Ben S Bernanke: The economic outlook and macroeconomic policy

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the National Press Club, Washington DC, 3 February 2011.

*   *   *

Good afternoon. I am pleased to be here at the National Press Club, and I’m especially glad for the opportunity to have a conversation with journalists who write about economic policy from our nation’s capital. Your job is not easy, but it is essential. Virtually every American is affected by developments in the economy and in economic policy. But contemporary economic issues can be highly complex, and few nonspecialists have the time or the background to master these issues on their own. The public must therefore rely on the diligent reporting, clear thinking, and lucid writing of reporters determined to go beyond dueling bumper stickers and sound bites to help people understand what they need to make good decisions, both in their personal finances and at the polls. These are weighty responsibilities, and the journalists I know take them very seriously.

Today, I will provide a brief update on the economy and how I expect it to evolve in the near term. Then I will turn to the implications for monetary policy. Finally, I will briefly discuss the daunting fiscal challenges that we face as a nation.

The economic outlook

The economic recovery that began in the middle of 2009 appears to have strengthened in recent months, although, to date, growth has not been fast enough to bring about a significant improvement in the job market. The early phase of the recovery, in the second half of 2009 and in early 2010, was largely attributable to the stabilization of the financial system, the effects of expansionary monetary and fiscal policies, and a strong boost to production from businesses rebuilding their depleted inventories. But economic growth slowed significantly last spring as the impetus from inventory building and fiscal stimulus diminished and as Europe’s debt problems roiled global financial markets.

More recently, however, we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold. Notably, we learned last week that households increased their spending in the fourth quarter, in real terms, at an annual rate of more than 4 percent. Although a significant portion of this pickup reflected strong sales of motor vehicles, the recent gains in consumer spending look to have been reasonably broad based. Businesses’ investments in new equipment and software grew robustly over most of last year, as firms replaced aging equipment and as the demand for their products and services expanded. In contrast, in the housing sector, the overhang of vacant and foreclosed homes continues to weigh heavily on both home prices and residential construction. Overall, however, improving household and business confidence, accommodative monetary policy, and more-supportive financial conditions, including an apparent increase in the willingness of banks to make loans, seems likely to lead to a more rapid pace of economic recovery in 2011 than we saw last year.

While indicators of spending and production have, on balance, been encouraging, the job market has improved only slowly. Following the loss of about 8–1/2 million jobs in 2008 and 2009, private-sector employment showed gains in 2010. However, these gains were barely sufficient to accommodate the inflow of recent graduates and other new entrants to the labor force and, therefore, not enough to significantly reduce the overall unemployment rate. Recent data do provide some grounds for optimism on the employment front; for example, initial claims for unemployment insurance have generally been trending down, and indicators of job openings and firms’ hiring plans have improved. Even so, with output growth likely to

be moderate for awhile and with employers reportedly still reluctant to add to their payrolls, it will be several years before the unemployment rate has returned to a more normal level. Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established.

On the inflation front, we have recently seen significant increases in some highly visible prices, notably for gasoline. Indeed, prices of many commodities have risen lately, largely as a result of the very strong demand from fast-growing emerging market economies, coupled, in some cases, with constraints on supply. Nevertheless, overall inflation remains quite low: Over the 12 months ending in December, prices for all the goods and services purchased by households increased by only 1.2 percent, down from 2.4 percent over the prior 12 months.[1] To assess underlying trends in inflation, economists also follow several alternative measures of inflation; one such measure is so-called core inflation, which excludes the more volatile food and energy components and therefore can be a better predictor of where overall inflation is headed. Core inflation was only 0.7 percent in 2010, compared with around 2–1/2 percent in 2007, the year before the recession began. Wage growth has slowed as well, with average hourly earnings increasing only 1.8 percent last year. These downward trends in wage and price inflation are not surprising, given the substantial slack in the economy.

Monetary policy

In sum, although economic growth will probably increase this year, we expect the unemployment rate to remain stubbornly above, and inflation to remain persistently below, the levels that Federal Reserve policymakers have judged to be consistent over the longer term with our mandate from the Congress to foster maximum employment and price stability. Under such conditions, the Federal Reserve would typically ease monetary policy by reducing the target for its short-term policy interest rate, the federal funds rate. However, the target range for the funds rate has been near zero since December 2008, and the Federal Reserve has indicated that economic conditions are likely to warrant an exceptionally low target rate for an extended period. As a result, for the past two years we have been using alternative tools to provide additional monetary accommodation.

In particular, over the past two years the Federal Reserve has further eased monetary conditions by purchasing longer-term securities on the open market. From December 2008 through March 2010, we purchased about $1.7 trillion in longer-term Treasury, agency, and agency mortgage-backed securities. In August 2010, we began reinvesting the proceeds from all securities that matured or were redeemed in longer-term Treasury securities, so as to keep the size of our securities holdings roughly constant. Around the same time, we began to signal to financial markets that we were considering providing additional monetary policy accommodation by conducting further asset purchases. And in early November, we announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year. All these purchases are settled through the banking system, with the result that depository institutions now hold a very high level of reserve balances with the Federal Reserve.

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by lowering market expectations for the future path of short-term interest rates, which, in turn, reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes, by reducing borrowing costs and raising asset prices,

---

[1] Inflation data are derived using the price index for personal consumption expenditures.

bolster household and business spending and thus increase economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby supporting the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose, however, as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Interestingly, these developments are also remarkably similar to those that occurred during the earlier episode of policy easing, notably in the months following our March 2009 announcement of a significant expansion in securities purchases. The fact that financial markets responded in very similar ways to each of these policy actions lends credence to the view that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy.

My colleagues and I have said that we will review the asset purchase program regularly in light of incoming information and will adjust it as needed to promote maximum employment and stable prices. In particular, it bears emphasizing that we have the necessary tools to smoothly and effectively exit from the asset purchase program at the appropriate time. In particular, our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. Moreover, we have developed additional tools that will allow us to drain or immobilize bank reserves as required to facilitate the smooth withdrawal of policy accommodation when conditions warrant. If needed, we could also tighten policy by redeeming or selling securities.

Fiscal policy

Fiscal policymakers also face significant challenges. The federal budget deficit has expanded to an average of more than 9 percent of gross domestic product (GDP) over the past two years, up from an average of about 2 percent of GDP during the three years prior to the recession. The extraordinarily wide deficit largely reflects the weakness of the economy along with the actions that the Administration and the Congress took to ease the recession and steady financial markets. However, even after economic and financial conditions have returned to normal, the federal budget will remain on an unsustainable path, with the budget gap becoming increasingly large over time, unless the Congress enacts significant changes in fiscal programs.

For example, under plausible assumptions about how fiscal policies might evolve in the absence of major legislative changes, the Congressional Budget Office (CBO) projects the deficit to fall from around 9 percent of GDP currently to roughly 5 percent of GDP by 2015,

but then to rise to about 6–1/2 percent of GDP by the end of the decade.[2] After that, it projects the budget outlook to deteriorate even more rapidly, with federal debt held by the public reaching almost 90 percent of GDP by 2020 and 150 percent of GDP by 2030, up from about 60 percent at the end of fiscal year 2010.

The long-term fiscal challenges confronting the nation are especially daunting because they are mostly the product of powerful underlying trends, not short-term or temporary factors. The two most important driving forces for the federal budget are the aging of the U.S. population and rapidly rising health-care costs. Indeed, the CBO projects that federal spending for health-care programs – which includes Medicare, Medicaid, and subsidies to purchase health insurance through new insurance exchanges – will roughly double as a percentage of GDP over the next 25 years.[3] The ability to control health-care costs, while still providing high-quality care to those who need it, will be critical for bringing the federal budget onto a sustainable path.

The retirement of the baby-boom generation will also strain Social Security, as the number of workers paying taxes into the system rises more slowly than the number of people receiving benefits. Currently, there are about five individuals between the ages of 20 and 64 for each person aged 65 and older. By 2030, when most of the baby boomers will have retired, this ratio is projected to decline to around 3.[4] Overall, the projected fiscal pressures associated with Social Security are considerably smaller than the pressures associated with federal health programs, but they are still notable.

The CBO's long-term budget projections, by design, do not account for the likely adverse economic effects of such high debt and deficits. But if government debt and deficits were actually to grow at the pace envisioned, the economic and financial effects would be severe. Sustained high rates of government borrowing would both drain funds away from private investment and increase our debt to foreigners, with adverse long-run effects on U.S. output, incomes, and standards of living. Moreover, diminishing investor confidence that deficits will be brought under control would ultimately lead to sharply rising interest rates on government debt and, potentially, to broader financial turmoil. In a vicious circle, high and rising interest rates would cause debt-service payments on the federal debt to grow even faster, causing further increases in the debt-to-GDP ratio and making fiscal adjustment all the more difficult.

How much adjustment is needed to restore fiscal sustainability in the United States? To help answer this question, it is useful to apply the concept of the primary budget deficit, which is the government budget deficit excluding interest payments on the national debt. To stabilize the ratio of federal debt to the GDP – a convenient benchmark for assessing fiscal sustainability – the primary budget deficit must be reduced to zero.[5] Under the CBO projection that I noted earlier, the primary budget deficit is expected to be 2 percent of GDP in 2015 and then rise to almost 3 percent of GDP in 2020 and 6 percent of GDP in 2030. These projections provide a gauge of the adjustments that will be necessary to attain fiscal

---

[2] The so-called alternative fiscal policy scenario, which assumes, among other things, that most of the tax cuts enacted in 2001 and 2003 are made permanent and that discretionary federal outlays rise at the same rate as GDP, is presented in Congressional Budget Office (2010), *The Long-Term Budget Outlook* (Washington: CBO, June (revised August)).

[3] See the two long-term scenarios for mandatory federal spending on health care shown in figure 2–3, p. 39, in CBO, *The Long-Term Budget Outlook*, in note 2.

[4] These figures are the inverse of the ratio of the population age 65 or older as a percentage of the population ages 20 to 64 shown in figure 3–2, p. 47, in CBO, *The Long-Term Budget Outlook*, in note 2.

[5] This result requires that the nominal rate of interest paid on government debt equal the rate of growth of nominal GDP, a condition which usually serves as a reasonable approximation. If the rate of interest on government debt is higher than the growth rate of nominal GDP, as might happen if creditors become wary of lending, then a primary budget surplus rather than primary balance is needed to stabilize the ratio of debt to GDP.

sustainability. To put the budget on a sustainable trajectory, policy actions – either reductions in spending or increases in revenues or some combination of the two – will have to be taken to eventually close these primary budget gaps.

By definition, the unsustainable trajectories of deficits and debt that the CBO outlines cannot actually happen, because creditors would never be willing to lend to a government with debt, relative to national income, that is rising without limit. The economist Herbert Stein succinctly described this type of situation: "If something cannot go on forever, it will stop."[6] One way or the other, fiscal adjustments sufficient to stabilize the federal budget must occur at some point. The question is whether these adjustments will take place through a careful and deliberative process that weighs priorities and gives people adequate time to adjust to changes in government programs or tax policies, or whether the needed fiscal adjustments will be a rapid and painful response to a looming or actual fiscal crisis. Acting now to develop a credible program to reduce future deficits would not only enhance economic growth and stability in the long run, but could also yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence. Plans recently put forward by the President's National Commission on Fiscal Responsibility and Reform and other prominent groups provide useful starting points for a much-needed national conversation. Although these proposals differ on many details, they demonstrate that realistic solutions to our fiscal problems are available.

Of course, economic growth is affected not only by the levels of taxes and spending, but also by their composition and structure. I hope that, in addressing our long-term fiscal challenges, the Congress and the Administration will seek reforms to the government's tax policies and spending priorities that serve not only to reduce the deficit, but also to enhance the long-term growth potential of our economy – for example, by reducing disincentives to work and to save, by encouraging investment in the skills of our workforce as well as in new machinery and equipment, by promoting research and development, and by providing necessary public infrastructure. Our nation cannot reasonably expect to grow its way out of our fiscal imbalances, but a more productive economy will ease the tradeoffs that we face.

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

---

[6] Herbert Stein (1997), "Herb Stein's Unfamiliar Quotations," *Slate*, May 16, www.slate.com/id/2561.