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, Washington, DC, 17 July 2013.

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Chairman Hensarling, Ranking Member Waters, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual Monetary Policy Report to the Congress. I will discuss current economic conditions and the outlook and then turn to monetary policy. I'll finish with a short summary of our ongoing work on regulatory reform.

The economic outlook

The economic recovery has continued at a moderate pace in recent quarters despite the strong headwinds created by federal fiscal policy.

Housing has contributed significantly to recent gains in economic activity. Home sales, house prices, and residential construction have moved up over the past year, supported by low mortgage rates and improved confidence in both the housing market and the economy. Rising housing construction and home sales are adding to job growth, and substantial increases in home prices are bolstering household finances and consumer spending while reducing the number of homeowners with underwater mortgages. Housing activity and prices seem likely to continue to recover, notwithstanding the recent increases in mortgage rates, but it will be important to monitor developments in this sector carefully.

Conditions in the labor market are improving gradually. The unemployment rate stood at 7.6 percent in June, about a half percentage point lower than in the months before the Federal Open Market Committee (FOMC) initiated its current asset purchase program in September. Nonfarm payroll employment has increased by an average of about 200,000 jobs per month so far this year. Despite these gains, the jobs situation is far from satisfactory, as the unemployment rate remains well above its longer-run normal level, and rates of underemployment and long-term unemployment are still much too high.

Meanwhile, consumer price inflation has been running below the Committee's longer-run objective of 2 percent. The price index for personal consumption expenditures rose only 1 percent over the year ending in May. This softness reflects in part some factors that are likely to be transitory. Moreover, measures of longer-term inflation expectations have generally remained stable, which should help move inflation back up toward 2 percent. However, the Committee is certainly aware that very low inflation poses risks to economic performance – for example, by raising the real cost of capital investment – and increases the risk of outright deflation. Consequently, we will monitor this situation closely as well, and we will act as needed to ensure that inflation moves back toward our 2 percent objective over time.

At the June FOMC meeting, my colleagues and I projected that economic growth would pick up in coming quarters, resulting in gradual progress toward the levels of unemployment and inflation consistent with the Federal Reserve's statutory mandate to foster maximum employment and price stability. Specifically, most participants saw real GDP growth beginning to step up during the second half of this year, eventually reaching a pace between 2.9 and 3.6 percent in 2015. They projected the unemployment rate to decline to between

5.8 and 6.2 percent by the final quarter of 2015. And they saw inflation gradually increasing toward the Committee's 2 percent objective.[1]

The pickup in economic growth projected by most Committee participants partly reflects their view that federal fiscal policy will exert somewhat less drag over time, as the effects of the tax increases and the spending sequestration diminish. The Committee also believes that risks to the economy have diminished since the fall, reflecting some easing of financial stresses in Europe, the gains in housing and labor markets that I mentioned earlier, the better budgetary positions of state and local governments, and stronger household and business balance sheets. That said, the risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect, or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery. More generally, with the recovery still proceeding at only a moderate pace, the economy remains vulnerable to unanticipated shocks, including the possibility that global economic growth may be slower than currently anticipated.

Monetary policy

With unemployment still high and declining only gradually, and with inflation running below the Committee's longer-run objective, a highly accommodative monetary policy will remain appropriate for the foreseeable future.

In normal circumstances, the Committee's basic tool for providing monetary accommodation is its target for the federal funds rate. However, the target range for the federal funds rate has been close to zero since late 2008 and cannot be reduced meaningfully further. Instead, we are providing additional policy accommodation through two distinct yet complementary policy tools. The first tool is expanding the Federal Reserve's portfolio of longer-term Treasury securities and agency mortgage-backed securities (MBS); we are currently purchasing $40 billion per month in agency MBS and $45 billion per month in Treasuries. The second tool is "forward guidance" about the Committee's plans for setting the federal funds rate target over the medium term.

Within our overall policy framework, we think of these two tools as having somewhat different roles. We are using asset purchases and the resulting expansion of the Federal Reserve's balance sheet primarily to increase the near-term momentum of the economy, with the specific goal of achieving a substantial improvement in the outlook for the labor market in a context of price stability. We have made some progress toward this goal, and, with inflation subdued, we intend to continue our purchases until a substantial improvement in the labor market outlook has been realized. In addition, even after purchases end, the Federal Reserve will be holding its stock of Treasury and agency securities off the market and reinvesting the proceeds from maturing securities, which will continue to put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

We are relying on near-zero short-term interest rates, together with our forward guidance that rates will continue to be exceptionally low – our second tool – to help maintain a high degree of monetary accommodation for an extended period after asset purchases end, even as the economic recovery strengthens and unemployment declines toward more-normal levels. In appropriate combination, these two tools can provide the high level of policy accommodation needed to promote a stronger economic recovery with price stability.

[1] These projections reflect FOMC participants' assessments based on their individual judgments regarding appropriate monetary policy.

In the interest of transparency, Committee participants agreed in June that it would be helpful to lay out more details about our thinking regarding the asset purchase program – specifically, to provide additional information on our assessment of progress to date, as well as of the likely trajectory of the program if the economy evolves as projected. This agreement to provide additional information did not reflect a change in policy.

The Committee's decisions regarding the asset purchase program (and the overall stance of monetary policy) depend on our assessment of the economic outlook and of the cumulative progress toward our objectives. Of course, economic forecasts must be revised when new information arrives and are thus necessarily provisional. As I noted, the economic outcomes that Committee participants saw as most likely in their June projections involved continuing gains in labor markets, supported by moderate growth that picks up over the next several quarters as the restraint from fiscal policy diminishes. Committee participants also saw inflation moving back toward our 2 percent objective over time. If the incoming data were to be broadly consistent with these projections, we anticipated that it would be appropriate to begin to moderate the monthly pace of purchases later this year. And if the subsequent data continued to confirm this pattern of ongoing economic improvement and normalizing inflation, we expected to continue to reduce the pace of purchases in measured steps through the first half of next year, ending them around midyear. At that point, if the economy had evolved along the lines we anticipated, the recovery would have gained further momentum, unemployment would be in the vicinity of 7 percent, and inflation would be moving toward our 2 percent objective. Such outcomes would be fully consistent with the goals of the asset purchase program that we established in September.

I emphasize that, because our asset purchases depend on economic and financial developments, they are by no means on a preset course. On the one hand, if economic conditions were to improve faster than expected, and inflation appeared to be rising decisively back toward our objective, the pace of asset purchases could be reduced somewhat more quickly. On the other hand, if the outlook for employment were to become relatively less favorable, if inflation did not appear to be moving back toward 2 percent, or if financial conditions – which have tightened recently – were judged to be insufficiently accommodative to allow us to attain our mandated objectives, the current pace of purchases could be maintained for longer. Indeed, if needed, the Committee would be prepared to employ all of its tools, including an increase the pace of purchases for a time, to promote a return to maximum employment in a context of price stability.

As I noted, the second tool the Committee is using to support the recovery is forward guidance regarding the path of the federal funds rate. The Committee has said it intends to maintain a high degree of monetary accommodation for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee anticipates that its current exceptionally low target range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6–1/2 percent and inflation and inflation expectations remain well behaved in the sense described in the FOMC's statement.

As I have observed on several occasions, the phrase "at least as long as" is a key component of the policy rate guidance. These words indicate that the specific numbers for unemployment and inflation in the guidance are thresholds, not triggers. Reaching one of the thresholds would not automatically result in an increase in the federal funds rate target; rather, it would lead the Committee to consider whether the outlook for the labor market, inflation, and the broader economy justified such an increase. For example, if a substantial part of the reductions in measured unemployment were judged to reflect cyclical declines in labor force participation rather than gains in employment, the Committee would be unlikely to view a decline in unemployment to 6–1/2 percent as a sufficient reason to raise its target for the federal funds rate. Likewise, the Committee would be unlikely to raise the funds rate if inflation remained persistently below our longer-run objective. Moreover, so long as the economy remains short of maximum employment, inflation remains near our longer-run objective, and inflation expectations remain well anchored, increases in the target for the federal funds rate, once they begin, are likely to be gradual.

Regulatory reform

I will finish by providing you with a brief update on progress on reforms to reduce the systemic risk of the largest financial firms. As Governor Tarullo discussed in his testimony last week before the Senate Banking, Housing, and Urban Affairs Committee, the Federal Reserve, with the other federal banking agencies, adopted a final rule earlier this month to implement the Basel III capital reforms.[2] The final rule increases the quantity and quality of required regulatory capital by establishing a new minimum common equity tier 1 capital ratio and implementing a capital conservation buffer. The rule also contains a supplementary leverage ratio and a countercyclical capital buffer that apply only to large and internationally active banking organizations, consistent with their systemic importance. In addition, the Federal Reserve will propose capital surcharges on firms that pose the greatest systemic risk and will issue a proposal to implement the Basel III quantitative liquidity requirements as they are phased in over the next few years. The Federal Reserve is considering further measures to strengthen the capital positions of large, internationally active banks, including the proposed rule issued last week that would increase the required leverage ratios for such firms.[3]

The Fed also is working to finalize the enhanced prudential standards set out in sections 165 and 166 of the Dodd-Frank Act. Among these standards, rules relating to stress testing and resolution planning already are in place, and we have been actively engaged in stress tests and reviewing the "first-wave" resolution plans. In coordination with other agencies, we have made significant progress on the key substantive issues relating to the Volcker rule and are hoping to complete it by year-end.

Finally, the Federal Reserve is preparing to regulate and supervise systemically important nonbank financial firms. Last week, the Financial Stability Oversight Council designated two nonbank financial firms; it has proposed the designation of a third firm, which has requested a hearing before the council.[4] We are developing a supervisory and regulatory framework that can be tailored to each firm's business mix, risk profile, and systemic footprint, consistent with the Collins amendment and other legal requirements under the Dodd-Frank Act.

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

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2 See Daniel K. Tarullo (2013), "Dodd-Frank Implementation," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 11; and Board of Governors of the Federal Reserve System (2013), "Federal Reserve Board Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions," press release, July 2.

3 See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2013), "Agencies Adopt Supplementary Leverage Ratio Notice of Proposed Rulemaking," joint press release, July 9.

4 U.S. Department of the Treasury (2013), "Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability," press release, July 9.