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GUEST OF HONOR

THE HONORABLE BEN S. BERNANKE

Chairman, Federal Reserve Bank

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Introductions

GLENN HUBBARD: Good afternoon everyone. Good afternoon. If I could have your attention. Welcome. It's my pleasure to welcome you to the 406th meeting of the Economic Club of New York and our 102nd year. I'm Glenn Hubbard, the Chairman of the organization. The club is one of the nation's in the world's leading non-partisan forums about economics and about business. More than a thousand great speakers have appeared before the club in years passed, and they are listed, of course, in your bulletin. I also wanted to recognize collectively the members of our Centennial Society. Several dedicated club members got together to make financial contributions to secure the club's future. Thus far there are 127 members who have made a contribution of $10,000 to be a member. Their names are also in your program.

Today, of course, we are pleased, delighted, honored to welcome the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke. These obviously are very interesting times from an economic perspective with questions about the recovery with the Federal Reserve drawn into a number of political and regulatory discussions and obviously Chairman Bernanke's stands at the center of this. He was sworn in on February 1, 2005 as the Chairman. Prior to that time, he was Chairman of the Council of Economic Advisors and previously a member of the Board of Governors of the Fed. Ben, prior to his government service, had a very distinguished career as an economist at Princeton University. His clear thinking, his clear speaking, his research, his intellect, his experimentation make him definitely the man for times like these. Mr. Chairman, the floor is yours?

BEN BERNANKE: Glenn, thank you very much. It's nice to be back here again with a few of my dearest friends. When I last spoke at the Economic Club of New York a little more than a year ago, the financial crisis had just taken a more virulent turn. In my remarks at that time, I described the extraordinary actions that policy makers around the globe were taking to address the crisis, and I expressed optimism that we had the tools necessary to stabilize the system. Today financial conditions are considerably better than they were then, but significant economic challenges remain. The flow of credit remains constrained, economic activity weak and unemployment much too high. Future setbacks are possible.

Nevertheless, I think it is fair to say that policymakers' forceful actions last Fall and others that followed were instrumental in bringing our financial and our economy back from the brink. The stabilization of financial markets and the gradual restoration of confidence are in turn helping to provide a necessary foundation for economic recovery. We are seeing early evidence of that recovery. Real GDP in the United States rose an estimated 3-1/2 percent at an annual rate in the third quarter following four consecutive quarters of decline. Most forecasters anticipate another moderate gain in the fourth quarter. How the economy will evolve in 2010 and beyond is less certain. On the one hand, those who see future weakness or even a relapse into recession next year point out that some of the sources of the recent pick up including a reduced pace of inventory liquidation and limited time policies such as the Cash for Clunkers program are likely to provide only temporary support to the economy.

On the other hand, those who are more optimistic, point indications of more fundamental improvements including strengthening consumer spending outside of autos, a nation recovery in home construction, continued stabilization in financial conditions and stronger growth abroad. My own view is that the recent pick up reflects more than purely temporary factors and that continued growth next year is likely. However, some important headwinds such as constrained bank lending and a weak job market likely will prevent the expansion from being as robust as we would hope. I'll discuss each of these problem areas in a bit more detail and then end with some further comments on the outlook for the economy and for policy.

I began today by alluding to the unprecedented financial panic that last Fall brought a number of financial institutions around the world to failure or the brink of failure. Policy makers in the United States and abroad deployed a number of tools to stem the panic. The Federal Reserve sharply increased its provision of short term liquidity to financial institutions. The U.S. Treasury injected capital into banks, and the Federal Deposit Insurance Corporation guaranteed bank viabilities. The Federal Reserve and the Treasury each took measures to stop a run on the money market mutual fund industry that began when a leading fund was unable to pay off its investors at par value. Throughout the Fall and early this year, a range of additional initiatives were required to stabilize major financial firms and markets both here and abroad. The ultimate purpose of financial stabilization, of course, was to restore the normal flow of credit which had been severely disrupted. The Federal Reserve did its part by creating new lending programs to support the functioning of some key credit markets such as the market for commercial paper, which is used to finance businesses day to day operations, and the market for asset-backed securities, which helps sustain the flow of funding for auto loans, small business loans, student loans and many other forms of credit. And we continued to insure that financial institutions had adequate access to liquidity.

Additionally, we supported private credit markets and helped lower rates on mortgage loans through large scale asset purchases including purchases of debt and mortgage-backed securities issued or backed by government sponsored enterprises. Partly as a result of these and other policy actions, many parts of the financial system have improved substantially. Inner Bank and other short term funding markets are functioning more normally. Interest rate spreads on mortgages, corporate bonds and other credit products have narrowed significantly, stock prices have rebounded and some securitization markets have resumed operation. In particular, borrowers with access to public equity and bond markets, including most larger firms, now generally are able to obtain credit without great difficulty. Other borrowers, such as state and local governments, have experienced improvement in their credit access as well. However, access to credit remains strained for borrowers who are particularly dependent on banks such as households and small businesses. Bank lending has contracted sharply this year and the Federal Reserves Senior Loan Officers opinion survey shows that banks continue to tighten the terms on which they extend credit for most types of loans, although recently the pace of tightening has slowed somewhat.

Partly as a result of these pressures, household has declined in recent quarters for the first time since 1951. For their part, many small businesses have seen their bank credit lines reduced or eliminated or have been able to obtain credit only on significantly more restrictive terms. The fraction of small businesses reporting difficulty in obtaining credit is near a record high and many of these businesses expect credit conditions to tighten further. To be sure, not all of the sharp reductions in bank lending this year reflect cutbacks in the availability of credit. The demand for credit has also fallen significantly. For example, households are spending less than they did last year on big ticket durable goods typically purchased with credit and businesses are reducing investment outlays and thus have less need to borrow. Because of weakened balance sheets, fewer potential borrowers are creditworthy even if they were willing to take on more debt. Also, write downs of bad debt show up on bank balance sheets as reductions in credit outstanding. Nevertheless, it appears that since the outbreak of the financial crisis, banks have tightened lending standards by more than would have been predicted by the decline in economic activity alone.

Several factors help explain the reluctance of banks to lend despite general improvement in financial conditions and increases in bank stock prices and earnings. First, bank funding markets were badly impaired for a time and some banks have accordingly decided or have been urged by regulators to hold larger buffers of liquid assets than before. Second, with loan losses still high and difficult to predict in the current environment and with further uncertainty attending how regulatory capital standards may change, banks are being especially conservative about taking on more risk. Third, many securitization markets remain impaired reducing an important source of funding for bank loans. In addition, changes to accounting rules at the beginning of next year will require banks to move a large volume of securitized assets back onto their balance sheets. Unfortunately, reduced bank lending may well slow the recovery by damping consumer spending especially on durable goods and by restricting the ability of some firms to finance their operations. The Federal Reserve has used its authority as a bank supervisor to help facilitate the flow of credit through the banking system. In November of 2008, with other banking agencies, we issued guidance to banks and bank examiners that emphasizes the importance of continuing to meet the needs of creditworthy borrowers while maintaining appropriate prudence in lending decisions.

This past Spring, the Federal Reserve led the Supervisory Capital Assessment Program (SCAP) sometimes known as the stress test, a coordinated comprehensive examination designed to insure that 19 of the countries largest banking organizations would remain well capitalized and able to lend to creditworthy borrowers even if economic conditions turned out to be worse than expected. The release of the assessment results in May increased investor confidence in the U.S. banking system. A week ago, the Federal Reserve announced that nine of ten of the firms that were determined to have required additional capital were able to fully meet the required capital buffers without any further capital from the U.S. Treasury and that aggregate tier 1 common equity at those ten firms increased by more than $77 billion since the conclusion of the assessment. The Federal Reserve will continue to work with banks to improve the access of creditworthy borrowers to the credit that they need. Lending to creditworthy borrowers is good for the economy, but it also benefits banks by maintaining profitable relationships with their customers. We continue to encourage banks to raise additional capital to support their lending and we continue to facilitate securitization through our Term Asset-Backed Securities Loan Facility, or TALF, and to support home lending through our purchases of mortgage-backed securities. Normalizing the flow of bank credit to good borrowers will continue to be a top priority for policy makers.

While I’m on the topic of bank lending, I’d like to add a few words about commercial real estate. Demand for commercial property has dropped as the economy has weakened leading to significant declines in property values, increased vacancy rates and falling rents. These poor fundamentals have caused a sharp deterioration in the quality of CRE loans on banks' books and of the loans that back commercial mortgage-backed securities or CMBS. Pressures may be particularly acute at smaller regional and community banks that entered the crisis with high concentrations of CRE loans. In response, banks have been reducing their exposure to these loans quite rapidly in recent months. Meanwhile, the market for securitizations backed by these loans remains all but closed.

With nearly $500 billion of CRE loans scheduled to mature annually over the next few years, the performance of this sector depends critically on the ability of borrowers to refinance many of those loans. Especially if CMBS financing remains unavailable, banks will face the tough decision of whether to roll over maturing debt or to foreclose. Recognizing the importance of this sector for the economic recovery, the Federal Reserve has extended the TALF program for existing CMBS through March 2010 and for newly structured CMBS through June. Moreover, the banking agencies recently encouraged banks to work with their creditworthy borrowers to restructure troubled CRE loans in a prudent manner and reminded examiners that absent other adverse factors, a loan should not be classified as impaired based solely on a decline in collateral value.

In addition to constrained bank lending, a second area of concern is the job market. Since December of 2007, the U.S. economy has lost on net about 8 million private sector jobs and the unemployment rate has risen from less than 5 percent to more than 10 percent. Both the decline in jobs and the increase in the unemployment rate have been more severe than in any other recession since World War II. Besides cutting jobs, many employers have reduced hours for the workers that they have retained. For example, the number of part time workers who report that they would like a full time job, but cannot find has more than doubled since the recession began, a much larger increase than in previous deep recessions. In addition, the average work week for production and non-supervisory workers has fallen to 33 hours, the lowest level in the post war period. These data suggest that the excess supply of labor is even greater than is indicated by the employment rate alone.

With the job market so weak, businesses have been able to find or retain all the workers they need with minimal wage increases or even with wage cuts. Indeed standard measures of wages, so significant slowing in wage gains over the past year, together with the reduction in hours worked, slower wage growth has led to stagnation in labor income. Weak income growth, should it persist, will restrain household spending. The best thing we can say about the labor market right now is that it may be getting worse more slowly. Declines in payroll employment over the past four months have averaged about 220,000 per month compared to 560,000 per month over the first half of the year. The number of initial claims for unemployment insurance is well off its highs of last Spring, but claims still have not fallen to ranges consistent with rising employment.

Although economic pain is widespread across industries and regions, different groups of workers have been affected differently. For example, the employment rate for men between the ages of 25 and 54 has risen from less than 4 percent in late 2007 to 10.3 percent in October, nearly double the rise in unemployment in adult women. This discrepancy likely reflects the high concentration of job losses in manufacturing, construction and financial services, industries in which men make up the majority of workers. From the perspective of America's economic future, the effect of the recession on young workers is particularly worrisome. The unemployment rate among people between the ages of 16 and 24 has risen to 19 percent and among African American youths, it is now about 30 percent. When young people are shut out of the job market, they lose valuable opportunities to gain work experience or on the job training potentially reducing their future wages and employment opportunities.

Given the weakness in the labor market, a natural question is whether we might be in for a so-called jobless recovery in which output is growing, but employment fails to increase. Productivity is defined as output per hour of work. Thus essentially by definition, a jobless recovery in which output is growing but hours of work are not must be a period of productivity growth. In the jobless recoveries that followed the 1990, '91 and 2001 recessions, productivity growth was quite strong. It may seem paradoxical that productivity growth, which in the longer term is the most important source of increases in real wages and living standards, can having adverse consequences for employment in the short term. But when the demand for goods and services is growing slowly, that may be the case. In fact, productivity growth has recently been quite high even when the economy was contracting. Output per hour in the non-pharm business sector is estimated to have risen at about 5-1/2 percent annual rate so far this year, well above long term averages.

One reason for recent productivity gains likely list the reaction of employers to the freefall in the economy that began in the second half of 2008. Normally employers are slow to cut their workforces when the economy turns down. The process of finding, hiring and training new workers is costly. Thus, if employers expected that the downturn will be not too severe nor too lengthy, they retain more existing workers than they need in the short term rather than laying them off and then trying to replace them when the recovery begins. However, in the recent downturn, employers were exceptionally uncertain about the future. Some, even fearing a second Great Depression, moreover tight credit conditions left little margin for error. Accordingly, to protect themselves against the worse possibilities, employers shed workers much more sharply than usual in recessions. Thus, the productivity gains this year generally reflect pronounced declines in labor input rather than greater output.

Will the increases in productivity persist? It is likely that in some cases, firms achieved their productivity gains by asking the remaining workers to provide more effort. The additional gains that can be achieved in this way are limited and probably temporary. Although continuing uncertainty and financial constraints might make such firms hesitant to hire, if demand, production and confidence pick up, they will find their labor force stretched thin and they will add new workers. However, other firms facing difficult financial conditions and intense pressure to cut costs seem to have found longer lasting, efficiency enhancing changes that allowed them to reduce their workforces and some less efficient firms, no longer able to compete, closed their doors.

Again, improved efficiency confers great benefits in the longer term. However, to the extent that firms are able to find further cost cutting measures as output expands, they may delay hiring. Other factors will affect near term employment growth as well. Business confidence in the durability of the expansion, for example, will help determine employers' willingness to hire. The current prevalence of part time work and short work weeks may slow job creation early in the recovery period as employers prefer to convert workers from part time to full time status and to add overtime work before turning to new hires. In addition, difficulties in obtaining credit could hinder the expansion of small and medium sized businesses and prevent the formation of new businesses. Because smaller businesses account for a significant portion of net employment gains during recoveries, limited credit could hinder job growth. Overall, a number of factors suggested employment gains may be modest during the early stages of the expansion.

Let me return now to the outlook for the economy and for policy. As I noted, I expect moderate growth to continue next year. Final demands show signs of strengthening supported by the broad improvement in financial conditions. Additionally, the beneficial influence of the inventory cycle on production should continue for somewhat longer. Housing faces important problems including continuing high foreclosure rates, but residential investment should become a small positive for growth next year rather than a significant drag as has been the case for the past several years. Prospects for non-residential construction are poor, however, given weak fundamentals and tight financing conditions. In the business sector, manufacturing activity has been expanding and should be helped by the continuing strength of the recovery in the emerging market economy, especially in Asia. As the recovery takes hold, enhanced business confidence, together with the low cost of capital for firms with access to public capital markets, should lead to a pick up in business spending on equipment and software, which has already shown signs of stabilizing.

I've already discussed two of the principle factors that may constrain the pace of the recovery, namely restrictive bank lending and a weak job market. Banks' reluctance to lend will limit the ability of some businesses to expand and to hire. I expect the situation to normalize gradually as improving economic conditions strengthen bank balance sheets and reduce uncertainty. The fallout for banks from commercial real estate could slow that progress somewhat, however. Jobs are likely to remain scarce for some time keeping households cautious about their spending. As the recovery becomes established, however, payrolls should begin to grow again at a pace that increases over time. Nevertheless, as net gains of roughly 100,000 jobs per month are needed just to absorb new entrants into the labor force, the unemployment rate likely will decline only slowly if economic growth remains moderate as I expect.

The outlook for inflation is also subject to a number of cross currents. Many factors affect inflation including slack and resource utilization, inflation expectations, exchange rates and prices of oil and other commodities. Although resource slack cannot be measured precisely, it is certainly high and it is showing through to underlying wage and price trends. Longer run inflation expectations are stable having responded relatively little either to downward or to upward pressure on inflation. Expectations can be early warning signs of inflation, however, and must be monitored carefully. Commodity prices have risen lately likely reflecting the pick up in global economic activity especially in resource intensive emerging market economies and the recent depreciation of the dollar. On net, notwithstanding significant cross currents, inflation seems likely to remain subdued for some time.

The foreign exchange value of the dollar has moved over a wide range during the past year or so. When financial stresses were most pronounced, a flight to the deepest and most liquid capital markets resulted in a marked increase in the dollar. More recently, as financial market functioning has improved and global economic activity has stabilized, these safe haven flows have abated and the dollar has accordingly retraced its gains. The Federal Reserve will continue to monitor these developments closely. We are attentive to the implications of changes in the value of the dollar and will continue to formulate policy to guard against risk to our dual mandate to foster both maximum employment and price stability. Our commitment to our dual objectives, together with the underlying strengths of the U.S. economy, will help insure that the dollar is strong and a source of global financial stability.

The Federal Open Market Committee continues to anticipate that economic conditions, including low rates or resource utilization, subdued inflation trends and stable inflation expectations are likely to warrant exceptionally low levels of the federal funds rate for an extended period. Of course, significant changes in economic conditions or the economic outlook would change the outlook for policy as well. We have a wide range of tools for removing monetary policy accommodation when the economic outlook requires us to do so, and we will calibrate the timing and pace of any future tightening to best foster maximum employment and price stability. Thank you very much.

GLENN HUBBARD: Thank you very much, Mr. Chairman, for those remarks. As is the club's tradition, we have two questioners from the club; one will be Henry Kaufman who's the

President of Henry Kaufman & Company, and Matt Winkler, the Editor and Chief of Bloomberg News. Henry, the first question is yours for the Chairman.

HENRY KAUFMAN: Thank you. Mr. Chairman, last year at this meeting I asked you roughly the following question: What information would you like to have that is not really available to the Federal Reserve, and you responded very candidly by saying that you would like to know what all that stuff is worth, meaning the toxic assets. Now, a year has passed and I'd like to put it into the current framework. What information would you now like to have that you do not have which would help you?

BEN BERNANKE: Well, I'd still like to know what the stuff is worth. We've made a lot of progress in trying to ascertain the value of bank assets. Of course, we have an ongoing supervisory process, but as I mentioned, I think I'd like to stress this for a moment. We had this remarkable exercise in the Spring where the Federal Reserve, working together with the FDIC and the Office of the Controller of Currency, simultaneously analyzed all the major portfolios of the 19 largest bank holding companies in the United States, together accounting for about two-thirds of all the assets in the banking system. So in doing that, we were able to look across banks, across examiners and across asset classes and we combined our usual intensive examination procedures with off site quantitative surveillance done by economists using a wide range of econometric and statistical methods. So it was a very complex exercise.

I think we learned an enormous amount in that exercise not only about the value of the banking system and the value of the assets held by banks, which, by the way, when we announced our results, as you know, the confidence in the banking sector rose significantly, but we also learned a great deal about, you know, how to examine banks in a comprehensive way across the entire system. And I think – Henry, I think, going forward, what we really need to know will be how to examine the system as a whole. I think one of the failures of regulatory oversight during the crisis was our – our when I talk about regulators in general – our focus on individual firms and how each individual firm was doing. I think one of the things we've learned and will be very, very challenging for us as we go forward will be that we need to look at the whole system. We need to see how markets and firms interact with each other, we need to know how risks are cutting across different portfolios, we need to see developments in credit markets before they become problems and that's going to be an enormous challenge for us. We are already beginning that process, and I look forward to continuing to learn more and more about our financial system as an organic whole rather than a collection of unrelated financial institutions.

MATT WINKLER: Mr. Chairman, Governor Mervyn King of the Bank of England gave a speech in Edinburgh about banks being too big. I wonder, did you read the Governor's speech? Are you going to give a speech like the Governor's speech or are you going to outdo him in lecturing bankers?

BEN BERNANKE: I always read Mervyn's speeches. I don't try to copy him because he's too clever, but I thought he had some very interesting ideas about the size of the banks and those issues. I would say one of the real important, perhaps the most important issue that our regulatory reform process has to address is too big to fail, which is the topic of Mervyn King's speech. It was unacceptable that the government had to intervene to prevent the failure of major financial institutions, with no choice, in order to prevent the collapse of the U.S. economy. In the future, it must be possible for banks and other financial institutions that come to the brink of failure and cannot pay their bills and their debts, they must have the freedom to fail and by doing that, we can create market discipline and the kind of information we need to prevent prices like the one we saw before.

So the question is how can we create the freedom to fail? I don't think simply making banks smaller is going to do it because banks can still be systemically critical, even if they're somewhat smaller, if they are incredibly interconnected with many other banks, if they provide critical services to the financial industry or if risks of various sorts grow across a whole range of banks. I mean, after all, in the 1930s, we didn't have too many large bank failures, but we had thousands of small bank failures. So I think in order to address too big to fail, the key element – I say the two key elements – one would be to make sure that those banks are very tightly supervised to make sure, first of all, that they are safe, and second of all, that they don't have an artificial incentive to become large. But critically, again, I think we need to have an alternative to bail out. We have to have an alternative which is some kind of resolution or special bankruptcy regime, which will allow the government to wind down safely a failing firm in a way that will stabilize the system that will allow creditors to take losses in predictable and understandable ways, but will not lead to a crisis of the sort we saw last September and October. So there are a lot of interesting ideas out there, reducing the size of banks, living wills, Chairman Volcker is here – he's talked about restricting proprietary trading. There are many things that are worth looking at are interesting, but I do think that we won't have a real market-based financial system until it is safe to let a financial firm fail.

HENRY KAUFMAN: Mr. Chairman, if the American economy moves ahead along the moderate economic growth plan as you suggest against the back drop of benign inflationary back drop, which you also suggest, how will the Federal Reserve respond to further financial speculative activities such as sharp increases in stock prices, commodity prices and in the carry trade? Would you respond through quantitative restrictive measures or through a selective approach?

BEN BERNANKE: Well, you've – Henry, as you know, you just introduced perhaps the most difficult problem in monetary policy of the decade, which is how to deal with asset bubbles. We've had two big asset bubbles in this decade, and both have resulted in severe downturns, particularly the credit bubble. So clearly we need to begin to address those issues in a serious way. I'd like to say that we, you know, we do carefully evaluate major classes of financial assets. It is inherently extraordinarily difficult to know whether an asset in price is in line with its fundamental value or not. But we are trying and we are looking at various models of valuation for stocks and bonds and other kinds of assets. For the U.S., again, extraordinarily difficult to tell but it's not obvious to me in any case that there's any large misalignments currently in the U.S. financial system. We'll continue to observe that, and I'll just note though that your view on that may depend very much on how you think the economy is going to evolve. So what I'm saying is conditional on moderate growth going forward.

Would we respond? We use our interest rate tool to try to meet our dual mandate, which is full employment and price stability. If addressing major misalignments in financial markets through the use of our interest rate tool would further that goal, then I think we'd have to think about it very seriously. But as important as that is, the problems still arise that identifying those misalignments are very difficult and knowing how much to move your interest rate tool and how to avoid bringing the rest of your economy down remains very, very challenging problems for monetary policymakers. So, therefore, what I would like to suggest is the same thing I suggested in the very first speech I gave as a Governor in 2002, the theme which is use the right tool for the job. And in particular, we are now working in this country to develop a macroprudential system wide regulatory system, which will give us the best possible chance – certainly not perfect – but the best possible chance to try to identify emerging risks including asset price misalignments and to try to restrain them and to protect the system in case one of them exists and bursts. So I do think that the best approach here, if at all possible, is to use supervisory regulatory methods to restrain undo risk taking and to make sure the system is resilient in case an asset price bubble bursts in the future. But, again, I think with respect to monetary policy, I think we can never say never, we have to keep an open mind, and we have to continue to evaluate all of these aspects in the economy to go forward.

MATT WINKLER: Now that, Mr. Chairman, we have unemployment at 10.2 percent and economists are daily parsing the difference between cyclical unemployment and structural unemployment, which you addressed to some extent in your talk today, are you and your research staff now no longer looking forward to a normal job recovery?

BEN BERNANKE: Well I did discuss that a bit in my remarks, as you pointed out. Recently, we've seen the interesting phenomenon that firms have come out of recessions in aggressive cost cutting mode and in doing so, they've actually created productivity gains, which have translated in the very short term. Again, I want to emphasize I'm not saying anything bad about productivity. It's incredibly important for our economy. In the very short term, cost cutting success in a way is actually a negative for the labor market in that it creates a short term slower growth. I tried to discuss the aspects of that again in my remarks. I guess my sense is that the increases in productivity we have seen so far are so large, so strong, that I'm a bit skeptical that they can be maintained going forward. I think that some, in some cases, you'll see firms that were gaining productivity just by making workers work harder or by cutting maintenance or other important tasks, will find that as demand begins to strengthen, they'll need to bring more workers back on.

So I don't know the answer with any certainty by any means, but looking at these patterns, I imagine that there will be some moderate job growth going forward that we will not see a sort of zero to negative job growth we've seen in some previous recessions. The issue though is that, as I said in my remarks, you need real GDP growth of about 2-1/2 percent or jobs growth of about 100,000 per month on payroll just to absorb workers coming into the labor market. So to make significant progress on the unemployment rate, we would need faster growth than that. So even though jobs are likely to be created next year, I'm concerned that the unemployment rate still might remain quite high by the end of the year.

HENRY KAUFMAN: Mr. Chairman, should large financial conglomerates which offer a deposit facility within their structure be allowed to engage in proprietary trading? And if your answer is yes, how would you try to limit the structure of this kind of activity?

BEN BERNANKE: Well, I think I know where that question came from. Chairman Volcker is smiling down here. Chairman Volcker's answer is no. Next question. Let me try. Let me try. I understand exactly what Chairman Volcker's concerned about and the issues he is raising. And I just want to raise a couple of – I hope they're subtleties and just mistakes – first, you know, there's a sense here of, you know, returning to Glass-Steagall, and separating these market making activities from commercial lending. I think that kind of movement would not be constructive. As we know, plenty of firms got into trouble making regular commercial loans and plenty of firms got into trouble in market making activities. So the separation of those two things, per se, will not necessarily lead to stability.

The question one has to ask is proprietary trading an important complement to the normal activities of a commercial bank? And I think the answer is maybe, the answer is maybe to that question. Full fledged proprietary trading arms may not be essential, but it is true that we look to commercial banks to hedge their positions, for example, to make markets for customers, to lay off risks in a variety of ways. And so it would be difficult to say with a sharp right line that banks should not be allowed to engage in any kind of proprietary trading in a sense of holding positions that are on their own books as opposed to on a customer's books.

Now that being said, I do think that supervisors and regulators need to evaluate this on a case by case basis. So, for example, if supervisors and regulators look at a large banking organization, which is doing proprietary trading or has some kind of proprietary trading organization, and they determine that this company is not able to manage the risks associated with that activity or that it creates other business risks, risks to safety and soundness, or it doesn't have enough capital and liquidity to safely engage in those activities, I think then that the supervisor should be allowed by law to insist that the company divest itself or shrink its activities. So I do take this idea seriously. I do think there would be circumstances on which a supervisor or regulator would force an institution to cut back on these kinds of activities. I find it difficult to draw a bright line because of the complementarity between some of these activities and other commercial banking and customer related activities. Thanks.

MATT WINKLER: Mr. Chairman, quantitative easing increasingly has figured in the discussion of monetary and fiscal policies. The IMF, in fact, recently published 49 pages on global fiscal policymaking. How critical is it for Secretary Geithner and Congress to get the fiscal house in order so you can get the monetary house in order?

BEN BERNANKE: Well, first of all, let me be clear for everyone that there is a big distinction between quantitative easing and the fiscal debt, the government debt. We engaged in quantitative easing, if you like, or I've called it credit easing because it's been focused at trying to get key credit markets functioning again. We did that for two reasons. First, because we hit the zero bound, and therefore, normal interest rate cuts couldn't achieve the goal anymore. And secondly, because in this extraordinary environment, many markets were not functioning properly and we thought we found ways to help those markets work better, and I think we had some success in doing that.

Now, we have already begun a process of phasing out or reducing many of these extraordinary actions. For example, if you look at the portion of our balance sheet related to short term lending in financial institutions to commercial paper markets and to other kinds of international swaps with foreign central banks and other kinds of short term lending, that amount has dropped from about $1.5 trillion at the beginning of the year to about roughly a fifth of that or less today and we have announced the closing of certain facilities and planned closings going forward. So we have already taken some very substantial steps towards moving towards a more normal type of monetary policy and as long as the economy proceeds along the path that we think it will, we want to continue to move back to more normal monetary policy functioning.

We will move to normal monetary policy as called for by the state of the economy independent of the fiscal situation. We are not involved in that. We are involved in looking at the economy and trying to stabilize the economy. With respect to fiscal policy, I think everybody knows including the Treasury, Administration and Congress, that the kinds of deficits we've seen this year and next year, about 10 percent of GDP are not sustainable, that we have to find an exit strategy for fiscal policy that will bring deficits down to a level of a few percentage points to GDP, which will result in a sustainable situation where debt relative to the gross national product gross domestic product doesn't grow indefinitely. That doesn't have to happen this year or next year. It's not going to happen this year or next year. In a recession this deep, you're going to have a deep deficit as well because of lost tax revenues and the like, but it is important for the Administration and Congress to begin setting forth a plan, a credible plan, to show how the country will move back towards sustainable deficits in the medium term and I think doing that is important for investor confidence, important for taxpayer confidence and I think that's well understood, but it doesn't make it any easier to accomplish.

GLENN HUBBARD: Henry, last question.

HENRY KAUFMAN: Mr. Chairman, there's been an extraordinary increase in financial concentration especially in the last few years, as you know. Now to what extent is there a concern about this financial concentration, and if large financial institutions are more or less protected, this puts considerable pressure on smaller institutions. And there's every indication that concentration therefore will increase. To what extent will the Federal Reserve work to limit that concentration or decrease it?

BEN BERNANKE: Well, Henry, you're absolutely right. The financial concentration has increased and it's quite large in some areas, categories. There are two reasons why we care about financial concentration. One is the traditional anti-trust issues, you know, it's is competition being hampered by concentration in particular markets or categories of firms. I think that may be true in some particular areas. I don't think that it's globally true in some sense because even though they're very large firms, there's also a lot of competition in many different markets and many different types of products. The Federal Reserve, whenever we look at a merger, part of our due diligence process is to look at all of the local areas where the merged institutions provide services, deposit and other services, and to make sure at the level of small cities or counties that the merger doesn't create undo concentration that would lead to reduced services and higher prices for customers.

So we are looking at this from a concentration, anti-trust monopoly point of view. I think it's an issue to some extent, but I don't think it's the major issue. I think the major issue is the second issue, which as I've already mentioned in your earlier question, Henry, it has to do with too big to fail. The incentive that firms have to grow too big in order to be, quote, too big to fail. My answer I think is the same what I said before, which is that we need to make sure that too big fail is a relic of the past, that we don't have that anymore. To do that, we need tougher regulation for large systemically critical firms, we need to strengthen the system overall, create stronger infrastructure so that the system can stand pressure on firms. We need to make sure that all systemically critical firms are subject to strong, consolidated supervision which looks at all the risks across the company, and most importantly, and I think this is absolutely critical, and as Congress looks to do financial regulatory reform, I hope they will put this at the very top of their priority list, we need to have some alternative to bankruptcy or bailout. We need to have another way to close firms that have come to the brink of failure without destroying the rest of the system, but in a way that will allow losses to creditors and which will therefore bring back the necessary market discipline that will mean that in the future, a failing firm will be allowed to fail. Thank you.

GLENN HUBBARD: Thank you very much Mr. Chairman. And thank you, Henry, and thank you, Matt, for your questions. Lunch will be served now. Just a reminder in terms of future events in the new year. We do have a date with New York Fed President Bill Dudley and with the Bank of Japan Governor Shirakawa and some other commitments that we're looking to nail down specific dates. So, welcome, and please enjoy the rest of your lunch.

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