

## **Ben S Bernanke: Current economic and financial conditions and the federal budget**

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on the Budget, US House of Representatives, Washington DC, 3 June 2009.

\* \* \*

Chairman Spratt, Ranking Member Ryan, and other members of the Committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the federal budget.

### **Economic developments and outlook**

The U.S. economy has contracted sharply since last fall, with real gross domestic product (GDP) having dropped at an average annual rate of about 6 percent during the fourth quarter of 2008 and the first quarter of this year. Among the enormous costs of the downturn is the loss of nearly 6 million jobs since the beginning of 2008. The most recent information on the labor market – the number of new and continuing claims for unemployment insurance through late May – suggests that sizable job losses and further increases in unemployment are likely over the next few months.

However, the recent data also suggest that the pace of economic contraction may be slowing. Notably, consumer spending, which dropped sharply in the second half of last year, has been roughly flat since the turn of the year, and consumer sentiment has improved. In coming months, households' spending power will be boosted by the fiscal stimulus program. Nonetheless, a number of factors are likely to continue to weigh on consumer spending, among them the weak labor market, the declines in equity and housing wealth that households have experienced over the past two years, and still-tight credit conditions.

Activity in the housing market, after a long period of decline, has also shown some signs of bottoming. Sales of existing homes have been fairly stable since late last year, and sales of new homes seem to have flattened out in the past couple of monthly readings, though both remain at depressed levels. Meanwhile, construction of new homes has been sufficiently restrained to allow the backlog of unsold new homes to decline – a precondition for any recovery in homebuilding.

Businesses remain very cautious and continue to reduce their workforces and capital investments. On a more positive note, firms are making progress in shedding the unwanted inventories that they accumulated following last fall's sharp downturn in sales. The Commerce Department estimates that the pace of inventory liquidation quickened in the first quarter, accounting for a sizable portion of the reported decline in real GDP in that period. As inventory stocks move into better alignment with sales, firms should become more willing to increase production.

We continue to expect overall economic activity to bottom out, and then to turn up later this year. Our assessments that consumer spending and housing demand will stabilize and that the pace of inventory liquidation will slow are key building blocks of that forecast. Final demand should also be supported by fiscal and monetary stimulus, and U.S. exports may benefit if recent signs of stabilization in foreign economic activity prove accurate. An important caveat is that our forecast also assumes continuing gradual repair of the financial system and an associated improvement in credit conditions; a relapse in the financial sector would be a significant drag on economic activity and could cause the incipient recovery to stall. I will provide a brief update on financial markets in a moment.

Even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further. We expect that the recovery will only gradually gain momentum and that economic slack will diminish slowly. In particular, businesses are likely to be cautious about hiring, and the unemployment rate is likely to rise for a time, even after economic growth resumes.

In this environment, we anticipate that inflation will remain low. The slack in resource utilization remains sizable, and, notwithstanding recent increases in the prices of oil and other commodities, cost pressures generally remain subdued. As a consequence, inflation is likely to move down some over the next year relative to its pace in 2008. That said, improving economic conditions and stable inflation expectations should limit further declines in inflation.

### **Conditions in financial markets**

Conditions in a number of financial markets have improved since earlier this year, likely reflecting both policy actions taken by the Federal Reserve and other agencies as well as the somewhat better economic outlook. Nevertheless, financial markets and financial institutions remain under stress, and low asset prices and tight credit conditions continue to restrain economic activity.

Among the markets where functioning has improved recently are those for short-term funding, including the interbank lending markets and the commercial paper market. Risk spreads in those markets appear to have moderated, and more lending is taking place at longer maturities. The better performance of short-term funding markets in part reflects the support afforded by Federal Reserve lending programs. It is encouraging that the private sector's reliance on the Fed's programs has declined as market stresses have eased, an outcome that was one of our key objectives when we designed our interventions. The issuance of asset-backed securities (ABS) backed by credit card, auto, and student loans has also picked up this spring, and ABS funding rates have declined, developments supported by the availability of the Federal Reserve's Term Asset-Backed Securities Loan Facility as a market backstop.

In markets for longer-term credit, bond issuance by nonfinancial firms has been relatively strong recently, and spreads between Treasury yields and rates paid by corporate borrowers have narrowed some, though they remain wide. Mortgage rates and spreads have also been reduced by the Federal Reserve's program of purchasing agency debt and agency mortgage-backed securities. However, in recent weeks, yields on longer-term Treasury securities and fixed-rate mortgages have risen. These increases appear to reflect concerns about large federal deficits but also other causes, including greater optimism about the economic outlook, a reversal of flight-to-quality flows, and technical factors related to the hedging of mortgage holdings.

As you know, last month, the federal bank regulatory agencies released the results of the Supervisory Capital Assessment Program (SCAP). The purpose of the exercise was to determine, for each of the 19 U.S.-owned bank holding companies with assets exceeding \$100 billion, a capital buffer sufficient for them to remain strongly capitalized and able to lend to creditworthy borrowers even if economic conditions over the next two years turn out to be worse than we currently expect. According to the findings of the SCAP exercise, under the more adverse economic outlook, losses at the 19 bank holding companies would total an estimated \$600 billion during 2009 and 2010. After taking account of potential resources to absorb those losses, including expected revenues, reserves, and existing capital cushions, we determined that 10 of the 19 institutions should raise, collectively, additional common equity of \$75 billion.

Each of the 10 bank holding companies requiring an additional buffer has committed to raise this capital by November 9. We are in discussions with these firms on their capital plans,

which are due by June 8. Even in advance of those plans being approved, the 10 firms have among them already raised more than \$36 billion of new common equity, with a number of their offerings of common shares being over-subscribed. In addition, these firms have announced actions that would generate up to an additional \$12 billion of common equity. We expect further announcements shortly as their capital plans are finalized and submitted to supervisors. The substantial progress these firms have made in meeting their required capital buffers, and their success in raising private capital, suggests that investors are gaining greater confidence in the banking system.

### **Fiscal policy in the current economic and financial environment**

Let me now turn to fiscal matters. As you are well aware, in February of this year, the Congress passed the American Recovery and Reinvestment Act, or ARRA, a major fiscal package aimed at strengthening near-term economic activity. The package included personal tax cuts and increases in transfer payments intended to stimulate household spending, incentives for business investment, increases in federal purchases, and federal grants for state and local governments.

Predicting the effects of these fiscal actions on economic activity is difficult, especially in light of the unusual economic circumstances that we face. For example, households confronted with declining incomes and limited access to credit might be expected to spend most of their tax cuts; then again, heightened economic uncertainties and the desire to increase precautionary saving or pay down debt might reduce households' propensity to spend. Likewise, it is difficult to judge how quickly funds dedicated to infrastructure needs and other longer-term projects will be spent and how large any follow-on effects will be. The Congressional Budget Office (CBO) has constructed a range of estimates of the effects of the stimulus package on real GDP and employment that appropriately reflects these uncertainties. According to the CBO's estimates, by the end of 2010, the stimulus package could boost the level of real GDP between about 1 percent and a little more than 3 percent and the level of employment by between roughly 1 million and 3-1/2 million jobs.

The increases in spending and reductions in taxes associated with the fiscal package and the financial stabilization program, along with the losses in revenues and increases in income-support payments associated with the weak economy, will widen the federal budget deficit substantially this year. The Administration recently submitted a proposed budget that projects the federal deficit to reach about \$1.8 trillion this fiscal year before declining to \$1.3 trillion in 2010 and roughly \$900 billion in 2011. As a consequence of this elevated level of borrowing, the ratio of federal debt held by the public to nominal GDP is likely to move up from about 40 percent before the onset of the financial crisis to about 70 percent in 2011. These developments would leave the debt-to-GDP ratio at its highest level since the early 1950s, the years following the massive debt buildup during World War II.

Certainly, our economy and financial markets face extraordinary near-term challenges, and strong and timely actions to respond to those challenges are necessary and appropriate. Nevertheless, even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance. Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in medical costs. The recent projections from the Social Security and Medicare trustees show that, in the absence of programmatic changes, Social Security and Medicare outlays will together increase from about 8-1/2 percent of GDP today to 10 percent by 2020 and 12-1/2 percent by 2030. With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands.

Addressing the country's fiscal problems will require a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American

people must confront is how large a share of the nation's economic resources to devote to federal government programs, including entitlement programs. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. In particular, over the longer term, achieving fiscal sustainability – defined, for example, as a situation in which the ratios of government debt and interest payments to GDP are stable or declining, and tax rates are not so high as to impede economic growth – requires that spending and budget deficits be well controlled.

Clearly, the Congress and the Administration face formidable near-term challenges that must be addressed. But those near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth.

### **Federal Reserve transparency**

Let me close today with an update on the Federal Reserve's initiatives to enhance the transparency of our credit and liquidity programs. As I noted last month in my testimony before the Joint Economic Committee, I asked Vice Chairman Kohn to lead a review of our disclosure policies, with the goal of increasing the range of information that we make available to the public.<sup>1</sup> That group has made significant progress, and we expect to begin publishing soon a monthly report on the Fed's balance sheet and lending programs that will summarize and discuss recent developments and provide considerable new information concerning the number of borrowers at our various facilities, the concentration of borrowing, and the collateral pledged. In addition, the reports will provide quarterly updates of key elements of the Federal Reserve's annual financial statements, including information regarding the System Open Market Account portfolio, our loan programs, and the special purpose vehicles that are consolidated on the balance sheet of the Federal Reserve Bank of New York. We hope that this information will be helpful to the Congress and others with an interest in the Federal Reserve's actions to address the financial crisis and the economic downturn. We will continue to look for opportunities to broaden the scope of the information and supporting analysis that we provide to the public.

---

<sup>1</sup> Ben S. Bernanke (2009), "The Economic Outlook," statement before the Joint Economic Committee, U.S. Congress, May 5.