Ben S Bernanke: The economic outlook

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, 22 May 2013.

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Chairman Brady, Vice Chair Klobuchar, and other members of the Committee, I appreciate this opportunity to discuss the economic outlook and economic policy.

Current economic conditions

Economic growth has continued at a moderate pace so far this year. Real gross domestic product (GDP) is estimated to have risen at an annual rate of 2–1/2 percent in the first quarter after increasing 1–3/4 percent during 2012. Economic growth in the first quarter was supported by continued expansion in demand by U.S. households and businesses, which more than offset the drag from declines in government spending, especially defense spending.

Conditions in the job market have shown some improvement recently. The unemployment rate, at 7.5 percent in April, has declined more than 1/2 percentage point since last summer. Moreover, gains in total nonfarm payroll employment have averaged more than 200,000 jobs per month over the past six months, compared with average monthly gains of less than 140,000 during the prior six months. In all, payroll employment has now expanded by about 6 million jobs since its low point, and the unemployment rate has fallen 2–1/2 percentage points since its peak.

Despite this improvement, the job market remains weak overall: The unemployment rate is still well above its longer-run normal level, rates of long-term unemployment are historically high, and the labor force participation rate has continued to move down. Moreover, nearly 8 million people are working part time even though they would prefer full-time work. High rates of unemployment and underemployment are extraordinarily costly: Not only do they impose hardships on the affected individuals and their families, they also damage the productive potential of the economy as a whole by eroding workers' skills and – particularly relevant during this commencement season – by preventing many young people from gaining workplace skills and experience in the first place. The loss of output and earnings associated with high unemployment also reduces government revenues and increases spending on income-support programs, thereby leading to larger budget deficits and higher levels of public debt than would otherwise occur.

Consumer price inflation has been low. The price index for personal consumption expenditures rose only 1 percent over the 12 months ending in March, down from about 2–1/4 percent during the previous 12 months. This slow rate of inflation partly reflects recent declines in consumer energy prices, but price inflation for other consumer goods and services has also been subdued. Nevertheless, measures of longer-term inflation expectations have remained stable and continue to run in the narrow ranges seen over the past several years. Over the next few years, inflation appears likely to run at or below the 2 percent rate that the Federal Open Market Committee (FOMC) judges to be most consistent with the Federal Reserve's statutory mandate to foster maximum employment and stable prices.

Over the nearly four years since the recovery began, the economy has been held back by a number of headwinds. Some of these headwinds have begun to dissipate recently, in part because of the Federal Reserve's highly accommodative monetary policy. Notably, the housing market has strengthened over the past year, supported by low mortgage rates and improved sentiment on the part of potential buyers. Increased housing activity is fostering job creation in construction and related industries, such as real estate brokerage and home furnishings, while higher home prices are bolstering household finances, which helps support the growth of private consumption.

Severe fiscal and financial strains in Europe, by weighing on U.S. exports and financial markets, have also restrained U.S. economic growth over the past couple of years. However, since last summer, financial conditions in the euro area have improved somewhat, which should help mitigate the economic slowdown there while also reducing the headwinds faced by the U.S. economy. Also, credit conditions in the United States have eased for some types of loans, as bank capital and asset quality have strengthened.

Fiscal policy

Fiscal policy, at all levels of government, has been and continues to be an important determinant of the pace of economic growth. Federal fiscal policy, taking into account both discretionary actions and so-called automatic stabilizers, was, on net, quite expansionary during the recession and early in the recovery. However, a substantial part of this impetus was offset by spending cuts and tax increases by state and local governments, most of which are subject to balanced-budget requirements, and by subsequent fiscal tightening at the federal level. Notably, over the past four years, state and local governments have cut civilian government employment by roughly 700,000 jobs, and total government employment has fallen by more than 800,000 jobs over the same period. For comparison, over the four years following the trough of the 2001 recession, total government employment rose by more than 500,000 jobs.

Most recently, the strengthening economy has improved the budgetary outlooks of most state and local governments, leading them to reduce their pace of fiscal tightening. At the same time, though, fiscal policy at the federal level has become significantly more restrictive. In particular, the expiration of the payroll tax cut, the enactment of tax increases, the effects of the budget caps on discretionary spending, the onset of the sequestration, and the declines in defense spending for overseas military operations are expected, collectively, to exert a substantial drag on the economy this year. The Congressional Budget Office (CBO) estimates that the deficit reduction policies in current law will slow the pace of real GDP growth by about 1–1/2 percentage points during 2013, relative to what it would have been otherwise.[1] In present circumstances, with short-term interest rates already close to zero, monetary policy does not have the capacity to fully offset an economic headwind of this magnitude.

Although near-term fiscal restraint has increased, much less has been done to address the federal government's longer-term fiscal imbalances. Indeed, the CBO projects that, under current policies, the federal deficit and debt as a percentage of GDP will begin rising again in the latter part of this decade and move sharply upward thereafter, in large part reflecting the aging of our society and projected increases in health-care costs, along with mounting debt service payments. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. Importantly, the objectives of effectively addressing longer-term fiscal imbalances and of minimizing the near-term fiscal headwinds facing the economic recovery are not incompatible. To achieve both goals simultaneously, the Congress and the Administration could consider replacing some of the near-term fiscal restraint now in law with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run.

[1] See Congressional Budget Office (2013), *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (Washington: CBO, February).

Monetary policy

With unemployment well above normal levels and inflation subdued, fostering our congressionally mandated objectives of maximum employment and price stability requires a highly accommodative monetary policy. Normally, the Committee would provide policy accommodation by reducing its target for the federal funds rate, thus putting downward pressure on interest rates generally. However, the federal funds rate and other short-term money market rates have been close to zero since late 2008, so the Committee has had to use other policy tools.

The first of these alternative tools is “forward guidance” about the FOMC’s likely future target for the federal funds rate. Since December, the Committee’s postmeeting statement has indicated that its current target range for the federal funds rate, 0 to 1/4 percent, will be appropriate “at least as long as the unemployment rate remains above 6–1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.” This guidance underscores the Committee’s intention to maintain highly accommodative monetary policy as long as needed to support continued progress toward maximum employment and price stability.

The second policy tool now in use is large-scale purchases of longer-term Treasury securities and agency mortgage-backed securities (MBS). These purchases put downward pressure on longer-term interest rates, including mortgage rates. For some months, the FOMC has been buying longer-term Treasury securities at a pace of $45 billion per month and agency MBS at a pace of $40 billion per month. The Committee has said that it will continue its securities purchases until the outlook for the labor market has improved substantially in a context of price stability. The Committee also has stated that in determining the size, pace, and composition of its asset purchases, it will take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives.

At its most recent meeting, the Committee made clear that it is prepared to increase or reduce the pace of its asset purchases to ensure that the stance of monetary policy remains appropriate as the outlook for the labor market or inflation changes. Accordingly, in considering whether a recalibration of the pace of its purchases is warranted, the Committee will continue to assess the degree of progress made toward its objectives in light of incoming information. The Committee also reiterated, consistent with its forward guidance regarding the federal funds rate, that it expects a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens.

In the current economic environment, monetary policy is providing significant benefits. Low real interest rates have helped support spending on durable goods, such as automobiles, and also contributed significantly to the recovery in housing sales, construction, and prices. Higher prices of houses and other assets, in turn, have increased household wealth and consumer confidence, spurring consumer spending and contributing to gains in production and employment. Importantly, accommodative monetary policy has also helped to offset incipient deflationary pressures and kept inflation from falling even further below the Committee’s 2 percent longer-run objective.

That said, the Committee is aware that a long period of low interest rates has costs and risks. For example, even as low interest rates have helped create jobs and supported the prices of homes and other assets, savers who rely on interest income from savings accounts or government bonds are receiving very low returns. Another cost, one that we take very seriously, is the possibility that very low interest rates, if maintained too long, could undermine financial stability. For example, investors or portfolio managers dissatisfied with low returns may “reach for yield” by taking on more credit risk, duration risk, or leverage. The Federal Reserve is working to address financial stability concerns through increased monitoring, a more systemic approach to supervising financial firms, and the ongoing implementation of reforms to make the financial system more resilient.

Recognizing the drawbacks of persistently low rates, the FOMC actively seeks economic conditions consistent with sustainably higher interest rates. Unfortunately, withdrawing policy accommodation at this juncture would be highly unlikely to produce such conditions. A premature tightening of monetary policy could lead interest rates to rise temporarily but would also carry a substantial risk of slowing or ending the economic recovery and causing inflation to fall further. Such outcomes tend to be associated with extended periods of lower, not higher, interest rates, as well as poor returns on other assets. Moreover, renewed economic weakness would pose its own risks to financial stability.

Because only a healthy economy can deliver sustainably high real rates of return to savers and investors, the best way to achieve higher returns in the medium term and beyond is for the Federal Reserve – consistent with its congressional mandate – to provide policy accommodation as needed to foster maximum employment and price stability. Of course, we will do so with due regard for the efficacy and costs of our policy actions and in a way that is responsive to the evolution of the economic outlook.