Approved: ARB/jb
Date: January 26, 2009

# MINUTES OF THE HOUSE FINANCIAL INSTITUTIONS COMMITTEE

The meeting was called to order by Chairman Anthony Brown at 3:30 p.m., January 21, 2009, in Room 545-N of the Capitol.

All members were present.

Committee staff present:
Joyce Bishop, Administrative Assistant
Melissa Calderwood, Kansas Legislative Research Department
Terri Weber, Kansas Legislative Research Department
Bruce Kinzie, Office of the Revisor of Statutes
Sean Ostrow, Office of the Revisor of Statutes

Conferees appearing before the committee:
Thomas Hoenig, President, Federal Reserve Bank of Kansas City

Others attending:
See attached list.

This was a joint meeting of the House Financial Institutions, House Insurance, and Senate Financial Institutions & Insurance Committees.

Chairperson Brown introduced Thomas Hoenig, President of the Federal Reserve Bank of Kansas City. His biography (Attachment 1), an Overview of the Federal Reserve System, (Attachment 2), and his latest speech, "The U.S. Economic Outlook: The Aftermath of Leverage" (Attachment 3), were distributed.

Following his presentation the floor was open to questions from attendees.

The next meeting of the Financial Institutions Committee is scheduled for January 26, 2009.

The meeting was adjourned at 4:38pm.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

**JOINT MEETING OF THE SENATE INSURANCE & FINANCIAL INSTITUTIONS, HOUSE FINANCIAL INSTITUTIONS, AND HOUSE INSURANCE COMMITTEES**

3:30pm,

Room 545-N

# GUEST LIST

DATE: January 21, 2009

| NAME | REPRESENTING |
|---|---|
| KEITH D. PANGBURN | KEARNEY & ASSOC. |
| Lee Modesitt | Intern. |
| PAUL DEGENER | CITIZENS Against Illegal Immigration |
| Alex Kotoyantz | P.I.A. |
| TOBi Bitner | federico Consulting |
| Diane Raley | Federal Reserve |
| Tom Hoenig | Federal Reserve. |
| Michelle Butler | Cap. Strategies |
| Matt Goddard | Heartland Community Bankers |
| Haley DaVee | KCUA |
| Marla Marsh | KCUA |
| John P. [illegible] | KS Dept. of credit unions |
| LARRY MAGILL | KAIA |
| Rick Fleming | Securities Commission |
| Gail Bright | Securities Commissioner's Office |
| Erin Hoestje | Securities Commissioner's Office |
| Deby [illegible] | Kansas Ins |
| Leslie Kaufman | Ks Co-op Council |
| Steve Iverson | FI&I (Senate) |

**JOINT MEETING OF THE SENATE INSURANCE & FINANCIAL INSTITUTIONS, HOUSE FINANCIAL INSTITUTIONS, AND HOUSE INSURANCE COMMITTEES**

3:30pm,

Room 545-N

# GUEST LIST

DATE: January 21, 2009

| NAME | REPRESENTING |
|---|---|
| Bev Beam | Senate FI & I |
| Randy Seiner | AIG |
| Dennis McKinney | Treasurer's Office |
| John Meetz | KS Ins. Dept. |
| Rick Wilborn | Farmers Alliance |
| Tom Thull | Office of the State Bank Commissioner |
| Matt Casey | GBA |
| Kathy Olsen | KBA |
| Doug Wareham | KBA |
| Chip Jorgensen | KBA |
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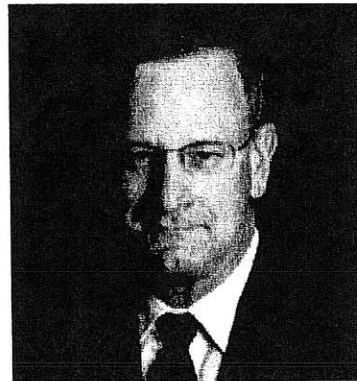
HOUSE FINANCIAL INSTITUTIONS
DATE: 1/21/2009
ATTACHMENT: 1

## Senior Management



### **Thomas M. Hoenig**, President



**Thomas M. Hoenig** (*Hawn-ig*) is president and chief executive officer of the Federal Reserve Bank of Kansas City. The Bank is one of 12 regional Banks in the Federal Reserve System, with responsibilities that include participating in setting national monetary policy, supervising and regulating commercial banks and bank holding companies, serving as the bank for the U.S. Government and for commercial banks, and providing other payments services to depository institutions.

Mr. Hoenig directs Federal Reserve activities in the Tenth Federal Reserve District -- an area that includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico, and the western third of Missouri. He is also a member of the Federal Reserve System's Open Market Committee, the key body with authority over monetary policy.
Mr. Hoenig received his doctorate in Economics from Iowa State University. He joined the Federal Reserve Bank in 1973 as an economist and was a senior officer in banking supervision during the banking crisis of the 1980s. He assumed the role of president on Oct. 1, 1991.

He is a member of the Board of Trustees of the Ewing Marion Kauffman Foundation and serves on the boards of directors of Midwest Research Institute and Union Station.

May 2008

Recent Speeches

- The U.S. Economic Outlook: The Aftermath of Leverage (January 7, 2009)
- Global Financial Crisis and the Regulatory Environment: Where Do We Go From Here? (November 17, 2008)
- The Financial Crisis and the Regulatory Environment (October 13, 2008)

### Tools

Contact Us
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### Quick Links

FedRing helps you survey similar content on different Federal Reserve web sites.

The Money Museum is an interactive experience that explores the economy and the Federal Reserve's role.

Online Tour Request

### Offsite Links

**Federal Reserve System**
Links to the Board of Governors, all 12 districts, and National Fed Resources.

# 1 Overview of the Federal Reserve System

*The Federal Reserve System is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded.*

Today, the Federal Reserve's duties fall into four general areas:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system

Most developed countries have a central bank whose functions are broadly similar to those of the Federal Reserve. The oldest, Sweden's Riksbank, has existed since 1668 and the Bank of England since 1694. Napoleon I established the Banque de France in 1800, and the Bank of Canada began operations in 1935. The German Bundesbank was reestablished after World War II and is loosely modeled on the Federal Reserve. More recently, some functions of the Banque de France and the Bundesbank have been assumed by the European Central Bank, formed in 1998.

## Background

During the nineteenth century and the beginning of the twentieth century, financial panics plagued the nation, leading to bank failures and business bankruptcies that severely disrupted the economy. The failure of the nation's banking system to effectively provide funding to troubled depository institutions contributed significantly to the economy's vulnerability to financial panics. Short-term credit is an important source of liquidity when a bank experiences unexpected and widespread withdrawals during a financial panic. A particularly severe crisis in 1907 prompted

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Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would help prevent and contain financial disruptions of this kind. After considerable debate, Congress passed the Federal Reserve Act "to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." President Woodrow Wilson signed the act into law on December 23, 1913.

DECEMBER 24, 1913–SIXTEEN PAGES. PRICE TWO

PRESIDENT'S SIGNATURE ENACTS CURRENCY LAW

Wilson Declares It the First of Series of Constructive Acts to Aid Business.

Makes Speech to Group of Democratic Leaders.

Conference Report Adopted in Senate by Vote of 43 to 25.

Banks All Over the Country Hasten to Enter Federal Reserve System.

Gov-Elect Walsh Calls Passage of Bill A Fine Christmas Present.

WILSON SEES DAWN OF NEW ERA IN BUSINESS

Aims to Make Prosperity Free to Have Unimpeded Momentum.

HOME VIEWS OF CURRENCY ACT

FOUR PENS USED BY PRESIDENT

President Wilson signed the Federal Reserve Act on December 23, 1913.

Soon after the creation of the Federal Reserve, it became clear that the act had broader implications for national economic and financial policy. As time has passed, further legislation has clarified and supplemented the original purposes. Key laws affecting the Federal Reserve have been the Banking Act of 1935; the Employment Act of 1946; the Bank Holding Company Act of 1956 and the amendments of 1970; the International Banking Act of 1978; the Full Employment and Balanced Growth Act of 1978; the Depository Institutions Deregulation and Monetary Control Act of 1980; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; the Federal Deposit Insurance Corporation Improvement Act of 1991; and the Gramm-Leach-Bliley Act of 1999. Congress has also adopted legislation defining the primary objectives of national economic policy, including the Employment Act of 1946; the Federal Reserve Reform Act of 1977; and the Full Employment and Balanced Growth Act of 1978, which is sometimes called the Humphrey-Hawkins Act, after its original sponsors. These objectives include economic growth in line with the economy's potential to expand; a high level of employment; stable prices (that is, stability in the purchasing power of the dollar); and moderate long-term interest rates.

The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or

anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as "independent within the government" is more accurate.

## Structure of the System

Congress designed the structure of the Federal Reserve System to give it a broad perspective on the economy and on economic activity in all parts of the nation. It is a federal system, composed of a central, governmental agency—the Board of Governors—in Washington, D.C., and twelve regional Federal Reserve Banks. The Board and the Reserve Banks share responsibility for supervising and regulating certain financial institutions and activities, for providing banking services to depository institutions and the federal government, and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.

*The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government.*

A major component of the System is the Federal Open Market Committee (FOMC), which is made up of the members of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The FOMC oversees open market operations, which is the main tool used by the Federal Reserve to influence overall monetary and credit conditions. These operations are described in greater detail in chapter 3.

The Federal Reserve implements monetary policy through its control over the federal funds rate—the rate at which depository institutions trade balances at the Federal Reserve. It exercises this control by influencing the demand for and supply of these balances through the following means:

- Open market operations—the purchase or sale of securities, primarily U.S. Treasury securities, in the open market to influence the level of balances that depository institutions hold at the Federal Reserve Banks
- Reserve requirements—requirements regarding the percentage of certain deposits that depository institutions must hold in reserve in the form of cash or in an account at a Federal Reserve Bank
- Contractual clearing balances—an amount that a depository institution agrees to hold at its Federal Reserve Bank in addition to any required reserve balance
- Discount window lending—extensions of credit to depository institutions made through the primary, secondary, or seasonal lending programs

Two other groups play roles in the functioning of the Federal Reserve Sys-

tem: depository institutions, through which monetary policy operates, and advisory committees, which make recommendations to the Board of Governors and to the Reserve Banks regarding the System's responsibilities.

## Board of Governors

The Board of Governors of the Federal Reserve System is a federal government agency. The Board is composed of seven members, who are appointed by the President of the United States and confirmed by the U.S. Senate. The full term of a Board member is fourteen years, and the appointments are staggered so that one term expires on January 31 of each even-numbered year. After serving a full term, a Board member may not be reappointed. If a member leaves the Board before his or her term expires, however, the person appointed and confirmed to serve the remainder of the term may later be reappointed to a full term.

The first Federal Reserve Board, 1914

The Chairman and the Vice Chairman of the Board are also appointed by the President and confirmed by the Senate. The nominees to these posts must already be members of the Board or must be simultaneously appointed to the Board. The terms for these positions are four years.

The Board of Governors is supported by a staff in Washington, D.C., numbering about 1,800 as of 2004. The Board's responsibilities require thorough analysis of domestic and international financial and economic developments. The Board carries out those responsibilities in conjunction with other components of the Federal Reserve System. The Board of Governors also supervises and regulates the operations of the Federal Reserve Banks, exercises broad responsibility in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection.

Policy regarding open market operations is established by the FOMC. However, the Board of Governors has sole authority over changes in reserve requirements, and it must approve any change in the discount rate initiated by a Federal Reserve Bank.

The Board also plays a major role in the supervision and regulation of the U.S. banking system. It has supervisory responsibilities for state-chartered banks that are members of the Federal Reserve System, bank holding companies (companies that control banks), the foreign activities of member banks, the U.S. activities of foreign banks, and Edge Act and agreement corporations (limited-purpose institutions that engage in a foreign banking business). The Board and, under delegated authority, the Federal

Reserve Banks, supervise approximately 900 state member banks and 5,000 bank holding companies. Other federal agencies also serve as the primary federal supervisors of commercial banks; the Office of the Comptroller of the Currency supervises national banks, and the Federal Deposit Insurance Corporation supervises state banks that are not members of the Federal Reserve System.

Some regulations issued by the Board apply to the entire banking industry, whereas others apply only to member banks, that is, state banks that have chosen to join the Federal Reserve System and national banks, which by law must be members of the System. The Board also issues regulations to carry out major federal laws governing consumer credit protection, such as the Truth in Lending, Equal Credit Opportunity, and Home Mortgage Disclosure Acts. Many of these consumer protection regulations apply to various lenders outside the banking industry as well as to banks.

Members of the Board of Governors are in continual contact with other policy makers in government. They frequently testify before congressional committees on the economy, monetary policy, banking supervision and regulation, consumer credit protection, financial markets, and other matters. For instance, as required by the Federal Reserve Act, the Chairman of the Board of Governors testifies before the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services on or about February 20 and July 20 of each year. The Chairman's testimony addresses the efforts, activities, objectives, and plans of the Board of Governors and the Federal Open Market Committee with respect to the conduct of monetary policy, as well as economic developments in the United States and the prospects for the future. Concurrently, the Board of Governors must submit a report on these same issues to the House and Senate committees before which the Chairman testifies.

The Board has regular contact with members of the President's Council of Economic Advisers and other key economic officials. The Chairman also meets from time to time with the President of the United States and has regular meetings with the Secretary of the Treasury.

The Chairman has formal responsibilities in the international arena as well. For example, he is the alternate U.S. member of the board of governors of the International Monetary Fund, a member of the board of the Bank for International Settlements (BIS), and a member, along with the heads of other relevant U.S. agencies and departments, of the National Advisory Council on International Monetary and Financial Policies. He is also a member of U.S. delegations to key international meetings, such as those of the finance ministers and central bank governors of the seven largest industrial countries—referred to as the Group of Seven, or G-7. He, other Board members, and Board staff members share many inter-

national responsibilities, including representing the Federal Reserve at meetings at the BIS in Basel, Switzerland, and at the Organisation for Economic Co-operation and Development in Paris, France.

One member of the Board of Governors serves as the System's representative to the Federal Financial Institutions Examination Council (FFIEC), which is responsible for coordinating, at the federal level, examinations of depository institutions and related policies. The FFIEC has representatives from the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, as well.

The Board publishes detailed statistics and other information about the System's activities and the economy in publications such as the quarterly *Federal Reserve Bulletin*, the monthly *Statistical Supplement*, and separate statistical releases. Through the *Federal Reserve Regulatory Service*, it provides materials relating to its regulatory and supervisory functions. Extensive information about the Board of Governors is available on the Board's web site (www.federalreserve.gov), including the testimony and speeches of Board members; actions on banking and consumer regulations and other matters; and statistics and research papers concerning economic, banking, and financial matters.

*The Reserve Banks are the operating arms of the central banking system.*

The Board is audited annually by a major public accounting firm. In addition, the Government Accountability Office (GAO) generally exercises its authority to conduct a number of reviews each year to look at specific aspects of the Federal Reserve's activities. The audit report of the public accounting firm and a complete list of GAO reviews under way are available in the Board's *Annual Report*, which is sent to Congress during the second quarter of each calendar year. Monetary policy is exempt from audit by the GAO because it is monitored directly by Congress through written reports, including the semiannual *Monetary Policy Report to the Congress*, prepared by the Board of Governors.

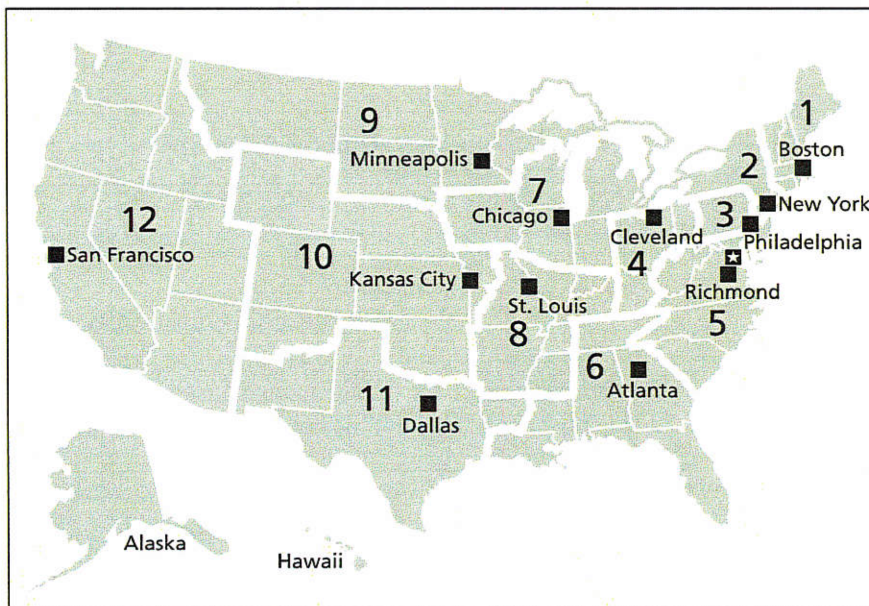
## Federal Reserve Banks

A network of twelve Federal Reserve Banks and their Branches (twenty-five as of 2004) carries out a variety of System functions, including operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The twelve Reserve Banks are each responsible for a particular geographic area or district of the United States. Each Reserve District is identified by a number and a letter (see the list of District offices on page 7). Besides carrying out functions for the System as a whole, such as administering nationwide banking and credit policies, each Reserve Bank acts as a depository for the banks in its own District and fulfills other District responsibilities. The various

## Federal Reserve District Banks and Branches

| Number | Letter | Bank | Branch |
|---|---|---|---|
| 1 | A | Boston | |
| 2 | B | New York | Buffalo, New York |
| 3 | C | Philadelphia | |
| 4 | D | Cleveland | Cincinnati, Ohio<br>Pittsburgh, Pennsylvania |
| 5 | E | Richmond | Baltimore, Maryland<br>Charlotte, North Carolina |
| 6 | F | Atlanta | Birmingham, Alabama<br>Jacksonville, Florida<br>Miami, Florida<br>Nashville, Tennessee<br>New Orleans, Louisiana |
| 7 | G | Chicago | Detroit, Michigan |
| 8 | H | St. Louis | Little Rock, Arkansas<br>Louisville, Kentucky<br>Memphis, Tennessee |
| 9 | I | Minneapolis | Helena, Montana |
| 10 | J | Kansas City | Denver, Colorado<br>Oklahoma City, Oklahoma<br>Omaha, Nebraska |
| 11 | K | Dallas | El Paso, Texas<br>Houston, Texas<br>San Antonio, Texas |
| 12 | L | San Francisco | Los Angeles, California<br>Portland, Oregon<br>Salt Lake City, Utah<br>Seattle, Washington |

## The Federal Reserve System




### Legend

■ Federal Reserve Bank city

☒ Board of Governors of the Federal Reserve System, Washington, D.C.

• Federal Reserve Branch city

— Branch boundary

### Notes

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) as well as by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska and the San Francisco Bank serves Hawaii.

The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands.

The Board of Governors revised the Branch boundaries of the System most recently in February 1996.



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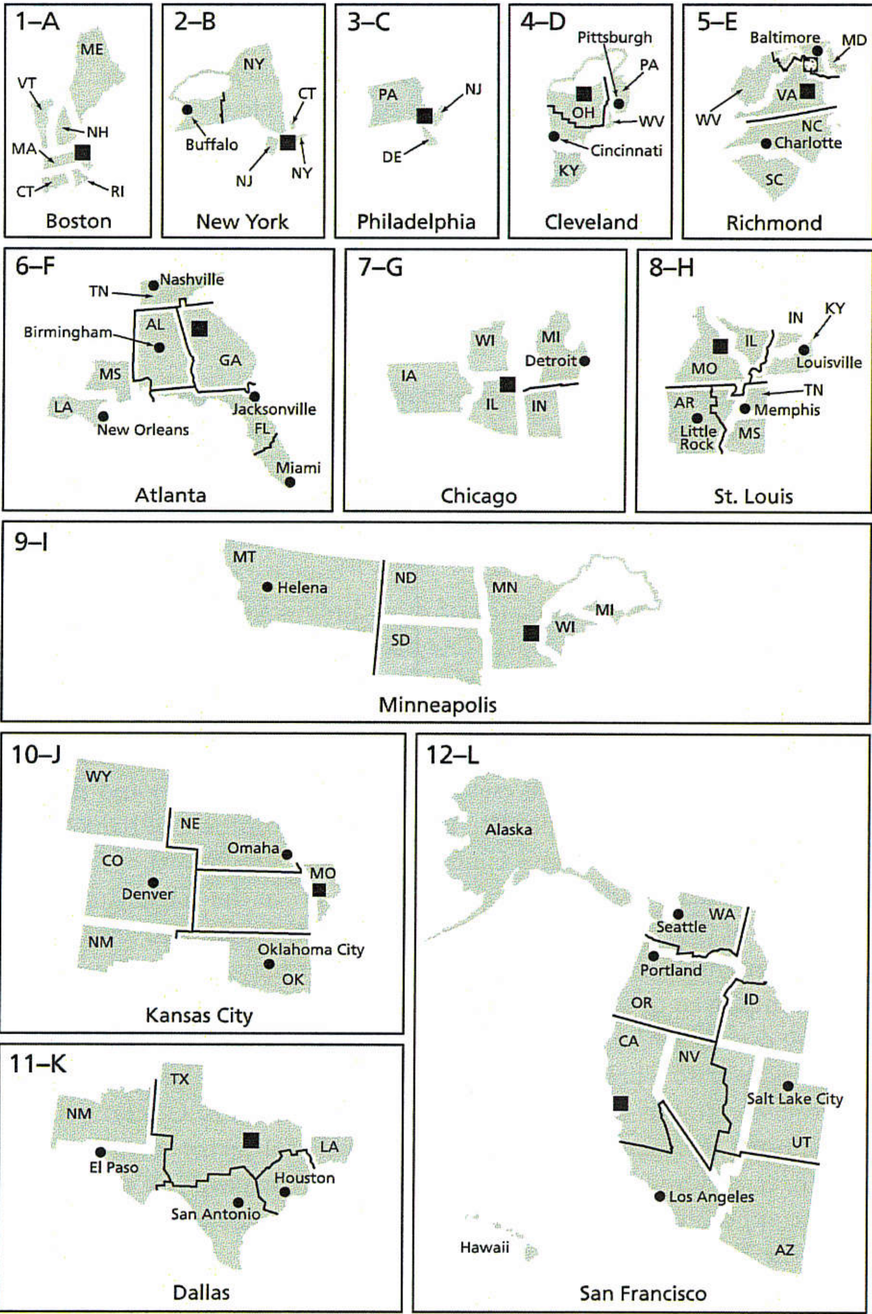




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offices and boundaries of the Federal Reserve Districts are shown on the maps on pages 8 and 9.

The Board of Governors has broad oversight responsibility for the operations and activities of the Federal Reserve Banks and their Branches. This authority includes oversight of the Reserve Banks' services to banks and other depository institutions and of their examination and supervision of various banking institutions. Each Federal Reserve Bank must submit its annual budget to the Board of Governors for approval. Particular types of expenditures—such as those for construction or major alterations of Reserve Bank buildings and for the salaries of Reserve Bank presidents and first vice presidents—also are subject to specific Board approval.

Congress chartered the Federal Reserve Banks for a public purpose. The Reserve Banks are the operating arms of the central banking system, and they combine both public and private elements in their makeup and organization. As part of the Federal Reserve System, the Banks are subject to oversight by Congress.

Each Reserve Bank has its own board of nine directors chosen from outside the Bank as provided by law. The boards of the Reserve Banks are intended to represent a cross-section of banking, commercial, agricultural, industrial, and public interests within the Federal Reserve District. Three directors, designated Class A directors, represent commercial banks that are members of the Federal Reserve System. Three Class B and three Class C directors represent the public. The member commercial banks in each District elect the Class A and Class B directors. The Board of Governors appoints the Class C directors to their posts. From the Class C directors, the Board of Governors selects one person as chairman and another as deputy chairman. No Class B or Class C director may be an officer, director, or employee of a bank or a bank holding company. No Class C director may own stock in a bank or a bank holding company. The directors in turn nominate a president and first vice president of the Reserve Bank, whose selection is subject to approval by the Board of Governors. Each Branch of a Reserve Bank has its own board of directors composed of at least three and no more than seven members. A majority of these directors are appointed by the Branch's Reserve Bank; the others are appointed by the Board of Governors.

Boards of directors of the Reserve Banks provide the Federal Reserve System with a wealth of information on economic conditions in virtually every corner of the nation. This information is used by the FOMC and the Board of Governors in reaching major decisions about monetary policy. Information from directors and other sources gathered by the Reserve Banks is also shared with the public in a special report—informally called the Beige Book—which is issued about two weeks



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before each meeting of the FOMC. In addition, every two weeks, the board of each Bank must recommend interest rates for its Bank's discount window lending, subject to review and determination by the Board of Governors.

The income of the Federal Reserve System is derived primarily from the interest on U.S. government securities that it has acquired through open market operations. Other major sources of income are the interest on foreign currency investments held by the System; interest on loans to depository institutions; and fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations.

After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury. About 95 percent of the Reserve Banks' net earnings have been paid into the Treasury since the Federal Reserve System began operations in 1914. (Income and expenses of the Federal Reserve Banks from 1914 to the present are included in the *Annual Report* of the Board of Governors.) In 2003, the Federal Reserve paid approximately $22 billion to the Treasury.

*After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury.*

The Board of Governors contracts with an accounting firm to conduct an audit of the Reserve Banks every year, and Board staff periodically reviews the operations of the Reserve Banks in key functional areas. The audited combined financial statements of the Reserve Banks are published in the Board's *Annual Report*. The Reserve Banks, like the Board, are subject to audit by the GAO, but certain functions, such as transactions with foreign central banks and open market operations, are excluded from the GAO's audit. Each Reserve Bank has an internal auditor who is responsible to the Bank's board of directors.

### Federal Open Market Committee

The FOMC is charged under law with overseeing open market operations, the principal tool of national monetary policy. These operations affect the amount of Federal Reserve balances available to depository institutions (see chapter 3), thereby influencing overall monetary and credit conditions. The FOMC also directs operations undertaken by the Federal Reserve in foreign exchange markets.

The FOMC is composed of the seven members of the Board of Governors and five of the twelve Reserve Bank presidents. The president of the Federal Reserve Bank of New York is a permanent member; the other

presidents serve one-year terms on a rotating basis.[1] All the presidents participate in FOMC discussions, contributing to the committee's assessment of the economy and of policy options, but only the five presidents who are committee members vote on policy decisions. The FOMC, under law, determines its own internal organization and by tradition elects the Chairman of the Board of Governors as its chairman and the president of the Federal Reserve Bank of New York as its vice chairman. Formal meetings typically are held eight times each year in Washington, D.C. Telephone consultations and other meetings are held when needed.

## Member Banks

*The FOMC is composed of the seven members of the Board of Governors and five of the twelve Reserve Bank presidents.*

The nation's commercial banks can be divided into three types according to which governmental body charters them and whether or not they are members of the Federal Reserve System. Those chartered by the federal government (through the Office of the Comptroller of the Currency in the Department of the Treasury) are national banks; by law, they are members of the Federal Reserve System. Banks chartered by the states are divided into those that are members of the Federal Reserve System (state member banks) and those that are not (state nonmember banks). State banks are not required to join the Federal Reserve System, but they may elect to become members if they meet the standards set by the Board of Governors. As of March 2004, of the nation's approximately 7,700 commercial banks approximately 2,900 were members of the Federal Reserve System—approximately 2,000 national banks and 900 state banks.

Member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 6 percent of their capital and surplus, half of which must be paid in while the other half is subject to call by the Board of Governors. The holding of this stock, however, does not carry with it the control and financial interest conveyed to holders of common stock in for-profit organizations. It is merely a legal obligation of Federal Reserve membership, and the stock may not be sold or pledged as collateral for loans. Member banks receive a 6 percent dividend annually on their stock, as specified by law, and vote for the Class A and Class B directors of the Reserve Bank. Stock in Federal Reserve Banks is not available for purchase by individuals or entities other than member banks.

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1. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. An alternate for each Reserve Bank president also is elected. This alternate, who must be a president or first vice president of a Reserve Bank, may serve on the FOMC in the absence of the relevant Reserve Bank president.

## Advisory Committees

The Federal Reserve System uses advisory committees in carrying out its varied responsibilities. Three of these committees advise the Board of Governors directly:

- ***Federal Advisory Council.*** This council, which is composed of twelve representatives of the banking industry, consults with and advises the Board on all matters within the Board's jurisdiction. It ordinarily meets four times a year, as required by the Federal Reserve Act. These meetings are held in Washington, D.C., customarily on the first Friday of February, May, September, and December, although occasionally the meetings are set for different times to suit the convenience of either the council or the Board. Annually, each Reserve Bank chooses one person to represent its District on the Federal Advisory Committee, and members customarily serve three one-year terms and elect their own officers.
- ***Consumer Advisory Council.*** This council, established in 1976, advises the Board on the exercise of its responsibilities under the Consumer Credit Protection Act and on other matters in the area of consumer financial services. The council's membership represents the interests of consumers, communities, and the financial services industry. Members are appointed by the Board of Governors and serve staggered three-year terms. The council meets three times a year in Washington, D.C., and the meetings are open to the public.
- ***Thrift Institutions Advisory Council.*** After the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which extended to thrift institutions the Federal Reserve's reserve requirements and access to the discount window, the Board of Governors established this council to obtain information and views on the special needs and problems of thrift institutions. Unlike the Federal Advisory Council and the Consumer Advisory Council, the Thrift Institutions Advisory Council is not a statutorily mandated body, but it performs a comparable function in providing firsthand advice from representatives of institutions that have an important relationship with the Federal Reserve. The council meets with the Board in Washington, D.C., three times a year. The members are representatives from savings and loan institutions, mutual savings banks, and credit unions. Members are appointed by the Board of Governors and generally serve for two years.

The Federal Reserve Banks also use advisory committees. Of these advisory committees, perhaps the most important are the committees (one for each Reserve Bank) that advise the Banks on matters of agriculture, small business, and labor. Biannually, the Board solicits the views of each of these committees by mail.

# The U.S. Economic Outlook:
# The Aftermath of Leverage

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

The Central Exchange
Kansas City, Missouri
January 7, 2009

HOUSE FINANCIAL INSTITUTIONS
DATE: 1/21/2009
ATTACHMENT: 3 - 1

I am pleased to once again be at the Central Exchange to share my outlook for the economy. It doesn't seem possible that it has been a year since I last spoke here and suggested that though the economy was going to slow, there was still the possibility of avoiding a recession. I thought we might avoid the recession if the housing market stabilized and the financial sector avoided further shocks.

The sad truth is that over the past year, the economy has been affected by several shocks – the further decline in housing, the turmoil in financial markets, and a sharp drop in consumer and business confidence. With the benefit of hindsight, we should not be all that surprised by the onset of these shocks. They are a consequence of excessive leverage accumulated over a decade, about which many of us expressed concerns.

The remedy to what we now face will require a rebalancing of domestic savings and investment within the U.S. economy. This rebalancing process and the length and depth of the recession itself will be determined importantly by how quickly financial firms, businesses and the consumer rebuild their diminished wealth and regain their confidence. It will be influenced also by the Federal Reserve's unprecedented actions and funding programs and forthcoming fiscal initiatives.

These are challenging times to say the least, and for the next few minutes, I want to share with you my perspective on them. I will start with some background on what led to this recession and then describe for you my outlook for 2009. I also will provide what information I can on the policy actions being taken to influence this outlook. And let me say at the outset that though I agree we must do all we reasonably can to revive the economy, I caution, based on my years of experience, that in our haste to mitigate this recession's effects, we not attempt shortcuts that put at risk future stability and growth.

**The U.S. Economy is in Recession**

The U.S. recession, we are told by the NBER, officially began more than a year ago in December 2007. In the third quarter of 2008, real GDP growth was -0.5 percent, and recent data suggests that the economy contracted at a much sharper rate in the fourth quarter.

Labor markets have weakened considerably throughout the year. The unemployment rate has risen from 4.9 percent in January 2008 to 6.7 percent in November, and total employment has fallen by 1.8 million jobs. And, as evidenced by the November employment report and recent layoff announcements, the deterioration in labor markets has intensified.

Worse yet, economic growth has slowed sharply in the rest of the world. Several European countries along with Japan appear to be in recession. As growth in the rest of the world slows, so does demand for U.S. exports, which was the one bright spot in the U.S. economy in 2008.

Finally, as is usually the case with recession, inflation has moderated considerably in recent months. After surging in the earlier half of 2008, the headline price indexes fell sharply in October and November due to the steep fall in energy prices. Core inflation also moderated following weak consumer demand and declining production costs from lower energy and commodity prices. But while inflation is receding for the moment, I must remind you that monetary policy is extremely accommodative, and if it remains so too long, as history suggests it may, inflation pressures could re-emerge as the economy recovers.

**Financial Leverage**

It seems so clear now, doesn't it, that the key factor underlying the current economic downturn has been the behavior of financial institutions and consumers, who increased their borrowing to unprecedented and ultimately unsustainable levels in the excitement of the "boom" in housing. As the reality of this leverage finally emerged, its effects started to show most notably in August 2007. An asset-pricing crisis eventually widened into a confidence crisis that spread throughout the economy.

Between 2001 and 2007, in an environment of low and then slowly rising interest rates and easy credit availability, financial institutions dramatically increased their packaging and selling of mortgages in response to increased demand for these securitized assets. During this period of rapidly rising real estate prices, these assets were judged to be safe, profitable investments.

In addition, we saw a surge in debt. Financial firms increased the level of domestic financial debt from \$8.5 trillion to \$16 trillion, or by 90 percent. Mortgage debt increased from \$4.9 trillion to \$10.5 trillion, a 114 percent increase. And total public debt outstanding increased from \$3.4 trillion to \$5.2 trillion. The building of assets through the use of debt was the way to easy wealth, so it seemed.

When the rise in real estate prices stalled in late 2006, investors became increasingly concerned about the value of these securitized, leveraged assets. In August 2007, the financial crisis emerged, full force, as short-term lending began to seize up.

The firms most strongly affected by these events were, of course, those that "took advantage" of one of the most aggressive leveraging periods in financial history. The debt-to-capital ratios for the largest 10 bank holding companies in aggregate increased

over the past ten years from about 14 to 1 to over 21 to 1. The debt-to-capital ratios for the investment banks were even higher at over 30 to 1.

The crisis that emerged as the implications of this leverage became more apparent resembled an old-style bank run. As problems developed and confidence waned many of these institutions found themselves without funding. They were unable to sell their securities in the market given the concerns about the value of the underlying assets. These events caused a broad base of participants to pull out of the markets to the point where they no longer function properly.

The resolution of the crisis will occur when the deleveraging process hits bottom and financial institutions are able to resume their role as intermediaries. This I suspect is dependent on at least two factors.

First, a stable market price needs to be established for the currently illiquid assets sitting on the balance sheets of financial institutions. Until these assets can be adequately valued and losses absorbed and future losses staunched, financial firms are going to have a difficult time raising capital and extending new loans.

Second, this will take time and will not be painless or simple to accomplish. It will require actions by both the monetary and fiscal authorities that are well thought out, well-defined, fully disclosed, and firmly and consistently executed across all financial firms. We have learned from events over this past year that this is no easy task.

**Consumer Leverage**

A related event having substantial negative repercussions for the U.S. economy is the fallout from the leveraging of U.S. consumers. Between 2001 and 2007, household debt increased from 97 percent of disposable personal income to 133 percent. This massive increase in borrowing was reflected most vividly through the increase of mortgage debt. The mortgage refinancing boom allowed homeowners to extract large quantities of equity from their homes at a time when house prices were appreciating rapidly. The overall result was that consumers spent at a rate roughly equal to their incomes, savings rates plunged to zero and borrowing soared.

Much of this borrowing was funded by foreigners. Between 2001 and 2007, the current account deficit increased by 56 percent as our demand for imports greatly exceeded exports. Foreign holdings of total U.S. Treasury debt increased sharply from 30 percent to 46 percent. Thus, while the United States spent, the rest of the world supported our habit. Now we're in withdrawal, and, yes, it is painful.

In the past two years, household wealth has fallen sharply with declines in house prices and equity values. For example, homeowners' equity share of household real estate has dropped from 55 percent to 45 percent, the lowest value on record. To rebalance and rebuild wealth, consumers are now increasing savings and decreasing spending. As I said, this is a difficult process, and without offsetting adjustments in other sectors of the economy, the effect of this rebalancing is slower growth in real GDP.

**The Aftermath of Leverage**

In the first half of 2008, the necessary structural adjustment began gradually. Real GDP grew at an annual rate of 1.8 percent while consumption grew at the slower rate of 1.0 percent. Over the last several years export growth was strong and the real net export deficit decreased. For a while at least it seemed we might come through the adjustment relatively well. I certainly thought it was possible.

But, then, mortgage foreclosure problems worsened. In early 2008, Bear Stearns collapsed, followed later by a series of liquidity and solvency crises involving the GSEs, Lehman Brothers, Merrill Lynch and AIG. For investors, there was confusion regarding how each was handled and how future problems might finally be resolved. The TARP was introduced and changed several times as it was being implemented.

These events added to uncertainty across the economy, and the financial turmoil worsened. In September and October, credit conditions tightened further, and businesses' and consumers' confidence seemed to collapse. Indeed, although the early attempts to staunch the recession were well-intentioned, it will be a subject of debate for some time on whether the rush to action might have contributed to the worsening of conditions.

In the meantime, these developments contributed to the sharp decline of 3.8 percent in consumption in the third quarter. And for the first time ever, the level of household debt declined. Based on recent indicators, this decline in consumption continued into the fourth quarter and has served to deepen the recession.

**The Outlook**

The process of absorbing financial loss, increasing savings and decreasing consumption, the pain of deleveraging, sets the context for the economic outlook. The hard fact is that the sharp deterioration of banking and credit conditions, the deepening slump in consumer and business confidence, and the ongoing housing correction must work its way through the economy. While we must do what we can to mitigate the effects of this deleveraging process, to attempt to avoid its effects entirely is to repeat past mistakes and may sow the seeds for the next crisis.

Accordingly, my outlook calls for the economy to contract further through much of 2009 until later in the year when the effects of policy actions begin to stimulate GDP growth.

Starting with consumption, we will most likely see a contraction at least into the second quarter. Improvements in both consumption and savings will be hampered by declines in disposable incomes as firms continue to cut costs through layoffs, reductions of hours and pay cuts. This will be particularly hard felt by households this month when the seasonal jobs during the holiday shopping season come to an end.

The outlook for business spending is also weak. Conditions in the manufacturing sector have worsened, and with this, the decline in corporate profits makes it unlikely that firms will expand equipment spending until they see a rebound in consumer demand. Spending on structures is expected to contract markedly due to tight credit conditions and waning demand for commercial building space.

Of course, the outlook for residential investment remains weak as well. Housing starts have fallen by 60 percent from peak levels in 2006, and the inventory of existing

single-family homes remains unusually high at an 11.5-month supply. The increase in foreclosure rates in the near term is likely to contribute to additional housing price declines.

Even the one recent source of strength for the economy, net exports, is expected to slow in 2009. After a robust expansion of U.S. exports in the first half of 2008, a rapid appreciation of the dollar combined with weakening world demand likely halted the expansion of exports in the second half of the year. The recent decline in the dollar should reverse this somewhat, but world demand is likely to be weak over the next several quarters.

Government spending at the state and local level is expected to slow as budgets are cut in response to a decline in tax revenues during this downturn. Government spending at the national level will provide a boost to the economy, depending on the size and content of the forthcoming stimulus package.

Putting all of the pieces of the outlook together, the picture for the last quarter of 2008 and at least the first half of this year is grim. The magnitude of the downturn is likely to surpass that of the 1990 and 2001 recessions.

While this immediate outlook is unsettling, over the longer horizon there is reason to expect that we can move through these difficulties and be a stronger economy when we emerge from recession. If we pursue systematic policies with the right balance of monetary and fiscal stimulus, the early signs of economic recovery could show themselves as early as the third quarter of 2009. It would be foolish to attempt to pinpoint the exact spark for the recovery, but there are important factors that should contribute to this result.

First, the recent sharp decline in oil and gasoline prices does increase consumer disposable income by billions of dollars, improve their financial position and serve to restore confidence. Second, while the housing market will continue to struggle, low mortgage rates and some decline in inventory will serve to stabilize home prices and moderate housing's extended drag on the economy. Third, a gradual improvement in financial conditions will increase the supply of credit and encourage demand. And finally, expansive monetary and fiscal policy will stimulate the economy and serve to offset some of those factors pulling it down.

Inflation will remain moderate over 2009 and much of 2010. Lower energy and commodity prices along with moderate improvement in demand for goods and services will keep price pressures temporarily contained. How prices behave beyond the immediate horizon depends most critically on how the Federal Reserve conducts policy and manages its expanding balance sheet in a strengthening economy. This is no doubt the central bank's most difficult longer-run challenge.

**Monetary Policy**

As I already have suggested, the FOMC has responded to the financial and economic crisis by steadily cutting the federal funds target rate from 5¼ percent in September 2007 to its current range between 0 and ¼ percent.

In addition, to provide continued support for the functioning of financial markets and to stimulate the economy, the Board of Governors, under provisions of the Federal Reserve Act, has authorized the creation of several new liquidity facilities and the FOMC has authorized the purchase of large quantities of additional assets for the Reserve Banks

to hold. The Federal Reserve has stated that with near-term inflation pressures diminished, it is prepared to provide expanded liquidity to the markets as needed. Plans include implementing a loan program to facilitate the extension of credit to consumers and small businesses.

These actions are unprecedented and are a powerful stimulus to the economy for 2009, but they come with their own set of risks. First, they are not designed to fix the problems within the financial industry but to go around the problem. They were taken because the intermediation process is broken, and financial institutions are thought to be in such a state that they are unable to expand their lending sufficiently to drive the economic recovery forward.

As a result, the Federal Reserve is not only providing liquidity to the financial industry, it is also taking on the financial industry's role as intermediary to business firms. This is a dramatic expansion of the central bank's role in the economy. It is reflected most vividly in the combined balance sheet of the 12 Reserve Banks, which has increased from $900 billion in mostly Treasury securities in the fall of 2007 to $2.3 trillion in other assets today, and this will increase still further in the months ahead.

The Federal Reserve must now manage its balance sheet in a manner that not only places liquidity into the economy but also in a manner that does not undermine the long-term functioning of markets. It must design an exit strategy that at the appropriate time both removes excess liquidity from the economy and allows it to withdraw as a significant intermediary. Failure to have such a strategy risks undermining an efficient financial market system.

Some of these facilities will automatically dissipate as the market's intermediation process returns to a more normal state. But the Federal Reserve also will have to undertake specific, timely actions if we are to remove the accommodative policy in an effective manner. The importance of doing this correctly cannot be overemphasized. As I have suggested, we have sometimes been slow to remove our accommodative policy, and in doing so, we have invited the next round of inflation, excess and crisis.

**Fiscal Policy**

Finally, a critical element affecting the recovery in 2009 will be the introduction of additional fiscal stimulus into the economy. To this point, the current administration and Congress have taken actions to recapitalize banks, and the FDIC has greatly expanded its guarantees of bank liabilities. But these actions might be viewed best as holding actions, designed to keep the economy from deteriorating further and faster while other solutions are developed. The incoming administration's stimulus package appears to involve expenditures for both short-term and longer-term projects.

The cost of the proposed actions is expected to exceed $700 billion and will almost certainly boost the economy in a time of recession. In the longer run, as we know, this too brings risks that cannot be ignored. It will add to our burden of managing a rapidly expanding national debt at the same time that we will be confronted with the looming obligations from rising Social Security, Medicare and defense expenditures. But for the moment, putting our economy back on its feet is the priority, and with the monetary and fiscal actions that are underway, we should see improvement as we enter the second half of 2009.

**Concluding Comments**

In the end, the greatest challenge that I see for the U.S. economy is not just the recession we are now suffering through but how we choose to address it. There are no shortcuts to stability, no painless methods to adjusting our saving-spending mix and returning to prosperity. We want to successfully get through this difficult deleveraging process, rebuild our national savings and wealth, and we want to do it in a fashion that does not sow the seeds of the next crisis. As we provide needed liquidity to the financial system to contain the crisis, we must be careful to build public confidence by assuring that our actions across financial firms are consistent, open, and understandable to the market and the public. We also must be patient and consider the long run. We must provide for an environment of stable prices and manageable debt levels so necessary for sustainable growth in our national income. If we fail to meet this mandate, we will only repeat the cycle of inflation, excess and crisis.