

Ben S Bernanke: On the outlook for the economy and policy

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Economic Club of New York, New York, 16 November 2009.

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When I last spoke at the Economic Club of New York a little more than a year ago, the financial crisis had just taken a much more virulent turn. In my remarks at that time, I described the extraordinary actions that policymakers around the globe were taking to address the crisis, and I expressed optimism that we had the tools necessary to stabilize the system.

Today, financial conditions are considerably better than they were then, but significant economic challenges remain. The flow of credit remains constrained, economic activity weak, and unemployment much too high. Future setbacks are possible. Nevertheless, I think it is fair to say that policymakers' forceful actions last fall, and others that followed, were instrumental in bringing our financial system and our economy back from the brink. The stabilization of financial markets and the gradual restoration of confidence are in turn helping to provide a necessary foundation for economic recovery. We are seeing early evidence of that recovery: Real gross domestic product (GDP) in the United States rose an estimated 3-1/2 percent at an annual rate in the third quarter, following four consecutive quarters of decline. Most forecasters anticipate another moderate gain in the fourth quarter.

How the economy will evolve in 2010 and beyond is less certain. On the one hand, those who see further weakness or even a relapse into recession next year point out that some of the sources of the recent pickup – including a reduced pace of inventory liquidation and limited-time policies such as the "cash for clunkers" program – are likely to provide only temporary support to the economy. On the other hand, those who are more optimistic point to indications of more fundamental improvements, including strengthening consumer spending outside of autos, a nascent recovery in home construction, continued stabilization in financial conditions, and stronger growth abroad.

My own view is that the recent pickup reflects more than purely temporary factors and that continued growth next year is likely. However, some important headwinds – in particular, constrained bank lending and a weak job market – likely will prevent the expansion from being as robust as we would hope. I'll discuss each of these problem areas in a bit more detail and then end with some further comments on the outlook for the economy and for policy.

Bank lending and credit availability

I began today by alluding to the unprecedented financial panic that last fall brought a number of major financial institutions around the world to failure or the brink of failure. Policymakers in the United States and abroad deployed a number of tools to stem the panic. The Federal Reserve sharply increased its provision of short-term liquidity to financial institutions, the U.S. Treasury injected capital into banks, and the Federal Deposit Insurance Corporation (FDIC) guaranteed bank liabilities. The Federal Reserve and the Treasury each took measures to stop a run on money market mutual funds that began when a leading fund was unable to pay off its investors at par value. Throughout the fall and early this year, a range of additional

initiatives were required to stabilize major financial firms and markets, both here and abroad.¹

The ultimate purpose of financial stabilization, of course, was to restore the normal flow of credit, which had been severely disrupted. The Federal Reserve did its part by creating new lending programs to support the functioning of some key credit markets, such as the market for commercial paper – which is used to finance businesses' day-to-day operations – and the market for asset-backed securities – which helps sustain the flow of funding for auto loans, small-business loans, student loans, and many other forms of credit; and we continued to ensure that financial institutions had adequate access to liquidity. Additionally, we supported private credit markets and helped lower rates on mortgages and other loans through large-scale asset purchases, including purchases of debt and mortgage-backed securities issued or backed by government-sponsored enterprises.

Partly as the result of these and other policy actions, many parts of the financial system have improved substantially. Interbank and other short-term funding markets are functioning more normally; interest rate spreads on mortgages, corporate bonds, and other credit products have narrowed significantly; stock prices have rebounded; and some securitization markets have resumed operation. In particular, borrowers with access to public equity and bond markets, including most large firms, now generally are able to obtain credit without great difficulty. Other borrowers, such as state and local governments, have experienced improvement in their credit access as well.

However, access to credit remains strained for borrowers who are particularly dependent on banks, such as households and small businesses. Bank lending has contracted sharply this year, and the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices shows that banks continue to tighten the terms on which they extend credit for most kinds of loans – although recently the pace of tightening has slowed somewhat. Partly as a result of these pressures, household debt has declined in recent quarters for the first time since 1951. For their part, many small businesses have seen their bank credit lines reduced or eliminated, or they have been able to obtain credit only on significantly more restrictive terms.² The fraction of small businesses reporting difficulty in obtaining credit is near a record high, and many of these businesses expect credit conditions to tighten further.

To be sure, not all of the sharp reductions in bank lending this year reflect cutbacks in the availability of bank credit. The demand for credit also has fallen significantly: For example, households are spending less than they did last year on big-ticket durable goods typically purchased with credit, and businesses are reducing investment outlays and thus have less need to borrow. Because of weakened balance sheets, fewer potential borrowers are creditworthy, even if they are willing to take on more debt. Also, write-downs of bad debt show up on bank balance sheets as reductions in credit outstanding. Nevertheless, it appears that, since the outbreak of the financial crisis, banks have tightened lending standards by more than would have been predicted by the decline in economic activity alone.

Several factors help explain the reluctance of banks to lend, despite general improvement in financial conditions and increases in bank stock prices and earnings. First, bank funding markets were badly impaired for a time, and some banks have accordingly decided (or have

¹ For an overview of the crisis from an international perspective, see Ben S. Bernanke (2009), "Reflections on a Year of Crisis", speech delivered at "Financial Stability and Macroeconomic Policy," a symposium sponsored by the Federal Reserve Bank of Kansas City, held at Jackson Hole, Wyoming, August 20-22.

² According to the October Senior Loan Officer Opinion Survey on Bank Lending Practices, moderate fractions of banks continued to tighten standards and terms for loans to small firms, though the net fractions doing so generally continued to decline from the peaks last fall. The Survey of Terms of Business Lending indicates that spreads on small loans and loans extended by small banks (both proxies for loans to small firms) have increased significantly during the first three quarters of 2009.

been urged by regulators) to hold larger buffers of liquid assets than before. Second, with loan losses still high and difficult to predict in the current environment, and with further uncertainty attending how regulatory capital standards may change, banks are being especially conservative in taking on more risk. Third, many securitization markets remain impaired, reducing an important source of funding for bank loans. In addition, changes to accounting rules at the beginning of next year will require banks to move a large volume of securitized assets back onto their balance sheets. Unfortunately, reduced bank lending may well slow the recovery by damping consumer spending, especially on durable goods, and by restricting the ability of some firms to finance their operations.

The Federal Reserve has used its authority as a bank supervisor to help facilitate the flow of credit through the banking system. In November 2008, with the other banking agencies, we issued guidance to banks and bank examiners that emphasized the importance of continuing to meet the needs of creditworthy borrowers, while maintaining appropriate prudence in lending decisions.³ This past spring, the Federal Reserve led the Supervisory Capital Assessment Program, or SCAP – a coordinated, comprehensive examination designed to ensure that 19 of the country's largest banking organizations would remain well capitalized and able to lend to creditworthy borrowers even if economic conditions turned out to be worse than expected. The release of the assessment results in May increased investor confidence in the U.S. banking system. A week ago, the Federal Reserve announced that 9 of 10 firms that were determined to have required additional capital were able to fully meet their required capital buffers without any further capital from the U.S. Treasury, and that aggregate Tier 1 common equity at the 10 firms increased by more than \$77 billion since the conclusion of the assessment.⁴

The Federal Reserve will continue to work with banks to improve the access of creditworthy borrowers to the credit they need. Lending to creditworthy borrowers is good for the economy, but it also benefits banks by maintaining their profitable relationships with good customers. We continue to encourage banks to raise additional capital to support their lending. And we continue to facilitate securitization through our Term Asset-Backed Securities Loan Facility (TALF) and to support home lending through our purchases of mortgage-backed securities. Normalizing the flow of bank credit to good borrowers will continue to be a top priority for policymakers.

While I am on the topic of bank lending, I would like to add a few words about commercial real estate (CRE). Demand for commercial property has dropped as the economy has weakened, leading to significant declines in property values, increased vacancy rates, and falling rents. These poor fundamentals have caused a sharp deterioration in the credit quality of CRE loans on banks' books and of the loans that back commercial mortgage-backed securities (CMBS). Pressures may be particularly acute at smaller regional and community banks that entered the crisis with high concentrations of CRE loans. In response, banks have been reducing their exposure to these loans quite rapidly in recent months. Meanwhile, the market for securitizations backed by these loans remains all but closed. With nearly \$500 billion of CRE loans scheduled to mature annually over the next few years, the performance of this sector depends critically on the ability of borrowers to refinance many of those loans. Especially if CMBS financing remains unavailable, banks will face the tough decision of whether to roll over maturing debt or to foreclose.

³ See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12.

⁴ See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Board Makes Announcement Regarding the Supervisory Capital Assessment Program (SCAP)," press release, November 9.

Recognizing the importance of this sector for the economic recovery, the Federal Reserve has extended the TALF programs for existing CMBS through March 2010 and newly structured CMBS through June. Moreover, the banking agencies recently encouraged banks to work with their creditworthy borrowers to restructure troubled CRE loans in a prudent manner, and reminded examiners that – absent other adverse factors – a loan should not be classified as impaired based solely on a decline in collateral value.⁵

The job market

In addition to constrained bank lending, a second area of great concern is the job market. Since December 2007, the U.S. economy has lost, on net, about 8 million private-sector jobs, and the unemployment rate has risen from less than 5 percent to more than 10 percent.⁶ Both the decline in jobs and the increase in the unemployment rate have been more severe than in any other recession since World War II.⁷

Besides cutting jobs, many employers have reduced hours for the workers they have retained. For example, the number of part-time workers who report that they want a full-time job but cannot find one has more than doubled since the recession began, a much larger increase than in previous deep recessions. In addition, the average workweek for production and nonsupervisory workers has fallen to 33 hours, the lowest level in the postwar period. These data suggest that the excess supply of labor is even greater than indicated by the unemployment rate alone.

With the job market so weak, businesses have been able to find or retain all the workers they need with minimal wage increases, or even with wage cuts. Indeed, standard measures of wages show significant slowing in wage gains over the past year. Together with the reduction in hours worked, slower wage growth has led to stagnation in labor income. Weak income growth, should it persist, will restrain household spending.

The best thing we can say about the labor market right now is that it may be getting worse more slowly. Declines in payroll employment over the past four months have averaged about 220,000 per month, compared with 560,000 per month over the first half of this year. The number of initial claims for unemployment insurance is well off its high of last spring, but claims still have not fallen to ranges consistent with rising employment.

Although economic pain is widespread across industries and regions, different groups of workers have been affected differently. For example, the unemployment rate for men between the ages of 25 and 54 has risen from less than 4 percent in late 2007 to 10.3 percent in October – nearly double the rise in unemployment among adult women. This discrepancy likely reflects the high concentration of job losses in manufacturing, construction, and financial services, industries in which men make up the majority of workers. From the perspective of America's economic future, the effect of the recession on young workers is particularly worrisome: The unemployment rate among people between the ages of 16 and 24 has risen to 19 percent – and among African American youths, it is now about 30 percent. When young people are shut out of the job market, they lose valuable opportunities to gain

⁵ See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts," press release, October 30.

⁶ This job loss figure includes an adjustment to reflect the preliminary estimate of the benchmark revision to payroll employment recently announced by the Bureau of Labor Statistics (BLS). According to the BLS, when the published data on payroll employment are benchmarked this coming February to comprehensive counts of employment from unemployment insurance tax records, the level of private payroll employment in March 2009 is expected to be revised down by 855,000.

⁷ This statement remains true when job loss is measured as a percentage of total initial payrolls rather than in absolute terms.

work experience and on-the-job training, potentially reducing their future wages and employment opportunities.⁸

Given this weakness in the labor market, a natural question is whether we might be in for a so-called jobless recovery, in which output is growing but employment fails to increase.

Productivity is defined as output per hour of work. Thus, essentially by definition, a jobless recovery – in which output is growing but hours of work are not – must be a period of productivity growth. In the jobless recoveries that followed the 1990-91 and 2001 recessions, productivity growth was quite strong. It may seem paradoxical that productivity growth – which in the longer term is the most important source of increases in real wages and living standards – can have adverse consequences for employment in the short term. But, when the demand for goods and services is growing slowly, that may be the case.

In fact, productivity growth has recently been quite high, even when the economy was contracting. Output per hour in the nonfarm business sector is estimated to have risen at about a 5-1/2 percent annual rate so far this year, well above longer-term averages. One reason for recent productivity gains likely was the reaction of employers to the freefall in the economy that began in the second half of 2008. Normally, employers are slow to cut their workforces when the economy turns down. The process of finding, hiring, and training new workers is costly. Thus, if employers expect the downturn will be neither too severe nor too lengthy, they retain more existing workers than they need in the short term, rather than laying them off and replacing them when the recovery begins. However, in the recent downturn, employers were exceptionally uncertain about the future, some even fearing a second Great Depression. Moreover, tight credit conditions left little margin for error. Accordingly, to protect themselves against the worst possibilities, employers shed workers much more sharply than usual in recessions. Thus, the productivity gains this year generally reflected pronounced declines in labor input rather than greater output.

Will the increases in productivity persist? It is likely that, in some cases, firms achieved their productivity gains by asking their remaining workers to provide extra effort. The additional gains that can be achieved in this way are limited and probably temporary. Although continuing uncertainty and financial constraints might make such firms hesitant to hire, if demand, production, and confidence pick up, they will find their labor forces stretched thin and will begin to add workers. However, other firms, facing difficult financial conditions and intense pressures to cut costs, seem to have found longer-lasting, efficiency-enhancing changes that allowed them to reduce their workforces; and some less-efficient firms, no longer able to compete, closed their doors. Again, improved efficiency confers great benefits in the longer term. However, to the extent that firms are able to find further cost-cutting measures as output expands, they may delay hiring.

Other factors will affect near-term employment growth as well. Business confidence in the durability of the expansion, for example, will help determine employers' willingness to hire. The current prevalence of part-time work and short workweeks may slow job creation early in the recovery period, as employers may prefer to convert workers from part-time to full-time status and to add overtime work before turning to new hires. In addition, difficulties in obtaining credit could hinder the expansion of small and medium-sized businesses and prevent the formation of new businesses. Because smaller businesses account for a significant portion of net employment gains during recoveries, limited credit could hinder job

⁸ Labor economists have documented these points. See, for example, David T. Ellwood (1982), "Teenage Unemployment: Permanent Scars or Temporary Blemishes?" in Richard B. Freeman and David A. Wise, eds., *The Youth Labor Market Problem: Its Nature, Causes, and Consequences* (Chicago: National Bureau of Economic Research and University of Chicago Press), pp. 349-90; and Thomas A. Mroz and Timothy H. Savage (2006), "The Long-Term Effects of Youth Unemployment," *Journal of Human Resources*, vol. 41 (Spring), pp. 259-93.

growth. Overall, a number of factors suggest that employment gains may be modest during the early stages of the expansion.

The outlook for the economy and policy

I return now to the outlook for the economy and policy. As I noted, I expect moderate economic growth to continue next year. Final demand shows signs of strengthening, supported by the broad improvement in financial conditions. Additionally, the beneficial influence of the inventory cycle on production should continue for somewhat longer. Housing faces important problems, including continuing high foreclosure rates, but residential investment should become a small positive for growth next year rather than a significant drag, as has been the case for the past several years. Prospects for nonresidential construction are poor, however, given weak fundamentals and tight financing conditions.

In the business sector, manufacturing activity has been expanding and should be helped by the continuing strength of the recovery in the emerging market economies, especially in Asia. As the recovery takes hold, enhanced business confidence, together with the low cost of capital for firms with access to public capital markets, should lead to a pickup in business spending on equipment and software, which has already shown signs of stabilizing.

I have discussed two of the principal factors that may constrain the pace of the recovery, namely, restrictive bank lending and the weak job market. Banks' reluctance to lend will limit the ability of some businesses to expand and hire. I expect this situation to normalize gradually, as improving economic conditions strengthen bank balance sheets and reduce uncertainty; the fallout for banks from commercial real estate could slow that progress, however. Jobs are likely to remain scarce for some time, keeping households cautious about spending. As the recovery becomes established, however, payrolls should begin to grow again, at a pace that increases over time. Nevertheless, as net gains of roughly 100,000 jobs per month are needed just to absorb new entrants to the labor force, the unemployment rate likely will decline only slowly if economic growth remains moderate, as I expect.

The outlook for inflation is also subject to a number of crosscurrents. Many factors affect inflation, including slack in resource utilization, inflation expectations, exchange rates, and the prices of oil and other commodities. Although resource slack cannot be measured precisely, it certainly is high, and it is showing through to underlying wage and price trends. Longer-run inflation expectations are stable, having responded relatively little either to downward or upward pressures on inflation; expectations can be early warnings of actual inflation, however, and must be monitored carefully. Commodities prices have risen lately, likely reflecting the pickup in global economic activity, especially in resource-intensive emerging market economies, and the recent depreciation of the dollar. On net, notwithstanding significant crosscurrents, inflation seems likely to remain subdued for some time.

The foreign exchange value of the dollar has moved over a wide range during the past year or so. When financial stresses were most pronounced, a flight to the deepest and most liquid capital markets resulted in a marked increase in the dollar. More recently, as financial market functioning has improved and global economic activity has stabilized, these safe haven flows have abated, and the dollar has accordingly retraced its gains. The Federal Reserve will continue to monitor these developments closely. We are attentive to the implications of changes in the value of the dollar and will continue to formulate policy to guard against risks to our dual mandate to foster both maximum employment and price stability. Our commitment to our dual objectives, together with the underlying strengths of the U.S. economy, will help ensure that the dollar is strong and a source of global financial stability.

The Federal Open Market Committee continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an

extended period. Of course, significant changes in economic conditions or the economic outlook would change the outlook for policy as well. We have a wide range of tools for removing monetary policy accommodation when the economic outlook requires us to do so, and we will calibrate the timing and pace of any future tightening to best foster maximum employment and price stability.