Ben S Bernanke: Semiannual Monetary Policy Report to the Congress

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 1 March 2011.

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Chairman Johnson, Ranking Member Shelby, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress*. I will begin with a discussion of economic conditions and the outlook before turning to monetary policy.

The economic outlook

Following the stabilization of economic activity in mid-2009, the U.S. economy is now in its seventh quarter of growth; last quarter, for the first time in this expansion, our nation's real gross domestic product (GDP) matched its pre-crisis peak. Nevertheless, job growth remains relatively weak and the unemployment rate is still high.

In its early stages, the economic recovery 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. Economic growth slowed significantly in the spring and early summer of 2010, 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, real consumer spending has grown at a solid pace since last fall, and business investment in new equipment and software has continued to expand. Stronger demand, both domestic and foreign, has supported steady gains in U.S. manufacturing output.

The combination of rising household and business confidence, accommodative monetary policy, and improving credit conditions seems likely to lead to a somewhat more rapid pace of economic recovery in 2011 than we saw last year. The most recent economic projections by Federal Reserve Board members and Reserve Bank presidents, prepared in conjunction with the Federal Open Market Committee (FOMC) meeting in late January, are for real GDP to increase 3-1/2 to 4 percent in 2011, about one-half percentage point higher than our projections made in November.[1] Private forecasters' projections for 2011 are broadly consistent with those of the FOMC participants and have also moved up in recent months.[2]

While indicators of spending and production have been encouraging on balance, the job market has improved only slowly. Following the loss of about 8-3/4 million jobs from early

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[1] Forecast ranges here and below refer to the central tendencies of the projections of FOMC participants, as presented in the "*Summary of Economic Projections*" released with the minutes of the January FOMC meeting.

[2] For example, both the Survey of Professional Forecasters (see the first quarter 2011 survey released by the Federal Reserve Bank of Philadelphia on February 11) and the Blue Chip forecasting panel (see the February 10, 2010, issue of *Blue Chip Economic Indicators* (New York: Aspen Publishers)) now project real GDP growth of about 3-1/2 percent from the fourth quarter of 2010 to the fourth quarter of 2011, about one-half percentage point higher than the corresponding projections made in August. Looking further ahead, most FOMC participants project that economic growth will pick up a bit more in 2012 and 2013, whereas private forecasters tend to see the expansion proceeding fairly steadily over the next few years. (Note: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts* are publications owned by Aspen Publishers. Copyright © 2009 by Aspen Publishers, Inc. All rights reserved; www.aspenpublishers.com.)

2008 through 2009, private-sector employment expanded by only a little more than 1 million during 2010, a gain barely sufficient to accommodate the inflow of recent graduates and other entrants to the labor force. We do see some grounds for optimism about the job market over the next few quarters, including notable declines in the unemployment rate in December and January, a drop in new claims for unemployment insurance, and an improvement in firms' hiring plans. Even so, if the rate of economic growth remains moderate, as projected, it could be several years before the unemployment rate has returned to a more normal level. Indeed, FOMC participants generally see the unemployment rate still in the range of 7-1/2 to 8 percent at the end of 2012. Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established.

Likewise, the housing sector remains exceptionally weak. The overhang of vacant and foreclosed houses is still weighing heavily on prices of new and existing homes, and sales and construction of new single-family homes remain depressed. Although mortgage rates are low and house prices have reached more affordable levels, many potential homebuyers are still finding mortgages difficult to obtain and remain concerned about possible further declines in home values.

Inflation has declined, on balance, since the onset of the financial crisis, reflecting high levels of resource slack and stable longer-term inflation expectations. Indeed, over the 12 months ending in January, prices for all of the goods and services consumed by households (as measured by the price index for personal consumption expenditures (PCE)) increased by only 1.2 percent, down from 2.5 percent in the year-earlier period. Wage growth has slowed as well, with average hourly earnings increasing only 1.9 percent over the year ending in January. In combination with productivity increases, slow wage growth has implied very tight restraint on labor costs per unit of output.

FOMC participants see inflation remaining low; most project that overall inflation will be about 1-1/4 to 1-3/4 percent this year and in the range of 1 to 2 percent next year and in 2013. Private-sector forecasters generally also anticipate subdued inflation over the next few years.[3] Measures of medium- and long-term inflation compensation derived from inflation-indexed Treasury bonds appear broadly consistent with these forecasts. Surveys of households suggest that the public's longer-term inflation expectations also remain stable.

Although overall inflation is low, since summer we have seen significant increases in some highly visible prices, including those of gasoline and other commodities. Notably, in the past few weeks, concerns about unrest in the Middle East and North Africa and the possible effects on global oil supplies have led oil and gasoline prices to rise further. More broadly, the increases in commodity prices in recent months have largely reflected rising global demand for raw materials, particularly in some fast-growing emerging market economies, coupled with constraints on global supply in some cases. Commodity prices have risen significantly in terms of all major currencies, suggesting that changes in the foreign exchange value of the dollar are unlikely to have been an important driver of the increases seen in recent months.

The rate of pass-through from commodity price increases to broad indexes of U.S. consumer prices has been quite low in recent decades, partly reflecting the relatively small weight of materials inputs in total production costs as well as the stability of longer-term inflation expectations. Currently, the cost pressures from higher commodity prices are also being offset by the stability in unit labor costs. Thus, the most likely outcome is that the recent rise

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[3] The Survey of Professional Forecasters projects PCE inflation to run at about 1-1/2 percent in 2011 and to subsequently rise gradually to nearly 2 percent by 2013. The corresponding projections from the Survey of Professional Forecasters for Consumer Price Index (CPI) inflation are about 1-3/4 percent this year and about 2 percent next year and in 2013. Blue Chip forecasts for CPI inflation stand at about 2 percent for both 2011 and 2012.

in commodity prices will lead to, at most, a temporary and relatively modest increase in U.S. consumer price inflation – an outlook consistent with the projections of both FOMC participants and most private forecasters. That said, sustained rises in the prices of oil or other commodities would represent a threat both to economic growth and to overall price stability, particularly if they were to cause inflation expectations to become less well anchored. We will continue to monitor these developments closely and are prepared to respond as necessary to best support the ongoing recovery in a context of price stability.

Monetary policy

As I noted earlier, the pace of recovery slowed last spring – to a rate that, if sustained, would have been insufficient to make meaningful progress against unemployment. With job creation stalling, concerns about the sustainability of the recovery increased. At the same time, inflation – already at very low levels – continued to drift downward, and market-based measures of inflation compensation moved lower as investors appeared to become more concerned about the possibility of deflation, or falling prices.[4]

Under such conditions, the Federal Reserve would normally ease monetary policy by reducing the target for its short-term policy interest rate, the federal funds rate. However, the target range for the federal 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. Consequently, another means of providing monetary accommodation has been necessary since that time. In particular, over the past two years the Federal Reserve has eased monetary conditions by purchasing longer-term Treasury securities, agency debt, and agency mortgage-backed securities (MBS) on the open market. The largest program of purchases, which lasted from December 2008 through March 2010, appears to have contributed to an improvement in financial conditions and a strengthening of the recovery. Notably, the substantial expansion of the program announced in March 2009 was followed by financial and economic stabilization and a significant pickup in the growth of economic activity in the second half of that year.

In August 2010, in response to the already-mentioned concerns about the sustainability of the recovery and the continuing declines in inflation to very low levels, the FOMC authorized a policy of reinvesting principal payments on our holdings of agency debt and agency MBS into longer-term Treasury securities. By reinvesting agency securities, rather than allowing them to continue to run off as our previous policy had dictated, the FOMC ensured that a high level of monetary accommodation would be maintained. Over subsequent weeks, Federal Reserve officials noted in public remarks that we were considering providing additional monetary accommodation through further asset purchases. In November, the Committee announced that it intended to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year.

Large-scale purchases of longer-term securities are a less familiar means of providing monetary policy stimulus than reducing the federal funds rate, but the two approaches 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 both lower borrowing costs and higher asset prices. This easing in financial conditions bolsters household and business spending and thus increases economic activity. By comparison, the Federal Reserve's purchases of longer-term securities, by lowering term premiums, put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets,

[4] For example, deflation probabilities inferred from prices of certain inflation-indexed bonds increased during this period.

these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy.

A wide range of market indicators supports the view that the Federal Reserve's recent actions have been effective. For example, since August, when we announced our policy of reinvesting principal payments on agency debt and agency MBS and indicated that we were considering more securities 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 to historically more normal levels. Yields on 5- to 10-year nominal 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 market responses are almost identical to those that occurred during the earlier episode of policy easing, notably in the months following our March 2009 announcement. In addition, as I already noted, most forecasters see the economic outlook as having improved since our actions in August; downside risks to the recovery have receded, and the risk of deflation has become negligible. Of course, it is too early to make any firm judgment about how much of the recent improvement in the outlook can be attributed to monetary policy, but these developments are consistent with it having had a beneficial effect.

My colleagues and I continue to regularly review the asset purchase program in light of incoming information, and we will adjust it as needed to promote the achievement of our mandate from the Congress of maximum employment and stable prices. We also continue to plan for the eventual exit from unusually accommodative monetary policies and the normalization of the Federal Reserve's balance sheet. We have all the tools we need to achieve a smooth and effective exit at the appropriate time. Currently, because the Federal Reserve's asset purchases are settled through the banking system, depository institutions hold a very high level of reserve balances with the Federal Reserve. Even if bank reserves remain high, however, our ability to pay interest on reserve balances will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required. Moreover, we have developed and tested additional tools that will allow us to drain or immobilize bank reserves to the extent needed to tighten the relationship between the interest rate paid on reserves and other short-term interest rates.[5] If necessary, the Federal Reserve can also drain reserves by ceasing the reinvestment of principal payments on the securities it holds or by selling some of those securities in the open market. The FOMC remains unwaveringly committed to price stability and, in particular, to achieving a rate of inflation in the medium term that is consistent with the Federal Reserve's mandate.

Federal Reserve transparency

The Congress established the Federal Reserve, set its monetary policy objectives, and provided it with operational independence to pursue those objectives. The Federal Reserve's operational independence is critical, as it allows the FOMC to make monetary policy decisions based solely on the longer-term needs of the economy, not in response to short-

[5] These tools include the ability to execute term reverse repurchase agreements with the primary dealers and other counterparties, which drains reserves from the banking system; and the issuance of term deposits to depository institutions, which immobilizes bank reserves for the period of the deposit.

term political pressures. Considerable evidence supports the view that countries with independent central banks enjoy better economic performance over time.[6]

However, in our democratic society, the Federal Reserve's independence brings with it the obligation to be accountable and transparent. The Congress and the public must have all the information needed to understand our decisions, to be assured of the integrity of our operations, and to be confident that our actions are consistent with the mandate given to us by the Congress.

On matters related to the conduct of monetary policy, the Federal Reserve is one of the most transparent central banks in the world, making available extensive records and materials to explain its policy decisions. For example, beyond the semiannual *Monetary Policy Report* I am presenting today, the FOMC provides a post-meeting statement, a detailed set of minutes three weeks after each policy meeting, quarterly economic projections together with an accompanying narrative, and, with a five-year lag, a transcript of each meeting and its supporting materials. In addition, FOMC participants often discuss the economy and monetary policy in public forums, and Board members testify frequently before the Congress.

In recent years the Federal Reserve has also substantially increased the information it provides about its operations and its balance sheet. In particular, for some time the Federal Reserve has been voluntarily providing extensive financial and operational information regarding the special credit and liquidity facilities put in place during the financial crisis, including full descriptions of the terms and conditions of each facility; monthly reports on, among other things, the types of collateral posted and the mix of participants using each facility; weekly updates about borrowings and repayments at each facility; and many other details.[7] Further, on December 1, as provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Federal Reserve Board posted on its public website the details of more than 21,000 individual credit and other transactions conducted to stabilize markets and support the economic recovery during the crisis. This transaction-level information demonstrated the breadth of these operations and the care that was taken to protect the interests of the taxpayer; indeed, despite the scope of these actions, the Federal Reserve has incurred no credit losses to date on any of the programs and expects no credit losses in any of the few programs that still have loans outstanding. Moreover, we are fully confident that independent assessments of these programs will show that they were highly effective in helping to stabilize financial markets, thus strengthening the economy. Overall, the operational effectiveness of the programs was recently supported as part of a comprehensive review of six lending facilities by the Board's independent Office of Inspector General.[8] In addition, we have been working closely with the Government Accountability Office, the Office of the Special Inspector General for the Troubled Asset Relief Program, the Congressional Oversight Panel, the Congress, and private-sector auditors on reviews of these facilities as well as a range of matters relating to the Federal Reserve's operations and governance. We will continue to seek ways of enhancing our transparency without compromising our ability to conduct policy in the public interest.

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

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[6] See, for example, Alberto Alesina and Lawrence H. Summers (1993), "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit and Banking*, vol. 25 (May), pp. 151–62; or, more recently, Christopher Crowe and Ellen E. Meade (2008), "Central Bank Independence and Transparency: Evolution and Effectiveness," *European Journal of Political Economy*, vol. 24 (December), pp. 763–77. See Ben S. Bernanke (2010), "Central Bank Independence, Transparency, and Accountability," at the Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo (May 25), for further discussion and references.

[7] See the reports available on the Board's webpage, "Credit and Liquidity Programs and the Balance Sheet."

[8] See Board of Governors of the Federal Reserve System, Office of Inspector General (2010), *The Federal Reserve's Section 13(3) Lending Facilities to Support Overall Market Liquidity: Function, Status, and Risk Management* (1.5 MB PDF) (Washington: Board of Governors OIG, November).