Ben S Bernanke: Semiannual Monetary Policy Report to the Congress

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington, DC, 19 July 2006.

* * *

Mr. Chairman and members of the Committee, I am pleased to be here again to present the Federal Reserve's Monetary Policy Report to the Congress.

Over the period since our February report, the U.S. economy has continued to expand. Real gross domestic product (GDP) is estimated to have risen at an annual rate of 5.6 percent in the first quarter of 2006. The available indicators suggest that economic growth has more recently moderated from that quite strong pace, reflecting a gradual cooling of the housing market and other factors that I will discuss. With respect to the labor market, more than 850,000 jobs were added, on net, to nonfarm payrolls over the first six months of the year, though these gains came at a slower pace in the second quarter than in the first. Last month the unemployment rate stood at 4.6 percent.

Inflation has been higher than we had anticipated in February, partly as a result of further sharp increases in the prices of energy and other commodities. During the first five months of the year, overall inflation as measured by the price index for personal consumption expenditures averaged 4.3 percent at an annual rate. Over the same period, core inflation - that is, inflation excluding food and energy prices - averaged 2.6 percent at an annual rate. To address the risk that inflation pressures might remain elevated, the Federal Open Market Committee (FOMC) continued to firm the stance of monetary policy, raising the federal funds rate another 3/4 percentage point, to 5-1/4 percent, in the period since our last report.

Let me now review the current economic situation and the outlook in a bit more detail, beginning with developments in the real economy and then turning to the inflation situation. I will conclude with some comments on monetary policy.

The U.S. economy appears to be in a period of transition. For the past three years or so, economic growth in the United States has been robust. This growth has reflected both the ongoing re-employment of underutilized resources, as the economy recovered from the weakness of earlier in the decade, and the expansion of the economy's underlying productive potential, as determined by such factors as productivity trends and growth of the labor force. Although the rates of resource utilization that the economy can sustain cannot be known with any precision, it is clear that, after several years of above-trend growth, slack in resource utilization has been substantially reduced. As a consequence, a sustainable, non-inflationary expansion is likely to involve a modest reduction in the growth of economic activity from the rapid pace of the past three years to a pace more consistent with the rate of increase in the nation's underlying productive capacity. It bears emphasizing that, because productivity growth seems likely to remain strong, the productive capacity of our economy should expand over the next few years at a rate sufficient to support solid growth in real output.

As I have noted, the anticipated moderation in economic growth now seems to be under way, although the recent erratic growth pattern complicates this assessment. That moderation appears most evident in the household sector. In particular, consumer spending, which makes up more than two-thirds of aggregate spending, grew rapidly during the first quarter but decelerated during the spring. One likely source of this deceleration was higher energy prices, which have adversely affected the purchasing power of households and weighed on consumer attitudes.

Outlays for residential construction, which have been at very high levels in recent years, rose further in the first quarter. More recently, however, the market for residential real estate has been cooling, as can be seen in the slowing of new and existing home sales and housing starts. Some of the recent softening in housing starts may have resulted from the unusually favorable weather during the first quarter of the year, which pulled forward construction activity, but the slowing of the housing market appears to be more broad-based than can be explained by that factor alone. Home prices, which have climbed at double-digit rates in recent years, still appear to be rising for the nation as a whole, though significantly less rapidly than before. These developments in the housing market are not particularly surprising, as the sustained run-up in housing prices, together with some increase in mortgage rates, has reduced affordability and thus the demand for new homes.

The slowing of the housing market may restrain other forms of household spending as well. With homeowners no longer experiencing increases in the equity value of their homes at the rapid pace seen in the past few years, and with the recent declines in stock prices, increases in household net worth are likely to provide less of a boost to consumer expenditures than they have in the recent past. That said, favorable fundamentals, including relatively low unemployment and rising disposable incomes, should provide support for consumer spending. Overall, household expenditures appear likely to expand at a moderate pace, providing continued impetus to the overall economic expansion.

Although growth in household spending has slowed, other sectors of the economy retain considerable momentum. Business investment in new capital goods appears to have risen briskly, on net, so far this year. In particular, investment in nonresidential structures, which had been weak since 2001, seems to have picked up appreciably, providing some offset to the slower growth in residential construction. Spending on equipment and software has also been strong. With a few exceptions, business inventories appear to be well aligned with sales, which reduces the risk that a buildup of unwanted inventories might act to reduce production in the future. Business investment seems likely to continue to grow at a solid pace, supported by growth in final sales, rising backlogs of orders for capital goods, and high rates of profitability. To be sure, businesses in certain sectors have experienced financial difficulties. In the aggregate, however, firms remain in excellent financial condition, and credit conditions for businesses are favorable.

Globally, output growth appears strong. Growth of the global economy will help support U.S. economic activity by continuing to stimulate demand for our exports of goods and services. One downside of the strength of the global economy, however, is that it has led to significant increases in the demand for crude oil and other primary commodities over the past few years. Together with heightened geopolitical uncertainties and the limited ability of suppliers to expand capacity in the short run, these rising demands have resulted in sharp rises in the prices at which those goods are traded internationally, which in turn has put upward pressure on costs and prices in the United States.

Overall, the U.S. economy seems poised to grow in coming quarters at a pace roughly in line with the expansion of its underlying productive capacity. Such an outlook is embodied in the projections of members of the Board of Governors and the presidents of Federal Reserve Banks that were made around the time of the FOMC meeting late last month, based on the assumption of appropriate monetary policy. In particular, the central tendency of those forecasts is for real GDP to increase about 3-1/4 percent to 3-1/2 percent in 2006 and 3 percent to 3-1/4 percent in 2007. With output expanding at a pace near that of the economy's potential, the civilian unemployment rate is expected to finish both 2006 and 2007 between 4-3/4 percent and 5 percent, close to its recent level.

I turn now to the inflation situation. As I noted, inflation has been higher than we expected at the time of our last report. Much of the upward pressure on overall inflation this year has been due to increases in the prices of energy and other commodities and, in particular, to the higher prices of products derived from crude oil. Gasoline prices have increased notably as a result of the rise in petroleum prices as well as factors specific to the market for ethanol. The pickup in inflation so far this year has also been reflected in the prices of a range of non-energy goods and services, as strengthening demand may have given firms more ability to pass energy and other costs through to consumers. In addition, increases in residential rents, as well as in the imputed rent on owner-occupied homes, have recently contributed to higher core inflation.

The recent rise in inflation is of concern to the FOMC. The achievement of price stability is one of the objectives that make up the Congress's mandate to the Federal Reserve. Moreover, in the long run, price stability is critical to achieving maximum employment and moderate long-term interest rates, the other parts of the congressional mandate.

The outlook for inflation is shaped by a number of factors, not the least of which is the course of energy prices. The spot price of oil has moved up significantly further in recent weeks. Futures quotes imply that market participants expect petroleum prices to roughly stabilize in coming quarters; such an outcome would, over time, reduce one source of upward pressure on inflation. However, expectations of a leveling out of oil prices have been consistently disappointed in recent years, and as the experience of the past week suggests, possible increases in these and other commodity prices remain a risk to the inflation outlook.

Although the costs of energy and other raw materials are important, labor costs are by far the largest component of business costs. Anecdotal reports suggest that the labor market is tight in some industries and occupations and that employers are having difficulty attracting certain types of skilled workers. To date, however, moderate growth in most broad measures of nominal labor compensation and the ongoing increases in labor productivity have held down the rise in unit labor costs, reducing pressure on inflation from the cost side. Employee compensation per hour is likely to rise more quickly over the next couple of years in response to the strength of the labor market. Whether faster increases in nominal compensation create additional cost pressures for firms depends in part on the extent to which they are offset by continuing productivity gains. Profit margins are currently relatively wide, and the effect of a possible acceleration in compensation on price inflation would thus also depend on the extent to which competitive pressures force firms to reduce margins rather than pass on higher costs.

The public's inflation expectations are another important determinant of inflation. The Federal Reserve must guard against the emergence of an inflationary psychology that could impart greater persistence to what would otherwise be a transitory increase in inflation. After rising earlier this year, measures of longer-term inflation expectations, based on surveys and on a comparison of yields on nominal and inflation-indexed government debt, have edged down and remain contained. These developments bear watching, however.

Finally, the extent to which aggregate demand is aligned with the economy's underlying productive potential also influences inflation. As I noted earlier, FOMC participants project that the growth in economic activity should moderate to a pace close to that of the growth of potential both this year and next. Should that moderation occur as anticipated, it should help to limit inflation pressures over time.

The projections of the members of the Board of Governors and the presidents of the Federal Reserve Banks, which are based on information available at the time of the last FOMC meeting, are for a gradual decline in inflation in coming quarters. As measured by the price index for personal consumption expenditures excluding food and energy, inflation is projected to be 2-1/4 percent to 2-1/2 percent this year and then to edge lower, to 2 percent to 2-1/4 percent next year.

The FOMC projections, which now anticipate slightly lower growth in real output and higher core inflation than expected in our February report, mirror the somewhat more adverse circumstances facing our economy, which have resulted from the recent steep run-up in energy costs and higher-than-expected inflation more generally. But they also reflect our assessment that, with appropriate monetary policy and in the absence of significant unforeseen developments, the economy should continue to expand at a solid and sustainable pace and core inflation should decline from its recent level over the medium term.

Although our baseline forecast is for moderating inflation, the Committee judges that some inflation risks remain. In particular, the high prices of energy and other commodities, in conjunction with high levels of resource utilization that may increase the pricing power of suppliers of goods and services, have the potential to sustain inflation pressures. More generally, if the pattern of elevated readings on inflation is more protracted or more intense than is currently expected, this higher level of inflation could become embedded in the public's inflation expectations and in price-setting behavior. Persistently higher inflation would erode the performance of the real economy and would be costly to reverse. The Federal Reserve must take account of these risks in making its policy decisions.

In our pursuit of maximum employment and price stability, monetary policy makers operate in an environment of uncertainty. In particular, we have imperfect knowledge about the effects of our own policy actions as well as of the many other factors that will shape economic developments during the forecast period. These uncertainties bear importantly on our policy decisions because the full influence of policy actions on the economy is felt only after a considerable period of time. The lags between policy actions and their effects imply that we must be forward-looking, basing our policy choices on the longer-term outlook for both inflation and economic growth. In formulating that outlook, we must take account of the possible future effects of previous policy actions - that is, of policy effects still "in the pipeline." Finally, as I have noted, we must consider not only what appears to be the most likely outcome but also the risks to that outlook and the costs that would be incurred should any of those risks be realized.

At the same time, because economic forecasting is far from a precise science, we have no choice but to regard all our forecasts as provisional and subject to revision as the facts demand. Thus, policy must be flexible and ready to adjust to changes in economic projections. In particular, as the Committee noted in the statement issued after its June meeting, the extent and timing of any additional firming that may be needed to address inflation risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by our analysis of the incoming information.

Thank you. I would be happy to take questions.