Ben S Bernanke: The economic outlook

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 28 March 2007.

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Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of the Committee, thank you for inviting me here this morning to present an update on the outlook for the U.S. economy. I will begin with a discussion of real economic activity and then turn to inflation.

Economic growth in the United States has slowed in recent quarters, reflecting in part the economy's transition from the rapid rate of expansion experienced over the preceding years to a more sustainable pace of growth. Real gross domestic product (GDP) rose at an annual rate of roughly 2 percent in the second half of 2006 and appears to be expanding at a similar rate early this year.

The principal source of the slowdown in economic growth that began last spring has been the substantial correction in the housing market. Following an extended boom in housing, the demand for homes began to weaken in mid-2005. By the middle of 2006, sales of both new and existing homes had fallen about 15 percent below their peak levels. Homebuilders responded to the fall in demand by sharply curtailing construction. Even so, the inventory of unsold homes has risen to levels well above recent historical norms. Because of the decline in housing demand, the pace of house-price appreciation has slowed markedly, with some markets experiencing outright price declines.

The near-term prospects for the housing market remain uncertain. Sales of new and existing homes were about flat, on balance, during the second half of last year. So far this year, sales of existing homes have held up, as have other indicators of demand such as mortgage applications for home purchase, and mortgage rates remain relatively low. However, sales of new homes have fallen, and continuing declines in starts have not yet led to meaningful reductions in the inventory of homes for sale. Even if the demand for housing falls no further, weakness in residential construction is likely to remain a drag on economic growth for a time as homebuilders try to reduce their inventories of unsold homes to more normal levels.

Developments in subprime mortgage markets raise some additional questions about the housing sector. Delinquency rates on variable-interest-rate loans to subprime borrowers, which account for a bit less than 10 percent of all mortgages outstanding, have climbed sharply in recent months. The flattening in home prices has contributed to the increase in delinquencies by making refinancing more difficult for borrowers with little home equity. In addition, a large increase in early defaults on recently originated subprime variable-rate mortgages casts serious doubt on the adequacy of the underwriting standards for these products, especially those originated over the past year or so. As a result of this deterioration in loan performance, investors have increased their scrutiny of the credit quality of securitized mortgages, and lenders in turn are evidently tightening the terms and standards applied in the subprime mortgage market.

Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families, the implications of these developments for the housing market as a whole are less clear. The ongoing tightening of lending standards, although an appropriate market response, will reduce somewhat the effective demand for housing, and foreclosed properties will add to the inventories of unsold homes. At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency. We will continue to monitor this situation closely.

Business spending has also slowed recently. Expenditures on capital equipment declined in the fourth quarter of 2006 and early this year. Much of the weakness in recent months has been in types of capital goods used heavily by the construction and motor vehicle industries, but we have seen some softening in the demand for other types of capital goods as well. Although some of this pullback can be explained by the recent moderation in the growth of output, the magnitude of the slowdown has been somewhat greater than would be expected given the normal evolution of the business cycle. In addition, inventory levels in some industries – again, most notably in industries linked to construction and motor vehicle production – rose over the course of last year, leading some firms to cut production to better align inventories with sales. Recent indicators suggest that the inventory adjustment process

may have largely run its course in the motor vehicle sector, but remaining imbalances in some other industries may continue to impose some restraint on industrial production for a time.

Despite the recent weak readings, we expect business investment in equipment and software to grow at a moderate pace this year, supported by high rates of profitability, strong business balance sheets, relatively low interest rates and credit spreads, and continued expansion of output and sales. Investment in nonresidential structures (such as office buildings, factories, and retail space) should also continue to expand, although not at the unusually rapid pace of 2006.

Thus far, the weakness in housing and in some parts of manufacturing does not appear to have spilled over to any significant extent to other sectors of the economy. Employment has continued to expand as job losses in manufacturing and residential construction have been more than offset by gains in other sectors, notably health care, leisure and hospitality, and professional and technical services, and unemployment remains low by historical standards. The continuing increases in employment, together with some pickup in real wages, have helped sustain consumer spending, which increased at a brisk pace during the second half of last year and has continued to be well maintained so far this year. Growth in consumer spending should continue to support the economic expansion in coming quarters. In addition, fiscal policy at both the federal and the state and local levels should impart a small stimulus to economic activity this year.

Outside the United States, economic activity in our major trading partners has continued to grow briskly. The strength of demand abroad has helped to spur strong growth in U.S. real exports, which rose about 9 percent last year, and a robust world economy should continue to provide opportunities for U.S. exporters this year. Growth in U.S. real imports slowed to about 3 percent in 2006, in part reflecting a drop in real terms in imports of crude oil and petroleum products. Despite the improvements in trade performance, the U.S. current account deficit remains large, averaging 6-1/2 percent of nominal GDP during 2006.

Overall, the economy appears likely to continue to expand at a moderate pace over coming quarters. As the inventory of unsold new homes is worked off, the drag from residential investment should wane. Consumer spending appears solid, and business investment seems likely to post moderate gains.

This forecast is subject to a number of risks. To the downside, the correction in the housing market could turn out to be more severe than we currently expect, perhaps exacerbated by problems in the subprime sector. Moreover, we could yet see greater spillover from the weakness in housing to employment and consumer spending than has occurred thus far. The possibility that the recent weakness in business investment will persist is an additional downside risk. To the upside, consumer spending – which has proved quite resilient despite the housing downturn and increases in energy prices – might continue to grow at a brisk pace, stimulating a more-rapid economic expansion than we currently anticipate.

Let me now turn to the inflation situation. Overall consumer price inflation has come down since last year, primarily as a result of the deceleration of consumers' energy costs. The consumer price index (CPI) increased 2.4 percent over the twelve months ending in February, down from 3.6 percent a year earlier. Core inflation slowed modestly in the second half of last year, but recent readings have been somewhat elevated and the level of core inflation remains uncomfortably high. For example, core CPI inflation over the twelve months ending in February was 2.7 percent, up from 2.1 percent a year earlier. Another measure of core inflation that we monitor closely, based on the price index for personal consumption expenditures excluding food and energy, shows a similar pattern.

Core inflation, which is a better measure of the underlying inflation trend than overall inflation, seems likely to moderate gradually over time. Despite recent increases in the price of crude oil, energy prices are below last year's peak. If energy prices remain near current levels, greater stability in the costs of producing non-energy goods and services will reduce pressure on core inflation over time. Of course, the prices of oil and other commodities are very difficult to predict, and they remain a source of considerable uncertainty in the inflation outlook.

Increases in rents – both market rent and owner's equivalent rent – account for a substantial part of the increase in core inflation over the past year. The acceleration in rents may have resulted in part from a shift in demand toward rental housing as families found homeownership less financially attractive. Rents should begin to decelerate as the demand for owner-occupied housing stabilizes and the supply of rental units increases. However, the extent and timing of that expected slowing is not yet clear.

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 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 be contained.

Although core inflation seems likely to moderate gradually over time, the risks to this forecast are to the upside. In particular, 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 most clearly in the tightness of the labor market. Indeed, anecdotal reports suggest that businesses are having difficulty recruiting well-qualified workers in a range of 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.

To be sure, faster growth in nominal labor compensation does not necessarily portend higher inflation. Increases in compensation may be offset by higher labor productivity or absorbed – at least for a time – 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 generally favorable, despite the recent slowing in some measures, and the markup of prices over unit labor costs is high by historical standards, so such an outcome is certainly possible. Moreover, if the economy grows at a moderate pace for a time, as seems most likely, pressures on resource utilization should ease.

However, a less benign possibility is that tight product markets might allow firms to pass some or all of their higher labor costs through to prices. In this case, increases in nominal compensation would not translate into increased purchasing power for workers but would add to inflation pressures. Thus, the high level of resource utilization remains an important upside risk to continued progress in reducing inflation.

In regard to monetary policy, the Federal Open Market Committee has left its target for the federal funds rate unchanged, at 5-1/4 percent, since last June. To date, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing in core inflation. Because core inflation is above the levels most conducive to the achievement of sustainable growth and price stability, the Committee indicated in the statement following its recent meeting that its predominant policy concern remains the risk that inflation will fail to moderate as expected. However, the uncertainties around the outlook have increased somewhat in recent weeks. Consequently, the Committee also indicated that future policy decisions will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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