Ben S Bernanke: Economic outlook

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 14 April 2010.

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 discuss economic and financial developments. I will also make a few remarks on the fiscal situation.

The economic outlook

Supported by stimulative monetary and fiscal policies and the concerted efforts of policymakers to stabilize the financial system, a recovery in economic activity appears to have begun in the second half of last year. An important impetus to the expansion was firms' success in working down the excess inventories that had built up during the contraction, which left companies more willing to expand production. Indeed, the boost from the slower drawdown in inventories accounted for the majority of the sharp rise in real gross domestic product (GDP) in the fourth quarter of last year, during which real GDP increased at an annual rate of 5.6 percent. With inventories now much better aligned with final sales, however, and with the support from fiscal policy set to diminish in the coming year, further economic expansion will depend on continued growth in private final demand.

On balance, the incoming data suggest that growth in private final demand will be sufficient to promote a moderate economic recovery in coming quarters. Consumer spending continued to increase in the first two months of this year and has now risen at an annual rate of about 2–1/2 percent in real terms since the middle of 2009. In particular, after slowing in January and February, sales of new light motor vehicles bounced back in March as manufacturers offered a new round of incentives. Going forward, consumer spending should be aided by a gradual pickup in jobs and earnings, the recovery in household wealth from recent lows, and some improvement in credit availability.

In the business sector, capital spending on equipment and software appears to have increased at a solid pace again in the first quarter. U.S. manufacturing output, which is benefiting from stronger export demand as well as the inventory adjustment I noted earlier, rose at an annual rate of 8 percent during the eight months ending in February. Also, as I will discuss further in a moment, financial conditions continue to strengthen, thus reducing an important headwind for the economy.

To be sure, significant restraints on the pace of the recovery remain, including weakness in both residential and nonresidential construction and the poor fiscal condition of many state and local governments. Sales of new and existing homes dropped back in January and February, and the pace of new single-family housing starts has changed little since the middle of last year. Outlays for nonresidential construction continue to contract amid rising vacancy rates, falling property prices, and difficulties in obtaining financing. Pressures on state and local budgets, though tempered by ongoing federal support, have led to continuing declines in employment and construction spending by state and local governments.

As you know, the labor market was particularly hard hit by the recession. Recently, we have seen some encouraging signs that layoffs are slowing and that employment has turned up. Manufacturing employment increased for a third month in March, and the number of temporary jobs – often a precursor of more permanent employment – has been rising since last October. New claims for unemployment insurance continue on a generally downward trend. However, if the pace of recovery is moderate, as I expect, a significant amount of time will be required to restore the 8–1/2 million jobs that were lost during the past two years. I am particularly concerned about the fact that, in March, 44 percent of the unemployed had been without a job for six months or more. Long periods without work erode individuals' skills and hurt future employment prospects. Younger workers may be particularly adversely affected if a weak labor market prevents them from finding a first job or from gaining important work experience.

On the inflation front, recent data continue to show a subdued rate of increase in consumer prices. For the three months ended in February, prices for personal consumption expenditures rose at an annual rate of 1–1/4 percent despite a further steep run-up in energy prices; core inflation, which excludes prices of food and energy, slowed to an annual rate of 1/2 percent. The moderation in inflation has been broadly based, affecting most categories of goods and services with the principal exception of some globally traded commodities and materials, including crude oil. Long-run inflation expectations appear stable; for example, expected inflation over the next 5 to 10 years, as measured by the Thomson Reuters/University of Michigan Surveys of Consumers was 2–3/4 percent in March, which is at the lower end of the narrow range that has prevailed for the past few years.

Financial market developments

Financial markets have improved considerably since I last testified before this Committee in May of last year. Conditions in short-term credit markets have continued to normalize; spreads in bank funding markets and the commercial paper market have returned to near pre-crisis levels. In light of these improvements, the Federal Reserve has largely wound down the extraordinary liquidity programs that it created to support financial markets during the crisis. The only remaining program, apart from the discount window, is the Term Asset-Backed Securities Loan Facility for loans backed by new-issue commercial mortgage-backed securities, and that facility is scheduled to close at the end of June. Overall, the Federal Reserve's liquidity programs appear to have made a significant contribution to the stabilization of the financial system, and they did so at no cost to taxpayers and with no credit losses.

The Federal Reserve also recently completed its purchases of $1.25 trillion of federal agency mortgage-backed securities and about $175 billion of agency debt. Purchases under these programs were phased down gradually, and to date, the transition in markets has been relatively smooth. The Federal Reserve's asset-purchase program appears to have improved market functioning and reduced interest-rate spreads not only in the mortgage market but in other longer-term debt markets as well.

On net, the financial condition of banking firms has strengthened markedly during recent quarters. Last spring, the Federal Reserve and other banking regulators evaluated the nation's largest bank holding companies under the Supervisory Capital Assessment Program, popularly known as the stress test, to ensure that they would have sufficient capital to remain viable and to lend to creditworthy borrowers even in a worse-than-expected economic scenario.[1] The release of the stress test results significantly increased market confidence in the banking system. Greater investor confidence in turn allowed the banks to

[1] For more on the SCAP, see Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program", speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, Jekyll Island, Ga., May 11; Board of Governors of the Federal Reserve System (2009), "Federal Reserve, OCC, and FDIC release results of the Supervisory Capital Assessment Program", press release, May 7; and Daniel K. Tarullo (2010), "Lessons from the Crisis Stress Tests", speech delivered at the Federal Reserve Board International Research Forum on Monetary Policy, Washington, March 26.

raise substantial amounts of new equity capital and, in many cases, to repay government capital. The Federal Reserve and other bank regulators continue to encourage the banks to build up their capital, ensure that they have adequate liquidity, improve their risk management, and restructure their employee compensation programs to better align risk and reward.

Despite their stronger financial positions, banks' lending to both households and businesses has continued to fall. The decline in large part reflects sluggish loan demand and the fact that many potential borrowers no longer qualify for credit, both results of a weak economy. The high rate of write-downs has also reduced the quantity of loans on banks' books. Banks have also been conservative in their lending policies, imposing tough lending standards and terms; this caution reflects bankers' concerns about the economic outlook and uncertainty about their own future losses and capital positions.

The Federal Reserve has been working to ensure that our bank supervision does not inadvertently impede sound lending and thus slow the recovery. Achieving the appropriate balance between necessary prudence and the need to continue making sound loans to creditworthy borrowers is in the interest of banks, borrowers, and the economy as a whole. Toward this end, in cooperation with the other banking regulators, we have issued policy statements to bankers and examiners emphasizing the importance of lending to creditworthy customers, working with troubled borrowers to restructure loans, managing commercial real estate exposures appropriately, and taking a careful but balanced approach to small business lending.[2] We have accompanied our guidance with training programs for both Federal Reserve and state examiners, and with outreach to bankers throughout the industry. For example, we just completed a training initiative that reached about 1,000 examiners. We are also conducting a series of meetings across the country with private- and public-sector partners to gather information about the credit needs of small businesses and how those needs can best be met.

We have also stepped up our information gathering, so that we can better understand factors that may be inhibiting bank lending. These efforts include a survey by examiners of banks' practices in working out loans, the results of which will serve as a baseline against which we will assess the effectiveness of our supervisory guidance. We are also obtaining additional information on small business credit conditions. For example, we assisted the National Federation of Independent Business in developing a survey to assess barriers to credit access by small businesses.[3] And we are using our own Senior Loan Officer Opinion Survey on Bank Lending Practices to monitor changes in bank lending to small businesses.[4]

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[2] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, 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; Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Conference of State Bank Supervisors (2010), "Regulators Issue Statement on Lending to Creditworthy Small Businesses", joint press release, February 5; Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2009), "Prudent Commercial Real Estate Loan Workouts", Supervision and Regulation Letter SR 09-7 (October 30); and Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Federal Financial Institutions Examination Council and Office of Thrift Supervision (2009), "Policy Statement on Prudent Commercial Real Estate Loan Workouts", joint policy statement, October 30.

[3] See William J. Dennis (2010), "Small Business Credit in a Deep Recession", National Federation of Small Business Research Foundation (Washington: NFIB, February).

[4] See Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices".

Fiscal policy

In addition to the near-term challenge of fostering improved economic performance and stronger labor markets, we as a nation face the difficult but essential task of achieving longer-term sustainability of the nation's fiscal position. The federal budget deficit is on track this year to be nearly as wide as the $1.4 trillion gap recorded in fiscal year 2009. To an important extent, these extremely large deficits are the result of the effects of the weak economy on revenues and outlays, along with the necessary actions that were taken to counter the recession and restore financial stability. But an important part of the deficit appears to be structural; that is, it is expected to remain even after economic and financial conditions have returned to normal.

In particular, the Administration and the Congressional Budget Office (CBO) project that the deficit will recede somewhat over the next two years as the temporary stimulus measures wind down and as economic recovery leads to higher revenues. Thereafter, however, the annual deficit is expected to remain high through 2020, in the neighborhood of 4 to 5 percent of GDP. Deficits at that level would lead the ratio of federal debt held by the public to the GDP, already expected to be greater than 70 percent at the end of fiscal 2012, to rise considerably further. This baseline projection assumes that most discretionary spending grows more slowly than nominal GDP, that no expiring tax cuts are extended, and that current provisions that provide most taxpayers relief from the alternative minimum tax are not further extended. Under an alternative scenario that drops those assumptions, the deficit at the end of 2020 would be 9 percent of GDP and the federal debt would balloon to more than 100 percent of GDP.[5]

Although sizable deficits are unavoidable in the near term, maintaining the confidence of the public and financial markets requires that policymakers move decisively to set the federal budget on a trajectory toward sustainable fiscal balance. A credible plan for fiscal sustainability could yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence. Timely attention to these issues is important, not only for maintaining credibility, but because budgetary changes are less likely to create hardship or dislocations when the individuals affected are given adequate time to plan and adjust. In other words, addressing the country's fiscal problems will require difficult choices, but postponing them will only make them more difficult.

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

[5] These figures have been calculated by the Federal Reserve using the CBO's estimates of the budgetary effects of selected policy alternatives to adjust the CBO's baseline budget projection released in a recent report (see Congressional Budget Office (2010), *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (Washington: CBO, January). The specific alternative policies used in these calculations included the CBO's estimates of the effects of reducing troop levels in overseas military operations to 60,000 by 2015, increasing regular discretionary appropriations at the rate of growth of nominal GDP, extending all expiring tax provisions, and indexing the alternative minimum tax for inflation.