Ben S Bernanke: Semiannual Monetary Policy Report to the Congress

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, US House of Representatives, 29 February 2012.

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Chairman Bachus, Ranking Member Frank, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual ***Monetary Policy Report to the Congress***. I will begin with a discussion of current economic conditions and the outlook and then turn to monetary policy.

The economic outlook

The recovery of the U.S. economy continues, but the pace of expansion has been uneven and modest by historical standards. After minimal gains in the first half of last year, real gross domestic product (GDP) increased at a 2-1/4 percent annual rate in the second half.[1] The limited information available for 2012 is consistent with growth proceeding, in coming quarters, at a pace close to or somewhat above the pace that was registered during the second half of last year.

We have seen some positive developments in the labor market. Private payroll employment has increased by 165,000 jobs per month on average since the middle of last year, and nearly 260,000 new private-sector jobs were added in January. The job gains in recent months have been relatively widespread across industries. In the public sector, by contrast, layoffs by state and local governments have continued. The unemployment rate hovered around 9 percent for much of last year but has moved down appreciably since September, reaching 8.3 percent in January. New claims for unemployment insurance benefits have also moderated.

The decline in the unemployment rate over the past year has been somewhat more rapid than might have been expected, given that the economy appears to have been growing during that time frame at or below its longer-term trend; continued improvement in the job market is likely to require stronger growth in final demand and production. Notwithstanding the better recent data, the job market remains far from normal: The unemployment rate remains elevated, long-term unemployment is still near record levels, and the number of persons working part time for economic reasons is very high.[2]

Household spending advanced moderately in the second half of last year, boosted by a fourth-quarter surge in motor vehicle purchases that was facilitated by an easing of constraints on supply related to the earthquake in Japan. However, the fundamentals that support spending continue to be weak: Real household income and wealth were flat in 2011, and access to credit remained restricted for many potential borrowers. Consumer sentiment, which dropped sharply last summer, has since rebounded but remains relatively low.

In the housing sector, affordability has increased dramatically as a result of the decline in house prices and historically low interest rates on conventional mortgages. Unfortunately, many potential buyers lack the down payment and credit history required to qualify for loans;

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[1] Data for the fourth quarter of 2011 from the national income and product accounts reflect the advance estimate released on January 27, 2012.

[2] In January, 5-1/2 million persons among those counted as unemployed–about 43 percent of the total–had been out of work for more than six months, and 8-1/4 million persons were working part time for economic reasons.

others are reluctant to buy a house now because of concerns about their income, employment prospects, and the future path of home prices. On the supply side of the market, about 30 percent of recent home sales have consisted of foreclosed or distressed properties, and home vacancy rates remain high, putting downward pressure on house prices. More-positive signs include a pickup in construction in the multifamily sector and recent increases in homebuilder sentiment.

Manufacturing production has increased 15 percent since the trough of the recession and has posted solid gains since the middle of last year, supported by the recovery in motor vehicle supply chains and ongoing increases in business investment and exports. Real business spending for equipment and software rose at an annual rate of about 12 percent over the second half of 2011, a bit faster than in the first half of the year. But real export growth, while remaining solid, slowed somewhat over the same period as foreign economic activity decelerated, particularly in Europe.

The members of the Board and the presidents of the Federal Reserve Banks recently projected that economic activity in 2012 will expand at or somewhat above the pace registered in the second half of last year. Specifically, their projections for growth in real GDP this year, provided in conjunction with the January meeting of the Federal Open Market Committee (FOMC), have a central tendency of 2.2 to 2.7 percent.[3] These forecasts were considerably lower than the projections they made last June.[4] A number of factors have played a role in this reassessment. First, the annual revisions to the national income and product accounts released last summer indicated that the recovery had been somewhat slower than previously estimated. In addition, fiscal and financial strains in Europe have weighed on financial conditions and global economic growth, and problems in U.S. housing and mortgage markets have continued to hold down not only construction and related industries, but also household wealth and confidence. Looking beyond 2012, FOMC participants expect that economic activity will pick up gradually as these headwinds fade, supported by a continuation of the highly accommodative stance for monetary policy.

With output growth in 2012 projected to remain close to its longer-run trend, participants did not anticipate further substantial declines in the unemployment rate over the course of this year. Looking beyond this year, FOMC participants expect the unemployment rate to continue to edge down only slowly toward levels consistent with the Committee's statutory mandate. In light of the somewhat different signals received recently from the labor market than from indicators of final demand and production, however, it will be especially important to evaluate incoming information to assess the underlying pace of economic recovery.

At our January meeting, participants agreed that strains in global financial markets posed significant downside risks to the economic outlook. Investors' concerns about fiscal deficits and the levels of government debt in a number of European countries have led to substantial increases in sovereign borrowing costs, stresses in the European banking system, and associated reductions in the availability of credit and economic activity in the euro area. To help prevent strains in Europe from spilling over to the U.S. economy, the Federal Reserve in November agreed to extend and to modify the terms of its swap lines with other major central banks, and it continues to monitor the European exposures of U.S. financial institutions.

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3 See table 1, "Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, January 2012," of the Summary of Economic Projections available at Board of Governors of the Federal Reserve System (2012), "Federal Reserve Board and Federal Open Market Committee Release Economic Projections from the January 24–25 FOMC Meeting," press release, January 25; also available in Part 4 of the February 2012 Monetary Policy Report to the Congress.

4 Ben S. Bernanke (2011), "Semiannual Monetary Policy Report to the Congress," statement before the Committee on Financial Services, U.S. House of Representatives, July 13.

A number of constructive policy actions have been taken of late in Europe, including the European Central Bank's program to extend three-year collateralized loans to European financial institutions. Most recently, European policymakers agreed on a new package of measures for Greece, which combines additional official-sector loans with a sizable reduction of Greek debt held by the private sector. However, critical fiscal and financial challenges remain for the euro zone, the resolution of which will require concerted action on the part of European authorities. Further steps will also be required to boost growth and competitiveness in a number of countries. We are in frequent contact with our counterparts in Europe and will continue to follow the situation closely.

As I discussed in my July testimony, inflation picked up during the early part of 2011.[5] A surge in the prices of oil and other commodities, along with supply disruptions associated with the disaster in Japan that put upward pressure on motor vehicle prices, pushed overall inflation to an annual rate of more than 3 percent over the first half of last year.[6] As we had expected, however, these factors proved transitory, and inflation moderated to an annual rate of 1-1/2 percent during the second half of the year–close to its average pace in the preceding two years. In the projections made in January, the Committee anticipated that, over coming quarters, inflation will run at or below the 2 percent level we judge most consistent with our statutory mandate. Specifically, the central tendency of participants' forecasts for inflation in 2012 ranged from 1.4 to 1.8 percent, about unchanged from the projections made last June.[7] Looking farther ahead, participants expected the subdued level of inflation to persist beyond this year. Since these projections were made, gasoline prices have moved up, primarily reflecting higher global oil prices–a development that is likely to push up inflation temporarily while reducing consumers' purchasing power. We will continue to monitor energy markets carefully. Longer-term inflation expectations, as measured by surveys and financial market indicators, appear consistent with the view that inflation will remain subdued.

Monetary policy

Against this backdrop of restrained growth, persistent downside risks to the outlook for real activity, and moderating inflation, the Committee took several steps to provide additional monetary accommodation during the second half of 2011 and early 2012. These steps included changes to the forward rate guidance included in the Committee's post-meeting statements and adjustments to the Federal Reserve's holdings of Treasury and agency securities.

The target range for the federal funds rate remains at 0 to 1/4 percent, and the forward guidance language in the FOMC policy statement provides an indication of how long the Committee expects that target range to be appropriate. In August, the Committee clarified the forward guidance language, noting that economic conditions–including low rates of resource utilization and a subdued outlook for inflation over the medium run–were likely to warrant exceptionally low levels for the federal funds rate at least through the middle of 2013. By providing a longer time horizon than had previously been expected by the public, the statement tended to put downward pressure on longer-term interest rates. At the January 2012 FOMC meeting, the Committee amended the forward guidance further, extending the horizon over which it expects economic conditions to warrant exceptionally low levels of the federal funds rate to at least through late 2014.

In addition to the adjustments made to the forward guidance, the Committee modified its policies regarding the Federal Reserve's holdings of securities. In September, the Committee

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5 Bernanke, "Semiannual Monetary Policy Report to the Congress" (see note 4).

6 Inflation is measured using the price index for personal consumption expenditures.

7 See table 1 available at Board of Governors, "Federal Reserve Board and Federal Open Market Committee Release Economic Projections" (see note 3).

put in place a maturity extension program that combines purchases of longer-term Treasury securities with sales of shorter-term Treasury securities. The objective of this program is to lengthen the average maturity of our securities holdings without generating a significant change in the size of our balance sheet. Removing longer-term securities from the market should put downward pressure on longer-term interest rates and help make financial market conditions more supportive of economic growth than they otherwise would have been. To help support conditions in mortgage markets, the Committee also decided at its September meeting to reinvest principal received from its holdings of agency debt and agency mortgage-backed securities (MBS) in agency MBS, rather than continuing to reinvest those proceeds in longer-term Treasury securities as had been the practice since August 2010. The Committee reviews the size and composition of its securities holdings regularly and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in the context of price stability.

Before concluding, I would like to say a few words about the statement of longer-run goals and policy strategy that the FOMC issued at the conclusion of its January meeting. The statement reaffirms our commitment to our statutory objectives, given to us by the Congress, of price stability and maximum employment. Its purpose is to provide additional transparency and increase the effectiveness of monetary policy. The statement does not imply a change in how the Committee conducts policy.

Transparency is enhanced by providing greater specificity about our objectives. Because the inflation rate over the longer run is determined primarily by monetary policy, it is feasible and appropriate for the Committee to set a numerical goal for that key variable. The FOMC judges that an inflation rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with its statutory mandate. While maximum employment stands on an equal footing with price stability as an objective of monetary policy, the maximum level of employment in an economy is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market; it is therefore not feasible for any central bank to specify a fixed goal for the longer-run level of employment. However, the Committee can estimate the level of maximum employment and use that estimate to inform policy decisions. In our most recent projections in January, for example, FOMC participants' estimates of the longer-run, normal rate of unemployment had a central tendency of 5.2 to 6.0 percent.[8] As I noted a moment ago, the level of maximum employment in an economy is subject to change; for instance, it can be affected by shifts in the structure of the economy and by a range of economic policies. If at some stage the Committee estimated that the maximum level of employment had increased, for example, we would adjust monetary policy accordingly.

The dual objectives of price stability and maximum employment are generally complementary. Indeed, at present, with the unemployment rate elevated and the inflation outlook subdued, the Committee judges that sustaining a highly accommodative stance for monetary policy is consistent with promoting both objectives. However, in cases where these objectives are not complementary, the Committee follows a balanced approach in promoting them, taking into account the magnitudes of the deviations of inflation and employment from levels judged to be consistent with the dual mandate, as well as the potentially different time horizons over which employment and inflation are projected to return to such levels.

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

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[8] See table 1 available at Board of Governors, "Federal Reserve Board and Federal Open Market Committee Release Economic Projections" (see note 3).