Ben S Bernanke: Semiannual Monetary Policy Report to the Congress

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, US Senate, Washington, DC, 24 February 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Dodd, Senator Shelby, and members of the Committee, I appreciate the opportunity to discuss monetary policy and the economic situation and to present the Federal Reserve's *Monetary Policy Report to the Congress.*

Recent economic and financial developments and the policy responses

As you are aware, the U.S. economy is undergoing a severe contraction. Employment has fallen steeply since last autumn, and the unemployment rate has moved up to 7.6 percent. The deteriorating job market, considerable losses of equity and housing wealth, and tight lending conditions have weighed down consumer sentiment and spending. In addition, businesses have cut back capital outlays in response to the softening outlook for sales as well as the difficulty of obtaining credit. In contrast to the first half of last year, when robust foreign demand for U.S. goods and services provided some offset to weakness in domestic spending, exports slumped in the second half as our major trading partners fell into recession and some measures of global growth turned negative for the first time in more than 25 years. In all, U.S. real gross domestic product (GDP) declined slightly in the third quarter of 2008, and that decline steepened considerably in the fourth quarter. The sharp contraction in economic activity appears to have continued into the first quarter of 2009.

The substantial declines in the prices of energy and other commodities last year and the growing margin of economic slack have contributed to a substantial lessening of inflation pressures. Indeed, overall consumer price inflation measured on a 12-month basis was close to zero last month. Core inflation, which excludes the direct effects of food and energy prices, also has declined significantly.

The principal cause of the economic slowdown was the collapse of the global credit boom and the ensuing financial crisis, which has affected asset values, credit conditions, and consumer and business confidence around the world. The immediate trigger of the crisis was the end of housing booms in the United States and other countries and the associated problems in mortgage markets, notably the collapse of the U.S. subprime mortgage market. Conditions in housing and mortgage markets have proved a serious drag on the broader economy both directly, through their impact on residential construction and related industries and on household wealth, and indirectly, through the effects of rising mortgage delinquencies on the health of financial institutions. Recent data show that residential construction and sales continue to be very weak, house prices continue to fall, and foreclosure starts remain at very high levels.

The financial crisis intensified significantly in September and October. In September, the Treasury and the Federal Housing Finance Agency placed the government-sponsored enterprises, Fannie Mae and Freddie Mac, into conservatorship, and Lehman Brothers Holdings filed for bankruptcy. In the following weeks, several other large financial institutions failed, came to the brink of failure, or were acquired by competitors under distressed circumstances. Losses at a prominent money market mutual fund prompted investors, who had traditionally considered money market mutual funds to be virtually risk-free, to withdraw large amounts from such funds. The resulting outflows threatened the stability of short-term funding markets, particularly the commercial paper market, upon which corporations rely heavily for their short-term borrowing needs. Concerns about potential losses also undermined confidence in wholesale bank funding markets, leading to further increases in bank borrowing costs and a tightening of credit availability from banks.

Recognizing the critical importance of the provision of credit to businesses and households from financial institutions, the Congress passed the Emergency Economic Stabilization Act last fall. Under the authority granted by this act, the Treasury purchased preferred shares in a broad range of depository institutions to shore up their capital bases. During this period, the Federal Deposit Insurance Corporation (FDIC) introduced its Temporary Liquidity Guarantee Program, which expanded its guarantees of bank liabilities to include selected senior unsecured obligations and all non-interest-bearing transactions deposits. The Treasury--in concert with the Federal Reserve and the FDIC--provided packages of loans and guarantees to ensure the continued stability of Citigroup and Bank of America, two of the world's largest banks. Over this period, governments in many foreign countries also announced plans to stabilize their financial institutions, including through large-scale capital injections, expansions of deposit insurance, and guarantees of some forms of bank debt.

Faced with the significant deterioration in financial market conditions and a substantial worsening of the economic outlook, the Federal Open Market Committee (FOMC) continued to ease monetary policy aggressively in the final months of 2008, including a rate cut coordinated with five other major central banks. In December the FOMC brought its target for the federal funds rate to a historically low range of 0 to 1/4 percent, where it remains today. The FOMC anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

With the federal funds rate near its floor, the Federal Reserve has taken additional steps to ease credit conditions. To support housing markets and economic activity more broadly, and to improve mortgage market functioning, the Federal Reserve has begun to purchase large amounts of agency debt and agency mortgage-backed securities. Since the announcement of this program last November, the conforming fixed mortgage rate has fallen nearly 1 percentage point. The Federal Reserve also established new lending facilities and expanded existing facilities to enhance the flow of credit to businesses and households. In response to heightened stress in bank funding markets, we increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers, and we expanded our network of swap lines with foreign central banks to ease conditions in interconnected dollar funding markets at home and abroad. We also established new lending facilities to support the functioning of the commercial paper market and to ease pressures on money market mutual funds. In an effort to restart securitization markets to support the extension of credit to consumers and small businesses, we joined with the Treasury to announce the Term Asset-Backed Securities Loan Facility (TALF). The TALF is expected to begin extending loans soon.

The measures taken by the Federal Reserve, other U.S. government entities, and foreign governments since September have helped to restore a degree of stability to some financial markets. In particular, strains in short-term funding markets have eased notably since the fall, and London interbank offered rates (Libor)--upon which borrowing costs for many households and businesses are based--have decreased sharply. Conditions in the commercial paper market also have improved, even for lower-rated borrowers, and the sharp outflows from money market mutual funds seen in September have been replaced by modest inflows. Corporate risk spreads have declined somewhat from extraordinarily high levels, although these spreads remain elevated by historical standards. Likely spurred by the improvements in pricing and liquidity, issuance of investment-grade corporate bonds has been strong, and speculative-grade issuance, which was near zero in the fourth quarter, has picked up somewhat. As I mentioned earlier, conforming fixed mortgage rates for households have declined. Nevertheless, despite these favorable developments, significant stresses persist in many markets. Notably, most securitization markets remain shut, other than that for conforming mortgages, and some financial institutions remain under pressure.

In light of ongoing concerns over the health of financial institutions, the Secretary of the Treasury recently announced a plan for further actions. This plan includes four principal elements: First, a new capital assistance program will be established to ensure that banks have adequate buffers of high-quality capital, based on the results of comprehensive stress tests to be conducted by the financial regulators, including the Federal Reserve. Second is a public-private investment fund in which private capital will be leveraged with public funds to purchase legacy assets from financial institutions. Third, the Federal Reserve, using capital provided by the Treasury, plans to expand the size and scope of the TALF to include securities backed by commercial real estate loans and potentially other types of asset-backed securities as well. Fourth, the plan includes a range of measures to help prevent unnecessary foreclosures. Together, over time these initiatives should further stabilize our financial institutions and markets, improving confidence and helping to restore the flow of credit needed to promote economic recovery.

Federal Reserve transparency

The Federal Reserve is committed to keeping the Congress and the public informed about its lending programs and balance sheet. For example, we continue to add to the information shown in the Fed's H.4.1 statistical release, which provides weekly detail on the balance sheet and the amounts outstanding for each of the Federal Reserve's lending facilities. Extensive additional information about each of the Federal Reserve's lending programs is available online.[1] The Fed also provides bimonthly reports to the Congress on each of its programs that rely on the section 13(3) authorities. Generally, our disclosure policies reflect the current best practices of major central banks around the world. In addition, the Federal Reserve's internal controls and management practices are closely monitored by an independent inspector general, outside private-sector auditors, and internal management and operations divisions, and through periodic reviews by the Government Accountability Office.

All that said, we recognize that recent developments have led to a substantial increase in the public's interest in the Fed's programs and balance sheet. For this reason, we at the Fed have begun a thorough review of our disclosure policies and the effectiveness of our communication. Today I would like to highlight two initiatives.

First, to improve public access to information concerning Fed policies and programs, we recently unveiled a new section of our website that brings together in a systematic and comprehensive way the full range of information that the Federal Reserve already makes available, supplemented by explanations, discussions, and analyses.[2] We will use that website as one means of keeping the public and the Congress fully informed about Fed programs.

Second, at my request, Board Vice Chairman Donald Kohn is leading a committee that will review our current publications and disclosure policies relating to the Fed's balance sheet and lending policies. The presumption of the committee will be that the public has a right to know, and that the nondisclosure of information must be affirmatively justified by clearly articulated criteria for confidentiality, based on factors such as reasonable claims to privacy, the confidentiality of supervisory information, and the need to ensure the effectiveness of policy.

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1 For links and references, see Ben S. Bernanke (2009), "Federal Reserve Programs to Strengthen Credit Markets and the Economy," testimony before the Committee on Financial Services, U.S. House of Representatives, February 10.

2 The website is located at http.//www.federalreserve.gov/monetarypolicy/bst.htm.

The economic outlook and the FOMC's quarterly projections

In their economic projections for the January FOMC meeting, monetary policy makers substantially marked down their forecasts for real GDP this year relative to the forecasts they had prepared in October. The central tendency of their most recent projections for real GDP implies a decline of 1/2 percent to 1-1/4 percent over the four quarters of 2009. These projections reflect an expected significant contraction in the first half of this year combined with an anticipated gradual resumption of growth in the second half. The central tendency for the unemployment rate in the fourth quarter of 2009 was marked up to a range of 8-1/2 percent to 8-3/4 percent. Federal Reserve policymakers continued to expect moderate expansion next year, with a central tendency of 2-1/2 percent to 3-1/4 percent growth in real GDP and a decline in the unemployment rate by the end of 2010 to a central tendency of 8 percent to 8-1/4 percent. FOMC participants marked down their projections for overall inflation in 2009 to a central tendency of 1/4 percent to 1 percent, reflecting expected weakness in commodity prices and the disinflationary effects of significant economic slack. The projections for core inflation also were marked down, to a central tendency bracketing 1 percent. Both overall and core inflation are expected to remain low over the next two years.

This outlook for economic activity is subject to considerable uncertainty, and I believe that, overall, the downside risks probably outweigh those on the upside. One risk arises from the global nature of the slowdown, which could adversely affect U.S. exports and financial conditions to an even greater degree than currently expected. Another risk derives from the destructive power of the so-called adverse feedback loop, in which weakening economic and financial conditions become mutually reinforcing. To break the adverse feedback loop, it is essential that we continue to complement fiscal stimulus with strong government action to stabilize financial institutions and financial markets. If actions taken by the Administration, the Congress, and the Federal Reserve are successful in restoring some measure of financial stability--and only if that is the case, in my view--there is a reasonable prospect that the current recession will end in 2009 and that 2010 will be a year of recovery. If financial conditions improve, the economy will be increasingly supported by fiscal and monetary stimulus, the salutary effects of the steep decline in energy prices since last summer, and the better alignment of business inventories and final sales, as well as the increased availability of credit.

To further increase the information conveyed by the quarterly projections, FOMC participants agreed in January to begin publishing their estimates of the values to which they expect key economic variables to converge over the longer run (say, at a horizon of five or six years), under the assumption of appropriate monetary policy and in the absence of new shocks to the economy. The central tendency for the participants' estimates of the longer-run growth rate of real GDP is 2-1/2 percent to 2-3/4 percent; the central tendency for the longer-run rate of unemployment is 4-3/4 percent to 5 percent; and the central tendency for the longer-run rate of inflation is 1-3/4 percent to 2 percent, with the majority of participants looking for 2 percent inflation in the long run. These values are all notably different from the central tendencies of the projections for 2010 and 2011, reflecting the view of policymakers that a full recovery of the economy from the current recession is likely to take more than two or three years.

The longer-run projections for output growth and unemployment may be interpreted as the Committee's estimates of the rate of growth of output and the unemployment rate that are sustainable in the long run in the United States, taking into account important influences such as the trend growth rates of productivity and the labor force, improvements in worker education and skills, the efficiency of the labor market at matching workers and jobs, government policies affecting technological development or the labor market, and other factors. The longer-run projections of inflation may be interpreted, in turn, as the rate of inflation that FOMC participants see as most consistent with the dual mandate given to it by the Congress--that is, the rate of inflation that promotes maximum sustainable employment while also delivering reasonable price stability. This further extension of the quarterly projections should provide the public a clearer picture of the FOMC's policy strategy for promoting maximum employment and price stability over time. Also, increased clarity about the FOMC's views regarding longer-run inflation should help to better stabilize the public's inflation expectations, thus contributing to keeping actual inflation from rising too high or falling too low.

At the time of our last Monetary Policy Report, the Federal Reserve was confronted with both high inflation and rising unemployment. Since that report, however, inflation pressures have receded dramatically while the rise in the unemployment rate has accelerated and financial conditions have deteriorated. In light of these developments, the Federal Reserve is committed to using all available tools to stimulate economic activity and to improve financial market functioning. Toward that end, we have reduced the target for the federal funds rate close to zero and we have established a number of programs to increase the flow of credit to key sectors of the economy. We believe that these actions, combined with the broad range of other fiscal and financial measures being put in place, will contribute to a gradual resumption of economic growth and improvement in labor market conditions in a context of low inflation. We will continue to work closely with the Congress and the Administration to explore means of fulfilling our mission of promoting maximum employment and price stability.