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 Financial Services, US House of Representatives Washington DC, 13 July 2011.

Chairman Bernanke presented identical remarks before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate on July 14, 2011.

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Chairman Bachus, Ranking Member Frank, 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 current economic conditions and the outlook and then turn to monetary policy.

The economic outlook

The U.S. economy has continued to recover, but the pace of the expansion so far this year has been modest. After increasing at an annual rate of 2-3/4 percent in the second half of 2010, real gross domestic product (GDP) rose at about a 2 percent rate in the first quarter of this year, and incoming data suggest that the pace of recovery remained soft in the spring. At the same time, the unemployment rate, which had appeared to be on a downward trajectory at the turn of the year, has moved back above 9 percent.

In part, the recent weaker-than-expected economic performance appears to have been the result of several factors that are likely to be temporary. Notably, the run-up in prices of energy, especially gasoline, and food has reduced consumer purchasing power. In addition, the supply chain disruptions that occurred following the earthquake in Japan caused U.S. motor vehicle producers to sharply curtail assemblies and limited the availability of some models. Looking forward, however, the apparent stabilization in the prices of oil and other commodities should ease the pressure on household budgets, and vehicle manufacturers report that they are making significant progress in overcoming the parts shortages and expect to increase production substantially this summer.

In light of these developments, the most recent projections by members of the Federal Reserve Board and presidents of the Federal Reserve Banks, prepared in conjunction with the Federal Open Market Committee (FOMC) meeting in late June, reflected their assessment that the pace of the economic recovery will pick up in coming quarters. Specifically, participants' projections for the increase in real GDP have a central tendency of 2.7 to 2.9 percent for 2011, inclusive of the weak first half, and 3.3 to 3.7 percent in 2012 – projections that, if realized, would constitute a notably better performance than we have seen so far this year.[1]

FOMC participants continued to see the economic recovery strengthening over the medium term, with the central tendency of their projections for the increase in real GDP picking up to 3.5 to 4.2 percent in 2013. At the same time, the central tendencies of the projections of real GDP growth in 2011 and 2012 were marked down nearly 1/2 percentage point compared with those reported in April, suggesting that FOMC participants saw at least some part of the first-half slowdown as persisting for a while. Among the headwinds facing the economy are the slow growth in consumer spending, even after accounting for the effects of higher food and energy prices; the continuing depressed condition of the housing sector; still-limited

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[1] Note that these projections do not incorporate the most recent economic news, including last Friday's labor market report.

access to credit for some households and small businesses; and fiscal tightening at all levels of government. Consistent with projected growth in real output modestly above its trend rate, FOMC participants expected that, over time, the jobless rate will decline – albeit only slowly – toward its longer-term normal level. The central tendencies of participants' forecasts for the unemployment rate were 8.6 to 8.9 percent for the fourth quarter of this year, 7.8 to 8.2 percent at the end of 2012, and 7.0 to 7.5 percent at the end of 2013.

The most recent data attest to the continuing weakness of the labor market: The unemployment rate increased to 9.2 percent in June, and gains in nonfarm payroll employment were below expectations for a second month. To date, of the more than 8-1/2 million jobs lost in the recession, 1-3/4 million have been regained. Of those employed, about 6 percent – 8.6 million workers – report that they would like to be working full time but can only obtain part-time work. Importantly, nearly half of those currently unemployed have been out of work for more than six months, by far the highest ratio in the post-World War II period. Long-term unemployment imposes severe economic hardships on the unemployed and their families, and, by leading to an erosion of skills of those without work, it both impairs their lifetime employment prospects and reduces the productive potential of our economy as a whole.

Much of the slowdown in aggregate demand this year has been centered in the household sector, and the ability and willingness of consumers to spend will be an important determinant of the pace of the recovery in coming quarters. Real disposable personal income over the first five months of 2011 was boosted by the reduction in payroll taxes, but those gains were largely offset by higher prices for gasoline and other commodities. Households report that they have little confidence in the durability of the recovery and about their own income prospects. Moreover, the ongoing weakness in home values is holding down household wealth and weighing on consumer sentiment. On the positive side, household debt burdens are declining, delinquency rates on credit card and auto loans are down significantly, and the number of homeowners missing a mortgage payment for the first time is decreasing. The anticipated pickups in economic activity and job creation, together with the expected easing of price pressures, should bolster real household income, confidence, and spending in the medium run.

Residential construction activity remains at an extremely low level. The demand for homes has been depressed by many of the same factors that have held down consumer spending more generally, including the slowness of the recovery in jobs and income as well as poor consumer sentiment. Mortgage interest rates are near record lows, but access to mortgage credit continues to be constrained. Also, many potential homebuyers remain concerned about buying into a falling market, as weak demand for homes, the substantial backlog of vacant properties for sale, and the high proportion of distressed sales are keeping downward pressure on house prices.

Two bright spots in the recovery have been exports and business investment in equipment and software. Demand for U.S.-made capital goods from both domestic and foreign firms has supported manufacturing production throughout the recovery thus far. Both equipment and software outlays and exports increased solidly in the first quarter, and the data on new orders received by U.S. producers suggest that the trend continued in recent months. Corporate profits have been strong, and larger nonfinancial corporations with access to capital markets have been able to refinance existing debt and lock in funding at lower yields. Borrowing conditions for businesses generally have continued to ease, although, as mentioned, the availability of credit appears to remain relatively limited for some small firms.

Inflation has picked up so far this year. The price index for personal consumption expenditures (PCE) rose at an annual rate of more than 4 percent over the first five months of 2011, and 2-1/2 percent on a 12-month basis. Much of the acceleration was the result of higher prices for oil and other commodities and for imported goods. In addition, prices of motor vehicles increased sharply when supplies of new models were curtailed by parts shortages associated with the earthquake in Japan. Most of the recent rise in inflation appears likely to be transitory, and FOMC participants expected inflation to subside in coming quarters to rates at or below the level of 2 percent or a bit less that participants view as consistent with our dual mandate of maximum employment and price stability. The central tendency of participants' forecasts for the rate of increase in the PCE price index was 2.3 to 2.5 percent for 2011 as a whole, which implies a significant slowing of inflation in the second half of the year. In 2012 and 2013, the central tendency of the inflation forecasts was 1.5 to 2.0 percent. Reasons to expect inflation to moderate include the apparent stabilization in the prices of oil and other commodities, which is already showing through to retail gasoline and food prices; the still-substantial slack in U.S. labor and product markets, which has made it difficult for workers to obtain wage gains and for firms to pass through their higher costs; and the stability of longer-term inflation expectations, as measured by surveys of households, the forecasts of professional private-sector economists, and financial market indicators.

Monetary policy

FOMC members' judgments that the pace of the economic recovery over coming quarters will likely remain moderate, that the unemployment rate will consequently decline only gradually, and that inflation will subside are the basis for the Committee's decision to maintain a highly accommodative monetary policy. As you know, that policy currently consists of two parts. First, the target range for the federal funds rate remains at 0 to 1/4 percent and, as indicated in the statement released after the June meeting, the Committee expects that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The second component of monetary policy has been to increase the Federal Reserve's holdings of longer-term securities, an approach undertaken because the target for the federal funds rate could not be lowered meaningfully further. The Federal Reserve's acquisition of longer-term Treasury securities boosted the prices of such securities and caused longer-term Treasury yields to be lower than they would have been otherwise. In addition, by removing substantial quantities of longer-term Treasury securities from the market, the Fed's purchases induced private investors to acquire other assets that serve as substitutes for Treasury securities in the financial marketplace, such as corporate bonds and mortgage-backed securities. By this means, the Fed's asset purchase program – like more conventional monetary policy – has served to reduce the yields and increase the prices of those other assets as well. The net result of these actions is lower borrowing costs and easier financial conditions throughout the economy.[2] We know from many decades of experience with monetary policy that, when the economy is operating below its potential, easier financial conditions tend to promote more rapid economic growth. Estimates based on a number of recent studies as well as Federal Reserve analyses suggest that, all else being equal, the second round of asset purchases probably lowered longer-term interest rates approximately 10 to 30 basis points.[3] Our analysis further indicates that a reduction in longer-

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2 The Federal Reserve's recently completed securities purchase program has changed the average maturity of Treasury securities held by the public only modestly, suggesting that such an effect likely did not contribute substantially to the reduction in Treasury yields. Rather, the more important channel of effect was the removal of Treasury securities from the market, which reduced Treasury yields generally while inducing private investors to hold alternative assets (the portfolio reallocation effect). The substitution into alternative assets raised their prices and lowered their yields, easing overall financial conditions.

3 Studies that have provided estimates of the effects of large-scale asset purchases, holding constant other factors, include James D. Hamilton and Jing (Cynthia) Wu (2011), "The Effectiveness of Alternative Monetary Policy Tools in a Zero Lower Bound Environment," NBER Working Paper Series No. 16956 (Cambridge, Mass: National Bureau of Economic Research, April), and Journal of Money, Credit and Banking (forthcoming); Arvind Krishnamurthy and Annette Vissing-Jorgensen (2011), "The Effects of Quantitative

term interest rates of this magnitude would be roughly equivalent in terms of its effect on the economy to a 40 to 120 basis point reduction in the federal funds rate.

In June, we completed the planned purchases of $600 billion in longer-term Treasury securities that the Committee initiated in November, while continuing to reinvest the proceeds of maturing or redeemed longer-term securities in Treasuries. Although we are no longer expanding our securities holdings, the evidence suggests that the degree of accommodation delivered by the Federal Reserve's securities purchase program is determined primarily by the quantity and mix of securities that the Federal Reserve holds rather than by the current pace of new purchases. Thus, even with the end of net new purchases, maintaining our holdings of these securities should continue to put downward pressure on market interest rates and foster more accommodative financial conditions than would otherwise be the case. It is worth emphasizing that our program involved purchases of securities, not government spending, and, as I will discuss later, when the macroeconomic circumstances call for it, we will unwind those purchases. In the meantime, interest on those securities is remitted to the U.S. Treasury.

When we began this program, we certainly did not expect it to be a panacea for the country's economic problems. However, as the expansion weakened last summer, developments with respect to both components of our dual mandate implied that additional monetary accommodation was needed. In that context, we believed that the program would both help reduce the risk of deflation that had emerged and provide a needed boost to faltering economic activity and job creation. The experience to date with the round of securities purchases that just ended suggests that the program had the intended effects of reducing the risk of deflation and shoring up economic activity. In the months following the August announcement of our policy of reinvesting maturing and redeemed securities and our signal that we were considering more purchases, inflation compensation as measured in the market for inflation-indexed securities rose from low to more normal levels, suggesting that the perceived risks of deflation had receded markedly. This was a significant achievement, as we know from the Japanese experience that protracted deflation can be quite costly in terms of weaker economic growth.

With respect to employment, our expectations were relatively modest; estimates made in the autumn suggested that the additional purchases could boost employment by about 700,000 jobs over two years, or about 30,000 extra jobs per month.[4] Even including the disappointing readings for May and June, which reflected in part the temporary factors discussed earlier, private payroll gains have averaged 160,000 per month in the first half of 2011, compared with average increases of only about 80,000 private jobs per month from May to August 2010. Not all of the step-up in hiring was necessarily the result of the asset purchase program, but the comparison is consistent with our expectations for employment gains. Of course, we will be monitoring developments in the labor market closely.

Once the temporary shocks that have been holding down economic activity pass, we expect to again see the effects of policy accommodation reflected in stronger economic activity and

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Easing on Interest Rates (PDF)," working paper (Evanston, Ill.: Kellogg School of Management, Northwestern University, June); Stefania D'Amico and Thomas B. King (2010), "Flow and Stock Effects of Large-Scale Treasury Purchases," Finance and Economics Discussion Series 2010–52 (Washington: Board of Governors of the Federal Reserve System, September); Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack (2011), "Large-Scale Asset Purchases by the Federal Reserve: Did They Work? (PDF)" Federal Reserve Bank of New York, Economic Policy Review, vol 17 (May), pp.41–59; and Eric T. Swanson (2011), "Let's Twist Again: A High-Frequency Event-Study Analysis of Operation Twist and Its Implications for QE2 (PDF)," Working Paper Series 2011–08 (San Francisco: Federal Reserve Bank of San Francisco, February), and Brookings Papers on Economic Activity (forthcoming).

4 See Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams (2011), "Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events? (PDF)" Working Paper Series 2011–01 (San Francisco: Federal Reserve Bank of San Francisco, January).

job creation. However, given the range of uncertainties about the strength of the recovery and prospects for inflation over the medium term, the Federal Reserve remains prepared to respond should economic developments indicate that an adjustment in the stance of monetary policy would be appropriate.

On the one hand, the possibility remains that the recent economic weakness may prove more persistent than expected and that deflationary risks might reemerge, implying a need for additional policy support. Even with the federal funds rate close to zero, we have a number of ways in which we could act to ease financial conditions further. One option would be to provide more explicit guidance about the period over which the federal funds rate and the balance sheet would remain at their current levels. Another approach would be to initiate more securities purchases or to increase the average maturity of our holdings. The Federal Reserve could also reduce the 25 basis point rate of interest it pays to banks on their reserves, thereby putting downward pressure on short-term rates more generally. Of course, our experience with these policies remains relatively limited, and employing them would entail potential risks and costs. However, prudent planning requires that we evaluate the efficacy of these and other potential alternatives for deploying additional stimulus if conditions warrant.

On the other hand, the economy could evolve in a way that would warrant a move toward less-accommodative policy. Accordingly, the Committee has been giving careful consideration to the elements of its exit strategy, and, as reported in the minutes of the June FOMC meeting, it has reached a broad consensus about the sequence of steps that it expects to follow when the normalization of policy becomes appropriate. In brief, when economic conditions warrant, the Committee would begin the normalization process by ceasing the reinvestment of principal payments on its securities, thereby allowing the Federal Reserve's balance sheet to begin shrinking. At the same time or sometime thereafter, the Committee would modify the forward guidance in its statement. Subsequent steps would include the initiation of temporary reserve-draining operations and, when conditions warrant, increases in the federal funds rate target. From that point on, changing the level or range of the federal funds rate target would be our primary means of adjusting the stance of monetary policy in response to economic developments.

Sometime after the first increase in the federal funds rate target, the Committee expects to initiate sales of agency securities from its portfolio, with the timing and pace of sales clearly communicated to the public in advance. Once sales begin, the pace of sales is anticipated to be relatively gradual and steady, but it could be adjusted up or down in response to material changes in the economic outlook or financial conditions. Over time, the securities portfolio and the associated quantity of bank reserves are expected to be reduced to the minimum levels consistent with the efficient implementation of monetary policy. Of course, conditions can change, and in choosing the time to begin policy normalization as well as the pace of that process, should that be the next direction for policy, we would carefully consider both parts of our dual mandate.

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