# Ben S Bernanke: The US economic outlook

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the International Monetary Conference, Atlanta, Georgia, 7 June 2011.

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I would like to thank the organizers for inviting me to participate once again in the International Monetary Conference. I will begin with a brief update on the outlook for the U.S. economy, then discuss recent developments in global commodity markets that are significantly affecting both the U.S. and world economies, and conclude with some thoughts on the prospects for monetary policy.

## The outlook for growth

U.S. economic growth so far this year looks to have been somewhat slower than expected. Aggregate output increased at only 1.8 percent at an annual rate in the first quarter, and supply chain disruptions associated with the earthquake and tsunami in Japan are hampering economic activity this quarter. A number of indicators also suggest some loss of momentum in the labor market in recent weeks. We are, of course, monitoring these developments. That said, with the effects of the Japanese disaster on manufacturing output likely to dissipate in coming months, and with some moderation in gasoline prices in prospect, growth seems likely to pick up somewhat in the second half of the year. Overall, the economic recovery appears to be continuing at a moderate pace, albeit at a rate that is both uneven across sectors and frustratingly slow from the perspective of millions of unemployed and underemployed workers.

As is often the case, the ability and willingness of households to spend will be an important determinant of the pace at which the economy expands in coming quarters. A range of positive and negative forces is currently influencing both household finances and attitudes. On the positive side, household incomes have been boosted by the net improvement in job market conditions since earlier this year as well as from the reduction in payroll taxes that the Congress passed in December. Increases in household wealth – largely reflecting gains in equity values – and lower debt burdens have also increased consumers' willingness to spend. On the negative side, households are facing some significant headwinds, including increases in food and energy prices, declining home values, continued tightness in some credit markets, and still-high unemployment, all of which have taken a toll on consumer confidence.

Developments in the labor market will be of particular importance in setting the course for household spending. As you know, the jobs situation remains far from normal. For example, aggregate hours of production workers – a comprehensive measure of labor input that reflects the extent of part-time employment and opportunities for overtime as well as the number of people employed – fell, remarkably, by nearly 10 percent from the beginning of the recent recession through October 2009. Although hours of work have increased during the expansion, this measure still remains about 6-1/2 percent below its pre-recession level. For comparison, the maximum decline in aggregate hours worked in the deep 1981–82 recession was less than 6 percent. Other indicators, such as total payroll employment, the ratio of employment to population, and the unemployment rate, paint a similar picture. Particularly concerning is the very high level of long-term unemployment – nearly half of the unemployed have been jobless for more than six months. People without work for long periods can find it increasingly difficult to obtain a job comparable to their previous one, as their skills tend to deteriorate over time and as employers are often reluctant to hire the long-term unemployed.

Although the jobs market remains quite weak and progress has been uneven, overall we have seen signs of gradual improvement. For example, private-sector payrolls increased at an average rate of about 180,000 per month over the first five months of this year, compared with less than 140,000 during the last four months of 2010 and less than 80,000 per month in the four months prior to that. As I noted, however, recent indicators suggest some loss of momentum, with last Friday's jobs market report showing an increase in private payrolls of just 83,000 in May. I expect hiring to pick up from last month's pace as growth strengthens in the second half of the year, but, again, the recent data highlight the need to continue monitoring the jobs situation carefully.

The business sector generally presents a more upbeat picture. Capital spending on equipment and software has continued to expand, reflecting an improving sales outlook and the need to replace aging capital. Many U.S. firms, notably in manufacturing but also in services, have benefited from the strong growth of demand in foreign markets. Going forward, investment and hiring in the private sector should be facilitated by the ongoing improvement in credit conditions. Larger businesses remain able to finance themselves at historically low interest rates, and corporate balance sheets are strong. Smaller businesses still face difficulties in obtaining credit, but surveys of both banks and borrowers indicate that conditions are slowly improving for those firms as well.

In contrast, virtually all segments of the construction industry remain troubled. In the residential sector, low home prices and mortgage rates imply that housing is quite affordable by historical standards; yet, with underwriting standards for home mortgages having tightened considerably, many potential homebuyers are unable to qualify for loans. Uncertainties about job prospects and the future course of house prices have also deterred potential buyers. Given these constraints on the demand for housing, and with a large inventory of vacant and foreclosed properties overhanging the market, construction of new single-family homes has remained at very low levels, and house prices have continued to fall. The housing sector typically plays an important role in economic recoveries; the depressed state of housing in the United States is a big reason that the current recovery is less vigorous than we would like.

Developments in the public sector also help determine the pace of recovery. Here, too, the picture is one of relative weakness. Fiscally constrained state and local governments continue to cut spending and employment. Moreover, the impetus provided to the growth of final demand by federal fiscal policies continues to wane.

The prospect of increasing fiscal drag on the recovery highlights one of the many difficult tradeoffs faced by fiscal policymakers: If the nation is to have a healthy economic future, policymakers urgently need to put the federal government's finances on a sustainable trajectory. But, on the other hand, a sharp fiscal consolidation focused on the very near term could be self-defeating if it were to undercut the still-fragile recovery. The solution to this dilemma, I believe, lies in recognizing that our nation's fiscal problems are inherently long-term in nature. Consequently, the appropriate response is to move quickly to enact a credible, *long-term* plan for fiscal consolidation. By taking decisions today that lead to fiscal consolidation over a longer horizon, policymakers can avoid a sudden fiscal contraction that could put the recovery at risk. At the same time, establishing a credible plan for reducing future deficits now would not only enhance economic performance in the long run, but could also yield near-term benefits by leading to lower long-term interest rates and increased consumer and business confidence.

### The outlook for inflation

Let me turn to the outlook for inflation. As you all know, over the past year, prices for many commodities have risen sharply, resulting in significantly higher consumer prices for gasoline and other energy products and, to a somewhat lesser extent, for food. Overall inflation measures reflect these price increases: For example, over the six months through April, the price index for personal consumption expenditures has risen at an annual rate of about 3-1/2 percent, compared with an average of less than 1 percent over the preceding two years.

Although the recent increase in inflation is a concern, the appropriate diagnosis and policy response depend on whether the rise in inflation is likely to persist. So far at least, there is not much evidence that inflation is becoming broad-based or ingrained in our economy; indeed, increases in the price of a single product – gasoline – account for the bulk of the recent increase in consumer price inflation.[1] Of course, gasoline prices are exceptionally important for both family finances and the broader economy; but the fact that gasoline price increases alone account for so much of the overall increase in inflation suggests that developments in the global market for crude oil and related products, as well as in other commodities markets, are the principal factors behind the recent movements in inflation, rather than factors specific to the U.S. economy. An important implication is that if the prices of energy and other commodities stabilize in ranges near current levels, as futures markets and many forecasters predict, the upward impetus to overall price inflation will wane and the recent increase in inflation will prove transitory. Indeed, the declines in many commodity prices seen over the past few weeks may be an indication that such moderation is occurring. I will discuss commodity prices further momentarily.

Besides the prospect of more-stable commodity prices, two other factors suggest that inflation is likely to return to more subdued levels in the medium term. First, the still-substantial slack in U.S. labor and product markets should continue to have a moderating effect on inflationary pressures. Notably, because of the weak demand for labor, wage increases have not kept pace with productivity gains. Thus the level of unit labor costs in the business sector is lower than it was before the recession. Given the large share of labor costs in the production costs of most firms (typically, a share far larger than that of raw materials costs), subdued unit labor costs should remain a restraining influence on inflation. To be clear, I am not arguing that healthy increases in real wages are inconsistent with low inflation; the two are perfectly consistent so long as productivity growth is reasonably strong.

The second additional factor restraining inflation is the stability of longer-term inflation expectations. Despite the recent pickup in overall inflation, measures of households' longer-term inflation expectations from the Michigan survey, the 10-year inflation projections of professional economists, the 5-year-forward measure of inflation compensation derived from yields on inflation-protected securities, and other measures of longer-term inflation expectations have all remained reasonably stable.[2] As long as longer-term inflation expectations are stable, increases in global commodity prices are unlikely to be built into domestic wage- and price-setting processes, and they should therefore have only transitory effects on the rate of inflation. That said, the stability of inflation expectations is ensured only as long as the commitment of the central bank to low and stable inflation remains credible. Thus, the Federal Reserve will continue to closely monitor the evolution of inflation and inflation expectations and will take whatever actions are necessary to keep inflation well controlled.

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[1] Through April, personal consumption expenditures (PCE) inflation over the previous six months was 3.6 percent at an annual rate; excluding gasoline, inflation over that period was 2 percent. Over a 12-month span, inflation through April was 2.2 percent; excluding gasoline, it was 1.2 percent.

[2] In the Thomson Reuters/University of Michigan Surveys of Consumers, the median reading on expected inflation over the next 5 to 10 years was 2.9 percent in May after having averaged 2.8 percent in 2010. In the Survey of Professional Forecasters (SPF) compiled by the Federal Reserve Bank of Philadelphia, the median projection for PCE inflation over the next 10 years was 2.3 percent in May, up from the 2.1 percent average reading last year. The equivalent SPF projection for CPI inflation was 2.4 percent, versus 2.3 percent in 2010. The 5-year forward measure of inflation compensation derived from TIPS stood at about 2-3/4 percent in May, down noticeably from the levels observed toward the end of 2010.

### Commodity prices

As I noted earlier, the rise in commodity prices has directly increased the rate of inflation while also adversely affecting consumer confidence and consumer spending. Let's look at these price increases in closer detail.

The basic facts are familiar. Oil prices have risen significantly, with the spot price of West Texas Intermediate crude oil near $100 per barrel as of the end of last week, up nearly 40 percent from a year ago. Proportionally, prices of corn and wheat have risen even more, roughly doubling over the past year. And prices of industrial metals have increased notably as well, with aluminum and copper prices up about one-third over the past 12 months. When the price of any product moves sharply, the economist's first instinct is to look for changes in the supply of or demand for that product. And indeed, the recent increase in commodity prices appears largely to be the result of the same factors that drove commodity prices higher throughout much of the past decade: strong gains in global demand that have not been met with commensurate increases in supply.

From 2002 to 2008, a period of sustained increases in commodity prices, world economic activity registered its fastest pace of expansion in decades, rising at an average rate of about 4-1/2 percent per year. This impressive performance was led by the emerging and developing economies, where real activity expanded at a remarkable 7 percent per annum. The emerging market economies have likewise led the way in the recovery from the global financial crisis: From 2008 to 2010, real gross domestic product (GDP) rose cumulatively by about 10 percent in the emerging market economies even as GDP was essentially unchanged, on net, in the advanced economies.[3]

Naturally, increased economic activity in emerging market economies has increased global demand for raw materials. Moreover, the heavy emphasis on industrial development in many emerging market economies has led their growth to be particularly intensive in the use of commodities, even as the consumption of commodities in advanced economies has stabilized or declined. For example, world oil consumption rose by 14 percent from 2000 to 2010; underlying this overall trend, however, was a 40 percent increase in oil use in emerging market economies and an outright decline of 4-1/2 percent in the advanced economies. In particular, U.S. oil consumption was about 2-1/2 percent lower in 2010 than in 2000, with net imports of oil down nearly 10 percent, even though U.S. real GDP rose by nearly 20 percent over that period.

This dramatic shift in the sources of demand for commodities is not unique to oil. If anything, the pattern is even more striking for industrial metals, where double-digit percentage rates of decline in consumption by the advanced economies over the past decade have been overwhelmed by triple-digit percentage increases in consumption by the emerging market economies.[4] Likewise, improving diets in the emerging market economies have significantly increased their demand for agricultural commodities. Importantly, in noting these facts, I intend no criticism of emerging markets; growth in those economies has conferred substantial economic benefits both within those countries and globally, and in any case, the consumption of raw materials relative to population in emerging-market countries remains substantially lower than in the United States and other advanced economies. Nevertheless, it

3 The GDP data cited here are from the International Monetary Fund's World Economic Outlook database. The difference between the advanced and emerging market economies is also evident in the statistics on industrial production, which is perhaps more directly relevant to the demand for commodities. According to the CPB Netherlands Bureau for Economic Policy Analysis, from March 2009 to March 2010, industrial production rose 26 percent in the emerging market economies and 11 percent in the advanced economies.

4 A portion of commodity use in the emerging market economies serves as inputs to the production of exports, some of which are ultimately consumed in advanced economies.

is undeniable that the tremendous growth in emerging market economies has considerably increased global demand for commodities in recent years.

Against this backdrop of extremely robust growth in demand, the supply of many commodities has lagged behind. For example, world oil production has increased less than 1 percent per year since 2004, compared with nearly 2 percent per year in the prior decade. In part, the slower increase in the supply of oil reflected disappointing rates of production in countries that are not part of the Organization of the Petroleum Exporting Countries (OPEC). However, OPEC has not shown much willingness to ramp up production, either. Most recently, OPEC production fell 1.3 million barrels per day from January to April of this year, reflecting the disruption to Libyan supplies and the lack of any significant offset from other OPEC producers. Indeed, OPEC's production of oil today remains about 3 million barrels per day below the peak level of mid-2008. With the demand for oil rising rapidly and the supply of crude stagnant, increases in oil prices are hardly a puzzle.

Production shortfalls have plagued many other commodities as well. Agricultural output has been hard hit by a spate of bad weather around the globe. For example, last summer's drought in Russia severely reduced that country's wheat crop. In the United States, high temperatures significantly impaired the U.S. corn crop last fall, and dry conditions are currently hurting the wheat crop in Kansas. Over the past year, droughts have also afflicted Argentina, China, and France. Fortunately, the lag between planting and harvesting for many crops is relatively short; thus, if more-typical weather patterns resume, supplies of agricultural commodities should rebound, thereby reducing the pressure on prices.

Not all commodity prices have increased, illustrating the point that supply and demand conditions can vary across markets. For example, prices for both lumber and natural gas are currently near their levels of the early 2000s. The demand for lumber has been curtailed by weakness in the U.S. construction sector, while the supply of natural gas in the United States has been increased by significant innovations in extraction techniques.[5] Among agricultural commodities, rice prices have remained relatively subdued, reflecting favorable growing conditions.

In all, these cases reinforce the view that the fundamentals of global supply and demand have been playing a central role in recent swings in commodity prices. That said, there is usually significant uncertainty about current and prospective supply and demand. Accordingly, commodity prices, like the prices of financial assets, can be volatile as market participants react to incoming news. Recently, commodity prices seem to have been particularly responsive to news bearing on the prospects for global economic growth as well as geopolitical developments.

As the rapid growth of emerging market economies seems likely to continue, should we therefore expect continued rapid increases in the prices of globally-traded commodities? While it is certainly possible that we will see further increases, there are good reasons to believe that commodity prices will not continue to rise at the rapid rates we have seen recently. In the short run, unexpected shortfalls in the supplies of key commodities result in sharp price increases, as usage patterns and available supplies are difficult to change quickly. Over longer periods, however, high levels of commodity prices curtail demand as households and firms adjust their spending and production patterns. Indeed, as I noted earlier, we have already seen significant reductions in commodity use in the advanced economies. Likewise, over time, high prices should elicit meaningful increases in supply, both as temporary factors, such as adverse weather, abate and as investments in productive capacity come to fruition. Finally, because expectations of higher prices lead financial market

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5 As natural gas is difficult to transport overseas, the increased supplies of natural gas in North America have not translated into significantly lower prices abroad. In the first quarter of 2011, natural gas prices in the United States were less than half of those in Germany.

participants to bid up the spot prices of commodities, predictable future developments bearing on the demands for and supplies of commodities tend already to be reflected in current prices. For these reasons, although unexpected developments could certainly lead to continued volatility in global commodity prices, it is reasonable to expect the effects of commodity prices on overall inflation to be relatively moderate in the medium term.

While supply and demand fundamentals surely account for most of the recent movements in commodity prices, some observers have attributed a significant portion of the run-up in prices to Federal Reserve policies, over and above the effects of those policies on U.S. economic growth. For example, some have argued that accommodative U.S. monetary policy has driven down the foreign exchange value of the dollar, thereby boosting the dollar price of commodities. Indeed, since February 2009, the trade-weighted dollar has fallen by about 15 percent. However, since February 2009, oil prices have risen 160 percent and nonfuel commodity prices are up by about 80 percent, implying that the dollar's decline can explain, at most, only a small part of the rise in oil and other commodity prices; indeed, commodity prices have risen dramatically when measured in terms of any of the world's major currencies, not just the dollar. But even this calculation overstates the role of monetary policy, as many factors other than monetary policy affect the value of the dollar. For example, the decline in the dollar since February 2009 that I just noted followed a comparable increase in the dollar, which largely reflected flight-to-safety flows triggered by the financial crisis in the latter half of 2008; the dollar's decline since then in substantial part reflects the reversal of those flows as the crisis eased. Slow growth in the United States and a persistent trade deficit are additional, more fundamental sources of recent declines in the dollar's value; in particular, as the United States is a major oil importer, any geopolitical or other shock that increases the global price of oil will worsen our trade balance and economic outlook, which tends to depress the dollar. In this case, the direction of causality runs from commodity prices to the dollar rather than the other way around. The best way for the Federal Reserve to support the fundamental value of the dollar in the medium term is to pursue our dual mandate of maximum employment and price stability, and we will certainly do that.

Another argument that has been made is that low interest rates have pushed up commodity prices by reducing the cost of holding inventories, thus boosting commodity demand, or by encouraging speculators to push commodity futures prices above their fundamental levels. In either case, if such forces were driving commodity prices materially and persistently higher, we should see corresponding increases in commodity inventories, as higher prices curtailed consumption and boosted production relative to their fundamental levels. In fact, inventories of most commodities have not shown sizable increases over the past year as prices rose; indeed, increases in prices have often been associated with lower rather than higher levels of inventories, likely reflecting strong demand or weak supply that tends to put pressure on available stocks.

Finally, some have suggested that very low interest rates in the United States and other advanced economies have created risks of economic overheating in emerging market economies and have thus indirectly put upward pressures on commodity prices. In fact, most of the recent rapid economic growth in emerging market economies appears to reflect a bounceback from the previous recession and continuing increases in productive capacity, as their technologies and capital stocks catch up with those in advanced economies, rather than being primarily the result of monetary conditions in those countries. More fundamentally, however, whatever the source of the recent growth in the emerging markets, the authorities in those economies clearly have a range of fiscal, monetary, exchange rate, and other tools that can be used to address any overheating that may occur. As in all countries, the primary objective of monetary policy in the United States should be to promote economic growth and price stability at home, which in turn supports a stable global economic and financial environment.

## Monetary policy

Let me conclude with a few words about the current stance of monetary policy. As I have discussed today, the economic recovery in the United States appears to be proceeding at a moderate pace and – notwithstanding unevenness in the rate of progress and some recent signs of reduced momentum – the labor market has been gradually improving. At the same time, the jobs situation remains far from normal, with unemployment remaining elevated. Inflation has risen lately but should moderate, assuming that commodity prices stabilize and that, as I expect, longer-term inflation expectations remain stable.

Against this backdrop, the Federal Open Market Committee (FOMC) has maintained a highly accommodative monetary policy, keeping its target for the federal funds rate close to zero and further easing monetary conditions through large-scale asset purchases. The FOMC has indicated that it will complete its purchases of $600 billion of Treasury securities by the end of this month while maintaining its existing policy of reinvesting principal payments from its securities holdings. The Committee also continues to anticipate that economic conditions are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The U.S. economy is recovering from both the worst financial crisis and the most severe housing bust since the Great Depression, and it faces additional headwinds ranging from the effects of the Japanese disaster to global pressures in commodity markets. In this context, monetary policy cannot be a panacea. Still, the Federal Reserve's actions in recent years have doubtless helped stabilize the financial system, ease credit and financial conditions, guard against deflation, and promote economic recovery. All of this has been accomplished, I should note, at no net cost to the federal budget or to the U.S. taxpayer.

Although it is moving in the right direction, the economy is still producing at levels well below its potential; consequently, accommodative monetary policies are still needed. Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established. At the same time, the longer-run health of the economy requires that the Federal Reserve be vigilant in preserving its hard-won credibility for maintaining price stability. As I have explained, most FOMC participants currently see the recent increase in inflation as transitory and expect inflation to remain subdued in the medium term. Should that forecast prove wrong, however, and particularly if signs were to emerge that inflation was becoming more broadly based or that longer-term inflation expectations were becoming less well anchored, the Committee would respond as necessary. Under all circumstances, our policy actions will be guided by the objectives of supporting the recovery in output and employment while helping ensure that inflation, over time, is at levels consistent with the Federal Reserve's mandate.