Ben S Bernanke: The US economic outlook

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Economic Club of Minnesota Luncheon, Minneapolis, Minnesota, 8 September 2011.

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Good afternoon. I am delighted to be in the Twin Cities and would like to thank the Economic Club of Minnesota for inviting me to kick off its 2011–2012 speaker series. Today I will provide a brief overview of the U.S. economic outlook and conclude with a few thoughts on monetary policy and on the longer-term prospects for our economy.

The outlook for US economic growth

In discussing the prospects for the economy and for policy in the near term, it bears recalling briefly how we got here. The financial crisis that gripped global markets in 2008 and 2009 was more severe than any since the Great Depression. Economic policymakers around the world saw the mounting risks of a global financial meltdown in the fall of 2008 and understood the extraordinarily dire economic consequences that such an event could have. Governments and central banks consequently worked forcefully and in close coordination to avert the looming collapse. The actions to stabilize the financial system were accompanied, both in the United States and abroad, by substantial monetary and fiscal stimulus. Despite these strong and concerted efforts, severe damage to the global economy could not be avoided. The freezing of credit, the sharp drops in asset prices, dysfunction in financial markets, and the resulting blows to confidence sent global production and trade into free fall in late 2008 and early 2009.

It has been almost exactly three years since the beginning of the most intense phase of the financial crisis, in the late summer and fall of 2008, and a bit more than two years since the official beginning of the economic recovery, in June 2009, as determined by the National Bureau of Economic Research’s Business Cycle Dating Committee. Where do we stand? There have been some positive developments over the past few years. In the financial sphere, our banking system and financial markets are significantly stronger and more stable. Credit availability has improved for many borrowers, though it remains tight in categories – such as small business lending – in which the balance sheets and income prospects of potential borrowers remain impaired. Importantly, given the sources of the crisis, structural reform is moving forward in the financial sector, with ambitious domestic and international efforts under way to enhance financial regulation and supervision, especially for the largest and systemically most important financial institutions.

Nevertheless, it is clear that the recovery from the crisis has been much less robust than we had hoped. From recent comprehensive revisions of government economic data, we have learned that the recession was even deeper and the recovery weaker than we had previously thought; indeed, aggregate output in the United States still has not returned to the level that it had attained before the crisis. Importantly, economic growth over the past two years has, for the most part, been at rates insufficient to achieve sustained reductions in the unemployment rate, which has recently been fluctuating a bit above 9 percent.

The pattern of sluggish economic growth was particularly evident in the first half of this year, with real gross domestic product (GDP) estimated to have increased at an annual rate of less than 1 percent, on average, in the first and second quarters. Some of this weakness can be attributed to temporary factors, including the strains put on consumer and business budgets by the run-ups earlier this year in the prices of oil and other commodities and the effects of the disaster in Japan on global supply chains and production. Accordingly, with commodity prices coming off their highs and manufacturers' problems with supply chains well along toward resolution, growth in the second half looks likely to pick up. However, the incoming data suggest that other, more persistent factors also have been holding back the recovery. Consequently, as noted in its statement following the August meeting, the Federal Open Market Committee (FOMC) now expects a somewhat slower pace of recovery over coming quarters than it did at the time of the June meeting, with greater downside risks to the economic outlook.

One striking aspect of the recovery is the unusual weakness in household spending. After contracting very sharply during the recession, consumer spending expanded moderately through 2010, only to decelerate in the first half of 2011. The temporary factors I mentioned earlier – the rise in commodity prices, which has hurt households' purchasing power, and the disruption in manufacturing following the Japanese disaster, which reduced auto availability and hence sales – are partial explanations for this deceleration. But households are struggling with other important headwinds as well, including the persistently high level of unemployment, slow gains in wages for those who remain employed, falling house prices, and debt burdens that remain high for many, notwithstanding that households, in the aggregate, have been saving more and borrowing less. Even taking into account the many financial pressures they face, households seem exceptionally cautious. Indeed, readings on consumer confidence have fallen substantially in recent months as people have become more pessimistic about both economic conditions and their own financial prospects.

Compared with the household sector, the business sector generally presents a more upbeat picture. Manufacturing production has risen nearly 15 percent since its trough, driven importantly by growth in exports. Indeed, the U.S. trade deficit has narrowed substantially relative to where it was before the crisis, reflecting in part the improved competitiveness of U.S. goods and services. Business investment in equipment and software has also continued to expand. Corporate balance sheets are healthy, and although corporate bond markets have tightened somewhat of late, companies with access to the bond markets have generally had little difficulty obtaining credit on favorable terms. But problems are evident in the business sector as well: Business investment in nonresidential structures, such as office buildings, factories, and shopping malls, has remained at a low level, held back by elevated vacancy rates at existing properties and difficulties, in some cases, in obtaining construction loans. Also, some business surveys, including those conducted by the Federal Reserve System, point to weaker conditions recently, with businesses reporting slower growth in production, new orders, and employment.

Why has this recovery been so slow and erratic? Historically, recessions have tended to sow the seeds of their own recoveries as reduced spending on investment, housing, and consumer durables generates pent-up demand. As the business cycle bottoms out and confidence returns, this pent-up demand, often augmented by the effects of stimulative monetary and fiscal policies, is met through increased production and hiring. Increased production in turn boosts business revenues and increased hiring raises household incomes – providing further impetus to business and household spending. Improving income prospects and balance sheets also make households and businesses more creditworthy, and financial institutions become more willing to lend. Normally, these developments create a virtuous circle of rising incomes and profits, more-supportive financial and credit conditions, and lower uncertainty, allowing the process of recovery to develop momentum.

These restorative forces are at work today, and they will continue to promote recovery over time. Unfortunately, the recession, besides being extraordinarily severe as well as global in scope, was also unusual in being associated with both a very deep slump in the housing market and a historic financial crisis. These two features of the downturn, individually and in combination, have acted to slow the natural recovery process.

Notably, the housing sector has been a significant driver of recovery from most recessions in the United States since World War II, but this time – with an overhang of distressed and foreclosed properties, tight credit conditions for builders and potential homebuyers, and ongoing concerns by both potential borrowers and lenders about continued house price declines – the rate of new home construction has remained at less than one-third of its pre-crisis peak. Depressed construction also has hurt providers of a wide range of goods and services related to housing and homebuilding, such as the household appliance and home furnishing industries. Moreover, even as tight credit for builders and potential homebuyers has been one of the factors restraining the housing recovery, the weak housing market has in turn adversely affected financial markets and the flow of credit. For example, the sharp declines in house prices in some areas have left many homeowners "underwater" on their mortgages, creating financial hardship for households and, through their effects on rates of mortgage delinquency and default, stress for financial institutions as well.

As I noted, the financial crisis of 2008 and 2009 played a central role in sparking the global recession. A great deal has been and continues to be done to address the causes and effects of the crisis, including extensive financial reforms. However, although banking and financial conditions in the United States have improved significantly since the depths of the crisis, financial stress continues to be a significant drag on the recovery, both here and abroad. This drag has become particularly evident in recent months, as bouts of sharp volatility and risk aversion in markets have reemerged in reaction to concerns about European sovereign debts and related strains as well as developments associated with the U.S. fiscal situation, including last month's downgrade of the U.S. long-term credit rating by one of the major ratings agencies and the recent controversy surrounding the raising of the U.S. federal debt ceiling. It is difficult to judge how much these events and the associated financial volatility have affected economic activity thus far, but there seems little doubt that they have hurt household and business confidence, and that they pose ongoing risks to growth.

While the weakness of the housing sector and continued financial volatility are two key reasons for the frustratingly slow pace of the recovery, other factors also may restrain growth in coming quarters. For example, state and local governments continue to tighten their belts by cutting spending and reducing payrolls in the face of ongoing budgetary pressures, and federal fiscal stimulus is being withdrawn. There is ample room for debate about the appropriate size and role for the government in the longer term, but – in the absence of adequate demand from the private sector – a substantial fiscal consolidation in the shorter term could add to the headwinds facing economic growth and hiring.

The prospect of an increasing fiscal drag on the economy in the face of an already sluggish recovery highlights one of the many difficult tradeoffs currently faced by fiscal policymakers. As I have emphasized on previous occasions, without significant policy changes to address the increasing fiscal burdens that will be associated with the aging of the population and the ongoing rise in health-care costs, the finances of the federal government will spiral out of control in coming decades, risking severe economic and financial damage. But, while prompt and decisive action to put the federal government's finances on a sustainable trajectory is urgently needed, fiscal policymakers should not, as a consequence, disregard the fragility of the economic recovery. Fortunately, the two goals – achieving fiscal sustainability, which is the result of responsible policies set in place for the longer term, and avoiding creation of fiscal headwinds for the recovery – are not incompatible. Acting now to put in place a credible plan for reducing future deficits over the long term, while being attentive to the implications of fiscal choices for the recovery in the near term, can help serve both objectives.

The outlook for inflation

Let me turn now from the outlook for growth to the outlook for inflation. Prices of many commodities, notably oil, increased sharply earlier this year. Higher gasoline and food prices translated directly into increased inflation for consumers, and in some cases producers of other goods and services were able to pass through their higher costs to their customers as well. In addition, the global supply disruptions associated with the disaster in Japan put upward pressure on motor vehicle prices. As a result of these influences, inflation picked up significantly; over the first half of this year, the price index for personal consumption expenditures rose at an annual rate of about 3–1/2 percent, compared with an average of less than 1–1/2 percent over the preceding two years.

However, inflation is expected to moderate in the coming quarters as these transitory influences wane. In particular, the prices of oil and many other commodities have either leveled off or have come down from their highs. Meanwhile, the step-up in automobile production should reduce pressure on car prices. Importantly, we see little indication that the higher rate of inflation experienced so far this year has become ingrained in the economy. Longer-term inflation expectations have remained stable according to the indicators we monitor, such as the measure of households' longer-term expectations from the Thompson Reuters/University of Michigan survey, the 10-year inflation projections of professional forecasters, and the five-year-forward measure of inflation compensation derived from yields of inflation-protected Treasury securities. In addition to the stability of longer-term inflation expectations, the substantial amount of resource slack that exists in U.S. labor and product markets should continue to have a moderating influence on inflationary pressures. Notably, because of ongoing weakness in labor demand over the course of the recovery, nominal wage increases have been roughly offset by productivity gains, leaving the level of unit labor costs close to where it had stood at the onset of the recession. Given the large share of labor costs in the production costs of most firms, subdued unit labor costs should be an important restraining influence on inflation.

Monetary policy

Although the FOMC expects a moderate recovery to continue and indeed to strengthen over time, the Committee has responded to recent developments – as I have already noted – by marking down its outlook for economic growth over coming quarters. The Committee also continues to anticipate that inflation will moderate over time, to a rate at or below the 2 percent or a bit less that most FOMC participants consider to be consistent with the Committee's dual mandate to promote maximum employment and price stability.

Given this outlook, the Committee decided at its August meeting to provide more specific forward guidance about its expectations for the future path of the federal funds rate. In particular, the statement following the meeting indicated that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. That is, in what the Committee judges to be the most likely scenarios for resource utilization and inflation in the medium term, the target for the federal funds rate would be held at its current low level for at least two more years.

In addition to refining our forward guidance, the Federal Reserve has a range of tools that could be used to provide additional monetary stimulus. We discussed the relative merits and costs of such tools at our August meeting. My FOMC colleagues and I will continue to consider those and other pertinent issues, including, of course, economic and financial developments, at our meeting in September and are prepared to employ these tools as appropriate to promote a stronger economic recovery in a context of price stability.

Conclusion

Let me conclude with just a few words on the longer-term prospects for our economy. As monetary and fiscal policymakers consider the appropriate policies to address the economy's current weaknesses, it is important to acknowledge its enduring strengths. Notwithstanding the trauma of the crisis and the recession, the U.S. economy remains the largest in the world, with a highly diverse mix of industries and a degree of international competitiveness that, if anything, has improved in recent years. Our economy retains its traditional advantages of a strong market orientation, a robust entrepreneurial culture, and flexible capital and labor markets. And our country remains a technological leader, with many of the world's leading research universities and the highest spending on research and development of any nation. Thus I do not expect the long-run growth potential of the U.S. economy to be materially affected by the financial crisis and the recession if – and I stress *if* – our country takes the necessary steps to secure that outcome. Economic policymakers face a range of difficult decisions, and every household and business must cope with the stresses and uncertainties that our current situation presents. These are not easy tasks. I have no doubt, however, that those challenges can be met, and that the fundamental strengths of our economy will ultimately reassert themselves. The Federal Reserve will certainly do all that it can to help restore high rates of growth and employment in a context of price stability.