Ben S Bernanke: The economic outlook

Testimony by 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, 5 May 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chair Maloney, Vice Chairman Schumer, Ranking Members Brownback and Brady, and other members of the Committee, I am pleased to be here today to offer my views on recent economic developments, the outlook for the economy, and current conditions in financial markets.

Recent economic developments

The U.S. economy has contracted sharply since last autumn, with real gross domestic product (GDP) having dropped at an annual rate of more than 6 percent in the fourth quarter of 2008 and the first quarter of this year. Among the enormous costs of the downturn is the loss of some 5 million payroll jobs over the past 15 months. The most recent information on the labor market – the number of new and continuing claims for unemployment insurance through late April – suggests that we are likely to see further sizable job losses and increased unemployment in coming months.

However, the recent data also suggest that the pace of contraction may be slowing, and they include some tentative signs that final demand, especially demand by households, may be stabilizing. Consumer spending, which dropped sharply in the second half of last year, grew in the first quarter. In coming months, households' spending power will be boosted by the fiscal stimulus program, and we have seen some improvement in consumer sentiment. Nonetheless, a number of factors are likely to continue to weigh on consumer spending, among them the weak labor market and the declines in equity and housing wealth that households have experienced over the past two years. In addition, credit conditions for consumers remain tight.

The housing market, which has been in decline for three years, has also shown some signs of bottoming. Sales of existing homes have been fairly stable since late last year, and sales of new homes have firmed a bit recently, though both remain at depressed levels. Although some of the boost to sales in the market for existing homes is likely coming from foreclosure-related transactions, the increased affordability of homes appears to be contributing more broadly to the steadying in the demand for housing. In particular, the average interest rate on conforming 30-year fixed-rate mortgages has dropped almost 1-3/4 percentage points since August, to about 4.8 percent. With sales of new homes up a bit and starts of single-family homes little changed from January through March, builders are seeing the backlog of unsold new homes decline – a precondition for any recovery in homebuilding.

In contrast to the somewhat better news in the household sector, the available indicators of business investment remain extremely weak. Spending for equipment and software fell at an annual rate of about 30 percent in both the fourth and first quarters, and the level of new orders remains below the level of shipments, suggesting further near-term softness in business equipment spending. Recent business surveys have been a bit more positive, but surveyed firms are still reporting net declines in new orders and restrained capital spending plans. Our recent survey of bank loan officers reported further weakening of demand for commercial and industrial loans.[1] The survey also showed that the net fraction of banks that tightened their business lending policies stayed elevated, although it has come down in the past two surveys.

Conditions in the commercial real estate sector are poor. Vacancy rates for existing office, industrial, and retail properties have been rising, prices of these properties have been falling, and, consequently, the number of new projects in the pipeline has been shrinking. Credit conditions in the commercial real estate sector are still severely strained, with no commercial mortgage-backed securities (CMBS) having been issued in almost a year. To try to help restart the CMBS market, the Federal Reserve announced last Friday that recently issued CMBS will in June be eligible collateral for our Term Asset-Backed Securities Loan Facility (TALF).[2]

An important influence on the near-term economic outlook is the extent to which businesses have been able to shed the unwanted inventories that they accumulated as sales turned down sharply last year. Some progress has been made; the Bureau of Economic Analysis estimates that an acceleration in inventory liquidation accounted for almost one-half of the reported decline in real GDP in the first quarter. As stocks move into better alignment with sales, a reduction in the pace of inventory liquidation should provide some support to production later this year.

The outlook for economic activity abroad is also an important consideration. The steep drop in U.S. exports that began last fall has been a significant drag on domestic production, and any improvement on that front would be helpful. A few indicators suggest, again quite tentatively, that the decline in foreign economic activity may also be moderating. And, as has been the case in the United States, investor sentiment and the functioning of financial markets abroad have improved somewhat.

As economic activity weakened during the second half of 2008 and prices of energy and other commodities began to fall rapidly, inflationary pressures diminished appreciably. Weakness in demand and reduced cost pressures have continued to keep inflation low so far this year. Although energy prices have recently risen some, the personal consumption expenditure (PCE) price index for energy goods and services in March remained more than 20 percent below its level a year earlier. Food price inflation has also continued to slow, as the moderation in crop and livestock prices has been passing through to the retail level. Core PCE inflation (prices excluding food and energy) dropped below an annual rate of 1 percent in the final quarter of 2008, when retailers and auto dealers marked down their prices significantly. In the first quarter of this year, core consumer price inflation moved back up, but to a still-low annual rate of 1.5 percent.

The economic outlook

We continue to expect economic activity to bottom out, then to turn up later this year. Key elements of this forecast are our assessments that the housing market is beginning to stabilize and that the sharp inventory liquidation that has been in progress will slow over the next few quarters. Final demand should also be supported by fiscal and monetary stimulus. An important caveat is that our forecast assumes continuing gradual repair of the financial system; a relapse in financial conditions would be a significant drag on economic activity and could cause the incipient recovery to stall. I will provide a brief update on financial markets in a moment.

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1 Board of Governors of the Federal Reserve System (2009), The April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices (Washington: Board of Governors, May 4).

2 Board of Governors of the Federal Reserve System (2009), "Federal Reserve Announces Expansion of Eligible Collateral under Term Asset-Backed Securities Loan Facility (TALF)," press release, May 1.

Even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further. We expect that the recovery will only gradually gain momentum and that economic slack will diminish slowly. In particular, businesses are likely to be cautious about hiring, implying that the unemployment rate could remain high for a time, even after economic growth resumes.

In this environment, we anticipate that inflation will remain low. Indeed, given the sizable margin of slack in resource utilization and diminished cost pressures from oil and other commodities, inflation is likely to move down some over the next year relative to its pace in 2008. However, inflation expectations, as measured by various household and business surveys, appear to have remained relatively stable, which should limit further declines in inflation.

Conditions in financial markets

As I noted, a sustained recovery in economic activity depends critically on restoring stability to the financial system. Conditions in a number of financial markets have improved in recent weeks, reflecting in part the somewhat more encouraging economic data. However, financial markets and financial institutions remain under considerable stress, and cumulative declines in asset prices, tight credit conditions, and high levels of risk aversion continue to weigh on the economy.

Among the markets that have recently begun to function a bit better are the markets for short-term funding, including the interbank markets and the commercial paper market. In particular, concerns about credit risk in those markets appear to have receded somewhat, there is more lending at longer maturities, and interest rates have declined. The modest improvement in funding conditions has contributed to diminished use of the Federal Reserve's liquidity facilities for financial institutions and of our commercial paper facility. The volume of foreign central bank liquidity swaps has also declined as dollar funding conditions have eased.

The issuance of asset-backed securities (ABS) backed by credit card, auto, and student loans all picked up in March and April, and ABS funding rates have declined, perhaps reflecting the availability of the Federal Reserve's TALF facility as a market backstop. Some of the recent issuance made use of TALF lending, but lower rates and spreads have facilitated issuance outside the TALF as well.

Mortgage markets have responded to the Federal Reserve's purchases of agency debt and agency mortgage-backed securities, with mortgage rates having fallen sharply since last fall, as I noted earlier. The decline in mortgage rates has spurred a pickup in refinancing as well as providing some support for housing demand. However, the supply of mortgage credit is still relatively tight, and mortgage activity remains heavily dependent on the support of government programs or the government-sponsored enterprises.

The combination of a broad rally in equity prices and a sizable reduction in risk spreads in corporate debt markets reflects a somewhat more optimistic view of the corporate sector on the part of investors, and perhaps some decrease in risk aversion. Bond issuance by nonfinancial firms has been relatively strong recently. Still, spreads over Treasury rates paid by both investment-grade and speculative-grade corporate borrowers remain quite elevated. Investors seemed to adopt a more positive outlook on the condition of financial institutions after several large banks reported profits in the first quarter, but readings from the credit default swap market and other indicators show that substantial concerns about the banking industry remain.

As you know, the federal bank regulatory agencies began conducting the Supervisory Capital Assessment Program in late February. The program is a forward-looking exercise intended to help supervisors gauge the potential losses, revenues, and reserve needs for the 19 largest bank holding companies in a scenario in which the economy declines more steeply than is generally anticipated. The simultaneous comprehensive assessment of the financial conditions of the 19 companies over a relatively short period of time required an extraordinary coordinated effort among the agencies.

The purpose of the exercise is to ensure that banks will have a sufficient capital buffer to remain strongly capitalized and able to lend to creditworthy borrowers even if economic conditions are worse than expected. Following the announcement of the results, bank holding companies will be required to develop comprehensive capital plans for establishing the required buffers. They will then have six months to execute those plans, with the assurance that equity capital from the Treasury under the Capital Assistance Program will be available as needed.

Federal Reserve transparency

I will conclude with a few comments on Federal Reserve transparency. The Federal Reserve remains committed to transparency and openness and, in particular, to keeping the Congress and the public informed about its lending programs and balance sheet. As you may know, we have created a separate section of our website devoted to providing data, explanations, and analyses bearing on these topics and related issues.[3] Recent postings include the annual financial statements of the 12 Federal Reserve Banks, the Board of Governors, and the limited liability companies created in 2008 in response to risks to the financial system, as well as the most recent reports to the Congress on our emergency lending programs.

Earlier this year I asked Vice Chairman Kohn to lead a review of our disclosure policies, with the goal of increasing the range of information that we make available to the public. The group has been making substantial progress, and I am pleased to say that we will soon be adding to the website material that provides the information requested in the Dodd-Shelby amendment to the recent budget resolution. Specifically, we will be adding new tables that provide information on the number of borrowers under each program and more information on the details of the credit extended, including measures of the concentrations of credit among borrowers. In addition, we will be providing monthly information on the collateral that is being taken under our various lending programs, including breakouts by types of collateral and by ratings categories. And we will be supplementing information provided on the valuation of collateral for the Maiden Lane facilities and the Commercial Paper Funding Facility. Finally, we will be providing additional information on the extent of our contracting with private firms with respect to our lending programs as well as on the terms and nature of such contracts. Over time, we expect to continue to expand the range of information on our website as our review of disclosure practices proceeds.

Thank you. I will be pleased to respond to your questions.

[3] "Credit and Liquidity Programs and the Balance Sheet," is a section of the Board's website.