Ben S Bernanke: Economic outlook and recent monetary policy actions

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 4 October 2011.

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Chairman Casey, Vice Chairman Brady, and other members of the Committee, I appreciate this opportunity to discuss the economic outlook and recent monetary policy actions.

It has been three years since the beginning of the most intense phase of the financial crisis in the late summer and fall of 2008, and more than two years since the economic recovery began in June 2009. There have been some positive developments: The functioning of financial markets and the banking system in the United States has improved significantly. Manufacturing production in the United States has risen nearly 15 percent since its trough, driven substantially by growth in exports; indeed, the U.S. trade deficit has been notably lower recently than it was before the crisis, reflecting in part the improved competitiveness of U.S. goods and services. Business investment in equipment and software has continued to expand, and productivity gains in some industries have been impressive. Nevertheless, it is clear that, overall, the recovery from the crisis has been much less robust than we had hoped. Recent revisions of government economic data show the recession as having been even deeper, and the recovery weaker, than previously estimated; indeed, by the second quarter of this year – the latest quarter for which official estimates are available – aggregate output in the United States still had not returned to the level that it had attained before the crisis. Slow economic growth has in turn led to slow rates of increase in jobs and household incomes.

The pattern of sluggish growth was particularly evident in the first half of this year, with real gross domestic product (GDP) estimated to have increased at an average annual rate of less than 1 percent. Some of this weakness can be attributed to temporary factors. Notably, earlier this year, political unrest in the Middle East and North Africa, strong growth in emerging market economies, and other developments contributed to significant increases in the prices of oil and other commodities, which damped consumer purchasing power and spending; and the disaster in Japan disrupted global supply chains and production, particularly in the automobile industry. With commodity prices having come off their highs and manufacturers' problems with supply chains well along toward resolution, growth in the second half of the year seems likely to be more rapid than in the first half.

However, the incoming data suggest that other, more persistent factors also continue to restrain the pace of recovery. Consequently, the Federal Open Market Committee (FOMC) now expects a somewhat slower pace of economic growth over coming quarters than it did at the time of the June meeting, when Committee participants most recently submitted economic forecasts.

Consumer behavior has both reflected and contributed to the slow pace of recovery. Households have been very cautious in their spending decisions, as declines in house prices and in the values of financial assets have reduced household wealth, and many families continue to struggle with high debt burdens or reduced access to credit. Probably the most significant factor depressing consumer confidence, however, has been the poor performance of the job market. Over the summer, private payrolls rose by only about 100,000 jobs per month on average – half of the rate posted earlier in the year.[1] Meanwhile, state and local

[1] The figure of 100,000 private jobs per month adjusts for the effects of the two-week strike by communications workers at Verizon, which held down measured payrolls in August.

governments have continued to shed jobs, as they have been doing for more than two years. With these weak gains in employment, the unemployment rate has held close to 9 percent since early this year. Moreover, recent indicators, including new claims for unemployment insurance and surveys of hiring plans, point to the likelihood of more sluggish job growth in the period ahead.

Other sectors of the economy are also contributing to the slower-than-expected rate of expansion. The housing sector has been a significant driver of recovery from most recessions in the United States since World War II. This time, however, a number of factors – including the overhang of distressed and foreclosed properties, tight credit conditions for builders and potential homebuyers, and the large number of "underwater" mortgages (on which homeowners owe more than their homes are worth) – have left the rate of new home construction at only about one-third of its average level in recent decades.

In the financial sphere, as I noted, banking and financial conditions in the United States have improved significantly since the depths of the crisis. Nonetheless, financial stresses persist. Credit remains tight for many households, small businesses, and residential and commercial builders, in part because weaker balance sheets and income prospects have increased the perceived credit risk of many potential borrowers. We have also recently seen bouts of elevated volatility and risk aversion in financial markets, partly in reaction to fiscal concerns both here and abroad. Domestically, the controversy during the summer regarding the raising of the federal debt ceiling and the downgrade of the U.S. long-term credit rating by one of the major rating agencies contributed to the financial turbulence that occurred around that time. Outside the United States, concerns about sovereign debt in Greece and other euro-zone countries, as well as about the sovereign debt exposures of the European banking system, have been a significant source of stress in global financial markets. European leaders are strongly committed to addressing these issues, but the need to obtain agreement among a large number of countries to put in place necessary backstops and to address the sources of the fiscal problems has slowed the process of finding solutions. It is difficult to judge how much these financial strains have affected U.S. economic activity thus far, but there seems little doubt that they have hurt household and business confidence, and that they pose ongoing risks to growth.

Another factor likely to weigh on the U.S. recovery is the increasing drag being exerted by the government sector. Notably, state and local governments continue to tighten their belts by cutting spending and employment in the face of ongoing budgetary pressures, while the future course of federal fiscal policies remains quite uncertain.

To be sure, fiscal policymakers face a complex situation. I would submit that, in setting tax and spending policies for now and the future, policymakers should consider at least four key objectives. One crucial objective is to achieve long-run fiscal sustainability. The federal budget is clearly not on a sustainable path at present. The Joint Select Committee on Deficit Reduction, formed as part of the Budget Control Act, is charged with achieving $1.5 trillion in additional deficit reduction over the next 10 years on top of the spending caps enacted this summer. Accomplishing that goal would be a substantial step; however, more will be needed to achieve fiscal sustainability.

A second important objective is to avoid fiscal actions that could impede the ongoing economic recovery. These first two objectives are certainly not incompatible, as putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term. Third, fiscal policy should aim to promote long-term growth and economic opportunity. As a nation, we need to think carefully about how federal spending priorities and the design of the tax code affect the productivity and vitality of our economy in the longer term. Fourth, there is evident need to improve the process for making long-term budget decisions, to create greater predictability and clarity, while avoiding disruptions to the financial markets and the economy.

In sum, the nation faces difficult and fundamental fiscal choices, which cannot be safely or responsibly postponed.

Returning to the discussion of the economic outlook, let me turn now to the prospects for inflation. Prices of many commodities, notably oil, increased sharply earlier this year, as I noted, leading to higher retail gasoline and food prices. In addition, producers of other goods and services were able to pass through some of their higher input costs to their customers. Separately, the global supply disruptions associated with the disaster in Japan put upward pressure on prices of motor vehicles. As a result of these influences, inflation picked up during the first half of this year; over that period, the price index for personal consumption expenditures rose at an annual rate of about 3-1/2 percent, compared with an average of less than 1-1/2 percent over the preceding two years.

As the FOMC anticipated, however, inflation has begun to moderate as these transitory influences wane. In particular, the prices of oil and many other commodities have either leveled off or have come down from their highs, and the step-up in automobile production has started to reduce pressures on the prices of cars and light trucks. Importantly, the higher rate of inflation experienced so far this year does not appear to have become ingrained in the economy. Longer-term inflation expectations have remained stable according to surveys of households and economic forecasters, and the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury securities suggests that inflation expectations among investors may have moved lower recently. In addition to the stability of longer-term inflation expectations, the substantial amount of resource slack in U.S. labor and product markets should continue to restrain inflationary pressures.

In view of the deterioration in the economic outlook over the summer and the subdued inflation picture over the medium run, the FOMC has taken several steps recently to provide additional policy accommodation. At the August meeting, the Committee provided greater clarity about its outlook for the level of short-term interest rates by noting that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. And at our meeting in September, the Committee announced that it intends to increase the average maturity of the securities in the Federal Reserve's portfolio. Specifically, it intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, leaving the size of our balance sheet approximately unchanged. This maturity extension program should put downward pressure on longer-term interest rates and help make broader financial conditions more supportive of economic growth than they would otherwise have been.

The Committee also announced in September that it will begin reinvesting principal payments on its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities rather than in longer-term Treasury securities. By helping to support mortgage markets, this action too should contribute to a stronger economic recovery. The Committee will continue to closely monitor economic developments and is prepared to take further action as appropriate to promote a stronger economic recovery in a context of price stability.

Monetary policy can be a powerful tool, but it is not a panacea for the problems currently faced by the U.S. economy. Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance, as I have noted today, but a wide range of other policies – pertaining to labor markets, housing, trade, taxation, and regulation, for example – also have important roles to play. For our part, we at the Federal Reserve will continue to work to help create an environment that provides the greatest possible economic opportunity for all Americans.