Ben S Bernanke: The economic outlook

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 2 April 2008.

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Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of the Committee, I am pleased to appear before the Joint Economic Committee. In response to deterioration in the near-term outlook for the economy and intensified strains in financial markets, in recent months the Federal Reserve has eased monetary policy substantially further and taken strong actions to increase market liquidity. In my remarks today, I will first offer my views on conditions in financial markets and the outlook for the U.S. economy, then discuss recent actions taken by the Federal Reserve.

Although our recent actions appear to have helped stabilize the situation somewhat, financial markets remain under considerable stress. Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and have increased the amount of collateral they require to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices.

Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises (GSEs), have reported substantial losses and writedowns, reducing their available capital. Several of these firms have been able to raise fresh capital to offset at least some of those losses, and others are in the process of doing so. However, financial institutions’ balance sheets have also expanded, as banks and other institutions have taken on their balance sheets various assets that can no longer be financed on a standalone basis. Thus, the capacity and willingness of some large institutions to extend new credit remains limited.

The effects of the financial strains on credit cost and availability have become increasingly evident, with some portions of the system that had previously escaped the worst of the turmoil – such as the markets for municipal bonds and student loans – having been affected. Another market that had previously been largely exempt from disruptions was that for mortgage-backed securities (MBS) issued by government agencies. However, beginning in mid-February, worsening liquidity conditions and reports of losses at the GSEs, Fannie Mae and Freddie Mac, caused the spread of agency MBS yields over the yields on comparable Treasury securities to rise sharply. Together with the increased fees imposed by the GSEs, the rise in this spread resulted in higher interest rates on conforming mortgages. More recently, agency MBS spreads and conforming mortgage rates have retraced part of this increase, and conforming mortgages continue to be readily available to households. However, for the most part, the nonconforming segment of the mortgage market continues to function poorly.

In corporate debt markets, yields and spreads on both investment-grade and speculative-grade corporate bonds rose through mid-March before falling more recently. Issuance of investment-grade bonds by both financial and nonfinancial corporations has been quite robust so far this year, but issuance of new high-yield debt has stalled. Strains continue to be evident in the commercial paper market as well, where risk spreads remain elevated and the quantity of commercial paper outstanding, particularly asset-backed paper, has decreased. Commercial and industrial loans at banks grew in January and February, but at a considerably slower pace than in previous months.

These developments in financial markets – which themselves reflect, in part, greater concerns about housing and the economic outlook more generally – have weighed on real economic activity. Notably, in the housing market, sales of both new and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall.[1] Starts of new single-family homes declined an additional 7 percent in February, bringing the cumulative decline since the early 2006 peak in single-family starts to more than 60 percent. Residential construction is likely to contract somewhat further in coming quarters as builders try to reduce their high inventories of unsold new homes.

Private payroll employment fell 101,000 in February, after two months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline. But the demand for labor has also moderated recently in other industries, such as business services and retail trade, and manufacturing employment has continued on its downward trend. Meanwhile, claims for unemployment insurance have risen somewhat on balance, and surveys indicate that employers have scaled back hiring plans and that jobseekers are experiencing greater difficulties finding work. The unemployment rate edged down in February and remains at a relatively low level; however, in light of the sluggishness of economic activity and other indicators of a softer labor market, I expect it to move somewhat higher in coming months.

After rising at an annual rate of about 3 percent over the first three quarters of last year, real disposable income has since increased at only about a 1 percent annual rate, reflecting weaker employment conditions and higher prices for energy and food. Concerns about employment and income prospects, together with declining home values and tighter credit conditions, have caused consumer spending to decelerate considerably from the solid pace seen during the first three quarters of last year. I expect the tax rebates associated with the fiscal stimulus package recently passed by the Congress to provide some support to consumer spending in coming quarters.

In the business sector, the pullback in hiring that I noted earlier has been accompanied by some reduction in capital spending plans, as weaker sales prospects, tighter credit, and heightened uncertainty have made business leaders more cautious. On a more positive note, the nonfinancial business sector remains financially sound, with liquid balance sheets and low leverage ratios, and most firms have been able to avoid unwanted buildups in inventories. In addition, many businesses are enjoying strong demand from abroad. Although the prospects for foreign economic growth have diminished somewhat in recent months, net exports should continue to provide considerable support to U.S. economic activity in coming quarters.

Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee (FOMC) at the end of January. It now appears likely that real gross domestic product (GDP) will not grow much, if at all, over the first half of 2008 and could even contract slightly. We expect economic activity to strengthen in the second half of the year, in part as the result of stimulative monetary and fiscal policies; and growth is expected to proceed at or a little above its sustainable pace in 2009, bolstered by a stabilization of housing activity, albeit at low levels, and gradually improving financial conditions. However, in light of the recent turbulence in financial markets, the uncertainty attending this forecast is quite high and the risks remain to the downside.

Inflation has also been a source of concern. The price index for personal consumption expenditures rose 3.4 percent over the twelve months ending in February, up from 2.3 percent over the preceding twelve-month period. To a large extent, this pickup in inflation has

[1] In February, sales of existing homes are reported to have turned up slightly, but sales of new homes continued to move down.

been the result of sharp increases in the prices of crude oil, agricultural products, and other globally traded commodities. Additionally, the decline in the foreign exchange value of the dollar has boosted some non-commodity import prices and thus contributed to inflation. However, the so-called core rate of inflation – that is, inflation excluding food and energy prices – has edged down recently after firming somewhat late last year.

We expect inflation to moderate in coming quarters. That expectation is based, in part, on futures markets' indications of a leveling out of prices for oil and other commodities, and it is consistent with our projection that global growth – and thus the demand for commodities – will slow somewhat during this period. And, as I noted, we project an easing of pressures on resource utilization. However, some indicators of inflation expectations have risen, and, overall, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully in the months ahead.

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I turn now to the Federal Reserve's policy responses to these financial and economic developments.

Well-functioning financial markets are essential for the efficacy of monetary policy and, indeed, for economic growth and stability. To improve market liquidity and market functioning, and consistent with its role as the nation's central bank, the Federal Reserve has supplemented its longstanding discount window by establishing three new facilities for lending to depository institutions and primary dealers.

The lending facilities now in place offer depository institutions and primary dealers two complementary alternatives for meeting funding needs. One pair of facilities – the discount window for depository institutions and the Primary Dealer Credit Facility for primary dealers – offers daily access to variable amounts of funding at the initiative of the borrowing institution. A second pair of facilities – the Term Auction Facility for depository institutions and the Term Securities Lending Facility for primary dealers – makes available predetermined aggregate amounts of longer-term funding on pre-announced dates, with the interest rate and the distribution of the awards across institutions being determined by competitive auction. Although these facilities operate through depository institutions and primary dealers, they are designed to support the broad financial markets and the economy by facilitating the provision of liquidity by those institutions to their customers and counterparties.

The Primary Dealer Credit Facility was put in place in the wake of the near-failure of Bear Stearns, a large investment bank. On March 13, Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for Chapter 11 bankruptcy the next day unless alternative sources of funds became available. This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences of such a failure for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The Federal Reserve has taken additional measures to improve market liquidity. We have initiated a series of twenty-eight-day single-tranche term repurchase transactions with primary dealers, expected to cumulate to $100 billion outstanding, in which dealers may offer any of the types of collateral that are eligible for conventional open market operations. We have also expanded and extended reciprocal currency arrangements ("swap lines") with the European Central Bank and the Swiss National Bank. Using these swap lines, the participating central banks are providing dollar liquidity to financial institutions in their jurisdictions, which should improve the functioning of the global market for dollar funding. These facilities and programs will be kept in place as long as conditions warrant their ongoing use. We are working closely with the Securities Exchange Commission to monitor the financial conditions and funding positions of primary dealers who might seek Federal Reserve credit.

To date, the recent liquidity measures implemented by the Federal Reserve seem to have been helpful in addressing some of the strains in financial markets. Funding pressures on primary dealers appear to have eased somewhat, and liquidity seems to have improved in several markets, including – as noted earlier – the market for agency mortgage-backed securities. To the extent that these measures improve market functioning, they will have favorable effects on the ability and willingness to make credit available to the broader economy. More-liquid markets also increase the efficacy of monetary policy, which in turn improves our ability to meet the goals set for us by the Congress – namely, to promote maximum employment and price stability.

As you know, in response to the further weakening of economic conditions, the Federal Reserve has continued to ease the stance of monetary policy. The FOMC reduced its target for the federal funds rate by a total of 125 basis points in January and by an additional 75 basis points at its March meeting, leaving the current target at 2-1/4 percent – 3 percentage points below its level last summer. As the Committee noted in its most recent post-meeting statement, we anticipate that these actions, together with the steps we have taken to foster market liquidity, will help to promote growth over time and to mitigate the risks to economic activity.

Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. I remain confident in our economy's long-term prospects.

Thank you. I would be pleased to take your questions.