Ben S Bernanke: Economic outlook and policy

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, 7 June 2012.

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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 economic policy.

Economic growth has continued at a moderate rate so far this year. Real gross domestic product (GDP) rose at an annual rate of about 2 percent in the first quarter after increasing at a 3 percent pace in the fourth quarter of 2011. Growth last quarter was supported by further gains in private domestic demand, which more than offset a drag from a decline in government spending.

Labor market conditions improved in the latter part of 2011 and earlier this year. The unemployment rate has fallen about 1 percentage point since last August; and payroll employment increased 225,000 per month, on average, during the first three months of this year, up from about 150,000 jobs added per month in 2011. In April and May, however, the reported pace of job gains slowed to an average of 75,000 per month, and the unemployment rate ticked up to 8.2 percent. This apparent slowing in the labor market may have been exaggerated by issues related to seasonal adjustment and the unusually warm weather this past winter.[1] But it may also be the case that the larger gains seen late last year and early this year were associated with some catch-up in hiring on the part of employers who had pared their workforces aggressively during and just after the recession.[2] If so, the deceleration in employment in recent months may indicate that this catch-up has largely been completed, and, consequently, that more-rapid gains in economic activity will be required to achieve significant further improvement in labor market conditions.

Economic growth appears poised to continue at a moderate pace over coming quarters, supported in part by accommodative monetary policy. In particular, increases in household spending have been relatively well sustained. Income growth has remained quite modest, but the recent declines in energy prices should provide some offsetting lift to real purchasing power. While the most recent readings have been mixed, consumer sentiment is nonetheless up noticeably from its levels late last year. And, despite economic difficulties in Europe, the demand for U.S. exports has held up well. The U.S. business sector is profitable and has become more competitive in international markets.

However, some of the factors that have restrained the recovery persist. Notably, households and businesses still appear quite cautious about the economy. For example, according to surveys, households continue to rate their income prospects as relatively poor and do not expect economic conditions to improve significantly. Similarly, concerns about developments in Europe, U.S. fiscal policy, and the strength and sustainability of the recovery have left some firms hesitant to expand capacity.

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1 In particular, the unusually warm weather this past winter may have brought forward some hiring in sectors such as construction where activity normally is subdued during the coldest months; thus, some of the slower pace of job gains this spring may have represented a payback for that earlier hiring. In addition, the estimated seasonal factors for some economic indicators may have been influenced by the timing of the steepest part of the decline in activity during the 2008–09 winter months; if so, the seasonal adjustment process may have resulted in an overstatement of economic activity this past winter and the understatement of activity in other months.

2 For further discussion, see Ben S. Bernanke (2012), “Recent Developments in the Labor Market”, speech delivered at the National Association for Business Economics Annual Conference, Washington, March 26.

The depressed housing market has also been an important drag on the recovery. Despite historically low mortgage rates and high levels of affordability, many prospective homebuyers cannot obtain mortgages, as lending standards have tightened and the creditworthiness of many potential borrowers has been impaired. At the same time, a large stock of vacant houses continues to limit incentives for the construction of new homes, and a substantial backlog of foreclosures will likely add further to the supply of vacant homes. However, a few encouraging signs in housing have appeared recently, including some pickup in sales and construction, improvements in homebuilder sentiment, and the apparent stabilization of home prices in some areas.

Banking and financial conditions in the United States have improved significantly since the depths of the crisis. Notably, recent stress tests conducted by the Federal Reserve of the balance sheets of the 19 largest U.S. bank holding companies showed that those firms have added about $300 billion to their capital since 2009; the tests also showed that, even in an extremely adverse hypothetical economic scenario, most of those firms would remain able to provide credit to U.S. households and businesses. Lending terms and standards have generally become less restrictive in recent quarters, although some borrowers, such as small businesses and (as already noted) potential homebuyers with less-than-perfect credit, still report difficulties in obtaining loans.

Concerns about sovereign debt and the health of banks in a number of euro-area countries continue to create strains in global financial markets. The crisis in Europe has affected the U.S. economy by acting as a drag on our exports, weighing on business and consumer confidence, and pressuring U.S. financial markets and institutions. European policymakers have taken a number of actions to address the crisis, but more will likely be needed to stabilize euro-area banks, calm market fears about sovereign finances, achieve a workable fiscal framework for the euro area, and lay the foundations for long-term economic growth. U.S. banks have greatly improved their financial strength in recent years, as I noted earlier. Nevertheless, the situation in Europe poses significant risks to the U.S. financial system and economy and must be monitored closely. As always, the Federal Reserve remains prepared to take action as needed to protect the U.S. financial system and economy in the event that financial stresses escalate.

Another factor likely to weigh on the U.S. recovery is the drag being exerted by fiscal policy. Reflecting ongoing budgetary pressures, real spending by state and local governments has continued to decline. Real federal government spending has also declined, on net, since the third quarter of last year, and the future course of federal fiscal policies remains quite uncertain, as I will discuss shortly.

With regard to inflation, large increases in energy prices earlier this year caused the price index for personal consumption expenditures to rise at an annual rate of about 3 percent over the first three months of this year. However, oil prices and retail gasoline prices have since retraced those earlier increases. In any case, increases in the prices of oil or other commodities are unlikely to result in persistent increases in overall inflation so long as household and business expectations of future price changes remain stable. Longer-term inflation expectations have, indeed, been quite well anchored, according to surveys of households and economic forecasters and as derived from financial market information. For example, the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury securities suggests that inflation expectations among investors have changed little, on net, since last fall and are lower than a year ago. Meanwhile, the substantial resource slack in U.S. labor and product markets should continue to restrain inflationary pressures. Given these conditions, inflation is expected to remain at or slightly below the 2 percent rate that the Federal Open Market Committee (FOMC) judges consistent with our statutory mandate to foster maximum employment and stable prices.

With unemployment still quite high and the outlook for inflation subdued, and in the presence of significant downside risks to the outlook posed by strains in global financial markets, the

FOMC has continued to maintain a highly accommodative stance of monetary policy. The target range for the federal funds rate remains at 0 to 1/4 percent, and the Committee has indicated in its recent statements that it anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014. In addition, the Federal Reserve has been conducting a program, announced last September, to lengthen the average maturity of its securities holdings by purchasing $400 billion of longer-term Treasury securities and selling an equal amount of shorter-term Treasury securities. The Committee also continues to reinvest principal received from its holdings of agency debt and agency mortgage-backed securities (MBS) in agency MBS and to roll over its maturing Treasury holdings at auction. These policies have supported the economic recovery by putting downward pressure on longer-term interest rates, including mortgage rates, and by making broader financial conditions more accommodative. 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 a context of price stability.

The economy's performance over the medium and longer term also will depend importantly on the course of fiscal policy. Fiscal policymakers confront daunting challenges. As they do so, they should keep three objectives in mind. First, to promote economic growth and stability, the federal budget must be put on a sustainable long-run path. The federal budget deficit, which averaged about 9 percent of GDP during the past three fiscal years, is likely to narrow in coming years as the economic recovery leads to higher tax revenues and lower income support payments. Nevertheless, the Congressional Budget Office (CBO) projects that, if current policies continue, the budget deficit would be close to 5 percent of GDP in 2017 when the economy is expected to be near full employment.[3] Moreover, under current policies and reasonable economic assumptions, the CBO projects that the structural budget gap and the ratio of federal debt to GDP will trend upward thereafter, in large part reflecting rapidly escalating health expenditures and the aging of the population. This dynamic is clearly unsustainable. At best, rapidly rising levels of debt will lead to reduced rates of capital formation, slower economic growth, and increased foreign indebtedness. At worst, they will provoke a fiscal crisis that could have severe consequences for the economy. To avoid such outcomes, fiscal policy must be placed on a sustainable path that eventually results in a stable or declining ratio of federal debt to GDP.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, a second objective should be to avoid unnecessarily impeding the current economic recovery. Indeed, a severe tightening of fiscal policy at the beginning of next year that is built into current law – the so-called fiscal cliff – would, if allowed to occur, pose a significant threat to the recovery. Moreover, uncertainty about the resolution of these fiscal issues could itself undermine business and household confidence. Fortunately, avoiding the fiscal cliff and achieving long-term fiscal sustainability are fully compatible and mutually reinforcing objectives. Preventing a sudden and severe contraction in fiscal policy will support the transition back to full employment, which should aid long-term fiscal sustainability. At the same time, a credible fiscal plan to put the federal budget on a longer-run sustainable path could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

A third objective for fiscal policy is to promote a stronger economy in the medium and long term through the careful design of tax policies and spending programs. To the fullest extent possible, federal tax and spending policies should increase incentives to work and save, encourage investments in workforce skills, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. Although we cannot

[3] This projection is the alternative fiscal scenario in the Congressional Budget Office (2012), *Updated Budget Projections: Fiscal Years 2012 to 2022* (Washington: CBO, March).

expect our economy to grow its way out of federal budget imbalances without significant adjustment in fiscal policies, a more productive economy will ease the tradeoffs faced by fiscal policymakers.

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