Ben S Bernanke: Federal Reserve Board's 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, 14 February 2007.

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Chairman Dodd, Senator Shelby, and other members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress.

Real activity in the United States expanded at a solid pace in 2006, although the pattern of growth was uneven. After a first-quarter rebound from weakness associated with the effects of the hurricanes that ravaged the Gulf Coast the previous summer, output growth moderated somewhat on average over the remainder of 2006. Real gross domestic product (GDP) is currently estimated to have increased at an annual rate of about 2-3/4 percent in the second half of the year.

As we anticipated in our July report, the U.S. economy appears to be making a transition from the rapid rate of expansion experienced over the preceding several years to a more sustainable average pace of growth. The principal source of the ongoing moderation has been a substantial cooling in the housing market, which has led to a marked slowdown in the pace of residential construction. However, the weakness in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other sectors of the economy. Consumer spending has continued to expand at a solid rate, and the demand for labor has remained strong. On average, about 165,000 jobs per month have been added to nonfarm payrolls over the past six months, and the unemployment rate, at 4.6 percent in January, remains low.

Inflation pressures appear to have abated somewhat following a run-up during the first half of 2006. Overall inflation has fallen, in large part as a result of declines in the price of crude oil. Readings on core inflation – that is, inflation excluding the prices of food and energy – have improved modestly in recent months. Nevertheless, the core inflation rate remains somewhat elevated.

In the five policy meetings since the July report, the Federal Open Market Committee (FOMC) has maintained the federal funds rate at 5-1/4 percent. So far, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing of core inflation. However, in the statement accompanying last month's policy decision, the FOMC again indicated that its predominant policy concern is the risk that inflation will fail to ease as expected and that it is prepared to take action to address inflation risks if developments warrant.

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

Consumer spending continues to be the mainstay of the current economic expansion. Personal consumption expenditures, which account for more than two-thirds of aggregate demand, increased at an annual rate of around 3-1/2 percent in real terms during the second half of last year, broadly matching the brisk pace of the previous three years. Consumer outlays were supported by strong gains in personal income, reflecting both the ongoing increases in payroll employment and a pickup in the growth of real wages. Real hourly compensation – as measured by compensation per hour in the nonfarm business sector deflated by the personal consumption expenditures price index – rose at an annual rate of around 3 percent in the latter half of 2006.

The resilience of consumer spending is all the more striking given the backdrop of the substantial correction in the housing market that became increasingly evident during the spring and summer of last year. By the middle of 2006, monthly sales of new and existing homes were about 15 percent lower than a year earlier, and the previously rapid rate of house-price appreciation had slowed markedly. The fall in housing demand in turn prompted a sharp slowing in the pace of construction of new homes. Even so, the backlog of unsold homes rose from about four-and-a-half months' supply in 2005 to nearly seven months' supply by the third quarter of last year. Single-family housing starts have dropped more than 30 percent since the beginning of last year, and employment growth in the construction sector has slowed substantially.

Some tentative signs of stabilization have recently appeared in the housing market: New and existing home sales have flattened out in recent months, mortgage applications have picked up, and some surveys find that homebuyers' sentiment has improved. However, even if housing demand falls no further, weakness in residential investment is likely to continue to weigh on economic growth over the next few quarters as homebuilders seek to reduce their inventories of unsold homes to more-comfortable levels.

Despite the ongoing adjustments in the housing sector, overall economic prospects for households remain good. Household finances appear generally solid, and delinquency rates on most types of consumer loans and residential mortgages remain low. The exception is subprime mortgages with variable interest rates, for which delinquency rates have increased appreciably. The labor market is expected to stay healthy, and real incomes should continue to rise, although the pace of employment gains may be slower than that to which we have become accustomed in recent years. In part, slower average job growth may simply reflect the moderation of economic activity. Also, the impending retirement of the leading edge of the baby-boom generation, and an apparent leveling out of women's participation rate in the workforce, which had risen for several decades, will likely restrain the growth of the labor force in coming years. With fewer jobseekers entering the labor force, the rate of job creation associated with the maintenance of stable conditions in the labor market will decline. All told, consumer expenditures appear likely to expand solidly in coming quarters, albeit a little less rapidly than the growth in personal incomes if, as we expect, households respond to the slow pace of home-equity appreciation by saving more out of current income.

The business sector remains in excellent financial condition, with strong growth in profits, liquid balance sheets, and corporate leverage near historical lows. Last year, those factors helped to support continued advances in business capital expenditures. Notably, investment in high-tech equipment rose 9 percent in 2006, and spending on nonresidential structures (such as office buildings, factories, and retail space) increased rapidly through much of the year after several years of weakness. Growth in business spending slowed toward the end of last year, reflecting mainly a deceleration of spending on business structures; a drop in outlays in the transportation sector, where spending is notably volatile; and some weakness in purchases of equipment related to construction and motor vehicle manufacturing. Over the coming year, capital spending is poised to expand at a moderate pace, supported by steady gains in business output and favorable financial conditions. Inventory levels in some sectors – most notably at motor vehicle dealers and in some construction-related manufacturing industries – rose over the course of last year, leading some firms to cut production to better align inventories with sales. Remaining imbalances may continue to impose modest restraint on industrial production during the early part of this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad helped spur a robust expansion in U.S. real exports, which grew about 9 percent last year. The pattern of real U.S imports was somewhat uneven, partly because of fluctuations in oil imports over the course of the year. On balance, import growth slowed in 2006, to 3 percent. Economic growth abroad should support further steady growth in U.S. exports this year. Despite the improvements in trade performance, the U.S. current account deficit remains large, averaging about 6-1/2 percent of nominal GDP during the first three quarters of 2006 (the latest available data).

Overall, the U.S. economy seems likely to expand at a moderate pace this year and next, with growth strengthening somewhat as the drag from housing diminishes. Such an outlook is reflected in the projections that the members of the Board of Governors and presidents of the Federal Reserve Banks made around the time of the FOMC meeting late last month. The central tendency of those forecasts – which are based on the information available at that time and on the assumption of appropriate monetary policy – is for real GDP to increase about 2-1/2 to 3 percent in 2007 and about 2-3/4 to 3 percent in 2008. The projection for GDP growth in 2007 is slightly lower than our projection last July. This difference partly reflects an expectation of somewhat greater weakness in residential construction during the first part of this year than we anticipated last summer. The civilian unemployment rate is expected to finish both 2007 and 2008 around 4-1/2 to 4-3/4 percent.

The risks to this outlook are significant. To the downside, the ultimate extent of the housing market correction is difficult to forecast and may prove greater than we anticipate. Similarly, spillover effects from developments in the housing market onto consumer spending and employment in housing-related industries may be more pronounced than expected. To the upside, output may expand more quickly than expected if consumer spending continues to increase at the brisk pace seen in the second half of 2006.

I turn now to the inflation situation. As I noted earlier, there are some indications that inflation pressures are beginning to diminish. The monthly data are noisy, however, and it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated. Recent declines in overall inflation have primarily reflected lower prices for crude oil, which have fed through to the prices of gasoline, heating oil, and other energy products used by consumers. After moving higher in the first half of 2006, core consumer price inflation has also edged lower recently, reflecting a relatively broad-based deceleration in the prices of core goods. That deceleration is probably also due to some extent to lower energy prices, which have reduced costs of production and thereby lessened one source of pressure on the prices of final goods and services. The ebbing of core inflation has likely been promoted as well by the stability of inflation expectations.

A waning of the temporary factors that boosted inflation in recent years will probably help foster a continued edging down of core inflation. In particular, futures quotes imply that oil prices are expected to remain well below last year's peak. If actual prices follow the path currently indicated by futures prices, inflation pressures would be reduced further as the benefits of the decline in oil prices from last year's high levels are passed through to a broader range of core goods and services. Nonfuel import prices may also put less pressure on core inflation, particularly if price increases for some other commodities, such as metals, slow from last year's rapid rates. But as we have been reminded only too well in recent years, the prices of oil and other commodities are notoriously difficult to predict, and they remain a key source of uncertainty to the inflation outlook. The contribution from rents and shelter costs should also fall back, following a step-up last year. The faster pace of rent increases last year may have been attributable in part to the reduced affordability of owner-occupied housing, which led to a greater demand for rental housing. Rents should rise somewhat less quickly this year and next, reflecting recovering demand for owner-occupied housing as well as increases in the supply of rental units, but the extent and pace of that adjustment is not yet clear.

Upward pressure on inflation could materialize if final demand were to exceed the underlying productive capacity of the economy for a sustained period. The rate of resource utilization is high, as can be seen in rates of capacity utilization above their long-term average and, most evidently, in the tightness of the labor market. Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in certain occupations. Measures of labor compensation, though still growing at a moderate pace, have shown some signs of acceleration over the past year, likely in part the result of tight labor market conditions.

The implications for inflation of faster growth in nominal labor compensation depend on several factors. Increases in compensation might be offset by higher labor productivity or absorbed by a narrowing of firms' profit margins rather than passed on to consumers in the form of higher prices; in these circumstances, gains in nominal compensation would translate into gains in real compensation as well. Underlying productivity trends appear favorable, and the markup of prices over unit labor costs is high by historical standards, so such an outcome is certainly possible. Moreover, if activity expands over the next year or so at the moderate pace anticipated by the FOMC, pressures in both labor and product markets should ease modestly. That said, the possibility remains that tightness in product markets could allow firms to pass higher labor costs through to prices, adding to inflation and effectively nullifying the purchasing power of at least some portion of the increase in labor compensation. Thus, the high level of resource utilization remains an important upside risk to continued progress on inflation.

Another significant factor influencing medium-term trends in inflation is the public's expectations of inflation. These expectations have an important bearing on whether transitory influences on prices, such as those created by changes in energy costs, become embedded in wage and price decisions and so leave a lasting imprint on the rate of inflation. It is encouraging that inflation expectations appear to have remained contained.

The projections of the members of the Board of Governors and the presidents of the Federal Reserve Banks are for inflation to continue to ebb over this year and next. In particular, the central tendency of those forecasts is for core inflation – as measured by the price index for personal consumption expenditures excluding food and energy – to be 2 to 2-1/4 percent this year and to edge lower, to 1-3/4 to 2 percent, next year. But as I noted earlier, the FOMC has continued to view the risk that inflation will not moderate as expected as the predominant policy concern.

Monetary policy affects spending and inflation with long and variable lags. Consequently, policy decisions must be based on an assessment of medium-term economic prospects. At the same time, because economic forecasting is an uncertain enterprise, policymakers must be prepared to respond flexibly to developments in the economy when those developments lead to a re-assessment of the outlook. The dependence of monetary policy actions on a broad range of incoming information complicates the public's attempts to understand and anticipate policy decisions.

Clear communication by the central bank about the economic outlook, the risks to that outlook, and its monetary policy strategy can help the public to understand the rationale behind policy decisions and to anticipate better the central bank's reaction to new information. This understanding should, in turn, enhance the effectiveness of policy and lead to improved economic outcomes. By reducing uncertainty, central bank transparency may also help anchor the public's longer-term expectations of inflation. Much experience has shown that well-anchored inflation expectations tend to help stabilize inflation and promote maximum sustainable economic growth. Good communication by the central bank is also vital for ensuring appropriate accountability for its policy actions, the full effects of which can be observed only after a lengthy period. A transparent policy process improves accountability by clarifying how a central bank expects to attain its policy objectives and by ensuring that policy is conducted in a manner that can be seen to be consistent with achieving those objectives.

Over the past decade or so, the Federal Reserve has significantly improved its methods of communication, but further progress is possible. As you know, the FOMC last year established a subcommittee to help the full Committee evaluate the next steps in this continuing process. Our discussions are directed at examining all aspects of our communications and have been deliberate and thorough. These discussions are continuing, and no decisions have been reached. My colleagues and I remain firmly committed to an open and transparent monetary policy process that enhances our ability to achieve our dual objectives of stable prices and maximum sustainable employment. I will keep members of this Committee apprised of developments as our deliberations move forward. I look forward to continuing to work closely with the members of this Committee and your colleagues in the Senate and House on the important issues pertaining to monetary policy and the other responsibilities with which the Congress has charged the Federal Reserve.

Thank you. I would be happy to take questions.