role as the liquidity provider of last resort, the Federal Reserve has taken a number of extraordinary steps. For instance, to provide banks and other depositories easier access to liquidity, we narrowed the spread of the primary credit rate (the rate at which banks borrow from the Fed's discount window) over the target federal funds rate from 100 basis points to 25 basis points; extended the term for which banks can borrow from the discount window to up to 90 days; and developed a program, called the Term Auction Facility, under which predetermined amounts of credit are auctioned to depository institutions for terms of up to 84 days. These innovations resulted in large increases in the amount of Federal Reserve credit extended to the banking system.

Following the funding crises faced by Bear Stearns and other institutions this past spring, we also expanded our liquidity programs to include primary dealers in the government securities market. It should be emphasized that the loans that we make to banks and primary dealers through our standing facilities are both overcollateralized and made with recourse to the borrowing firm, which serves to minimize the Federal Reserve's exposure to credit risk. To further improve funding conditions, the Federal Reserve has also recently introduced facilities to purchase highly rated commercial paper at a term of three months and to provide backup liquidity for money market mutual funds.

In our globalized financial markets, the provision of dollar liquidity has international as well as domestic aspects. To improve dollar funding conditions in important foreign markets, the Federal Reserve has approved bilateral currency swap agreements with 14 foreign central banks. Swap facilities allow each of the central banks involved to borrow foreign currency from the other; in this case, foreign central banks such as the Bank of Japan, the European Central Bank, the Bank of England, and the Swiss National Bank have borrowed dollars from the Federal Reserve to re-lend to banks in their jurisdictions. Because short-term funding markets are interconnected, the provision of dollar liquidity in major foreign markets eases conditions in dollar funding markets globally, including here in the United States. Importantly, these swap arrangements pose essentially no credit risk because our counterparties are the foreign central banks themselves, which take responsibility for the extension of dollar credit within their jurisdictions.

Judging the effectiveness of the Federal Reserve's liquidity programs is difficult. Obviously, they have not yet returned private credit markets to normal functioning. But I

am confident that market functioning would have been more seriously impaired in the absence of our actions. My reading of the evidence and the reports we have received is that these programs have been helpful in lowering spreads in certain short-term funding markets, enabling financial and nonfinancial businesses to obtain credit that would have been costly or difficult to obtain elsewhere, and allowing a more orderly process of asset sales and the necessary deleveraging by financial institutions. Ultimately, however, market participants themselves must address the fundamental sources of financial strains by raising new capital, restructuring balance sheets, and improving risk management. This process is likely to take some time. The Federal Reserve's various liquidity measures should help facilitate that process indirectly by boosting investor confidence and by reducing the risk of severe disruption during the period of adjustment. Once financial conditions become more normal, the extraordinary provision of liquidity by the Federal Reserve will no longer be needed, and financial institutions will again look to private counterparties, and not central banks, as a source of ongoing funding.

Consistent with the historical mission of the Federal Reserve, the third component of our policy response has been to use all our available tools to promote financial stability, which is essential for healthy economic growth. At times, this has required working to preserve the stability of systemically critical financial institutions, so as to avoid further costly disruptions to both the financial system and the broader economy during this extraordinary period. In particular, the Federal Reserve collaborated with the Treasury to facilitate the acquisition of the investment bank Bear Stearns by JPMorgan Chase and to stabilize the large insurer, American International Group (AIG). We worked with the Treasury and the Federal Deposit Insurance Corporation (FDIC) to put