Ben S Bernanke: The economic outlook and the federal budget situation

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on the Budget, US House of Representatives, Washington DC, 2 February 2012.

*   *   *

Chairman Ryan, Vice Chairman Garrett, Ranking Member Van Hollen, and other members of the Committee, I appreciate this opportunity to discuss my views on the economic outlook, monetary policy, and the challenges facing federal fiscal policymakers.

The economic outlook

Over the past two and a half years, the U.S. economy has been gradually recovering from the recent deep recession. While conditions have certainly improved over this period, the pace of the recovery has been frustratingly slow, particularly from the perspective of the millions of workers who remain unemployed or underemployed. Moreover, the sluggish expansion has left the economy vulnerable to shocks. Indeed, last year, supply chain disruptions stemming from the earthquake in Japan, a surge in the prices of oil and other commodities, and spillovers from the European debt crisis risked derailing the recovery. Fortunately, over the past few months, indicators of spending, production, and job market activity have shown some signs of improvement; and, in economic projections just released, Federal Open Market Committee (FOMC) participants indicated that they expect somewhat stronger growth this year than in 2011. The outlook remains uncertain, however, and close monitoring of economic developments will remain necessary.

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. Although real consumer spending rose moderately last quarter, households continue to face significant headwinds. Notably, real household income and wealth stagnated in 2011, and access to credit remained tight for many potential borrowers. Consumer sentiment has improved from the summer's depressed levels but remains at levels that are still quite low by historical standards.

Household spending will depend heavily on developments in the labor market. Overall, the jobs situation does appear to have improved modestly over the past year: Private payroll employment increased by about 160,000 jobs per month in 2011, the unemployment rate fell by about 1 percentage point, and new claims for unemployment insurance declined somewhat. Nevertheless, as shown by indicators like the rate of unemployment and the ratio of employment to population, we still have a long way to go before the labor market can be said to be operating normally. Particularly troubling is the unusually high level of long-term unemployment: More than 40 percent of the unemployed have been jobless for more than six months, roughly double the fraction during the economic expansion of the previous decade.

Uncertain job prospects, along with tight mortgage credit conditions, continue to hold back the demand for housing. Although low interest rates on conventional mortgages and the drop in home prices in recent years have greatly improved the affordability of housing, both residential sales and construction remain depressed. A persistent excess supply of vacant homes, largely stemming from foreclosures, is keeping downward pressure on prices and limiting the demand for new construction.

In contrast to the household sector, the business sector has been a relative bright spot in the current recovery. Manufacturing production has increased 15 percent since its trough, and capital spending by businesses has expanded briskly over the past two years, driven in part by the need to replace aging equipment and software. Moreover, many U.S. firms, notably in manufacturing but also in services, have benefited from strong demand from foreign markets over the past few years.

More recently, the pace of growth in business investment has slowed, likely reflecting concerns about both the domestic outlook and developments in Europe. However, there are signs that these concerns are abating somewhat. If business confidence continues to improve, U.S. firms should be well positioned to increase both capital spending and hiring: Larger businesses are still able to obtain credit at historically low interest rates, and corporate balance sheets are strong. And, though many smaller businesses continue to face difficulties in obtaining credit, surveys indicate that credit conditions have begun to improve modestly for those firms as well.

Globally, economic activity appears to be slowing, restrained in part by spillovers from fiscal and financial developments in Europe. The combination of high debt levels and weak growth prospects in a number of European countries has raised significant concerns about their fiscal situations, leading to substantial increases in sovereign borrowing costs, concerns about the health of European banks, and associated reductions in confidence and the availability of credit in the euro area. Resolving these problems will require concerted action on the part of European authorities. They are working hard to address their fiscal and financial challenges. Nonetheless, risks remain that developments in Europe or elsewhere may unfold unfavorably and could worsen economic prospects here at home. We are in frequent contact with European authorities, and we will continue to monitor the situation closely and take every available step to protect the U.S. financial system and the economy.

Let me now turn to a discussion of inflation. As we had anticipated, overall consumer price inflation moderated considerably over the course of 2011. In the first half of the year, a surge in the prices of gasoline and food – along with some pass-through of these higher prices to other goods and services – had pushed consumer inflation higher. Around the same time, supply disruptions associated with the disaster in Japan put upward pressure on motor vehicle prices. As expected, however, the impetus from these influences faded in the second half of the year, leading inflation to decline from an annual rate of about 3–1/2 percent in the first half of 2011 to about 1–1/2 percent in the second half – close to its average pace in the preceding two years. In an environment of well-anchored inflation expectations, more-stable commodity prices, and substantial slack in labor and product markets, we expect inflation to remain subdued.

Against that backdrop, the Federal Open Market Committee (FOMC) decided last week to maintain its highly accommodative stance of monetary policy. In particular, the Committee decided to continue its program to extend the average maturity of its securities holdings, to maintain its existing policy of reinvesting principal payments on its portfolio of securities, and to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee now anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014.

As part of our ongoing effort to increase the transparency and predictability of monetary policy, following its January meeting the FOMC released a statement intended to provide greater clarity about the Committee's longer-term goals and policy strategy.[1] The statement begins by emphasizing the Federal Reserve's firm commitment to pursue its congressional mandate to foster stable prices and maximum employment. To clarify how it seeks to achieve these objectives, the FOMC stated its collective view that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate; and it indicated that the central tendency of FOMC participants' current estimates of the longer-run

[1] Board of Governors of the Federal Reserve System (2012), "*Federal Reserve Issues FOMC Statement of Longer-Run Goals and Policy Strategy*," press release, January 25.

normal rate of unemployment is between 5.2 and 6.0 percent. The statement noted that these statutory objectives are generally complementary, but when they are not, the Committee will take a balanced approach in its efforts to return both inflation and employment to their desired levels.

Fiscal policy challenges

In the remainder of my remarks, I would like to briefly discuss the fiscal challenges facing your Committee and the country. The federal budget deficit widened appreciably with the onset of the recent recession, and it has averaged around 9 percent of gross domestic product (GDP) over the past three fiscal years. This exceptional increase in the deficit has mostly reflected the automatic cyclical response of revenues and spending to a weak economy as well as the fiscal actions taken to ease the recession and aid the recovery. As the economy continues to expand and stimulus policies are phased out, the budget deficit should narrow over the next few years.

Unfortunately, even after economic conditions have returned to normal, the nation will still face a sizable structural budget gap if current budget policies continue. Using information from the recent budget outlook by the Congressional Budget Office, one can construct a projection for the federal deficit assuming that most expiring tax provisions are extended and that Medicare's physician payment rates are held at their current level. Under these assumptions, the budget deficit would be more than 4 percent of GDP in fiscal year 2017, assuming that the economy is then close to full employment.[2] Of even greater concern is that longer-run projections, based on plausible assumptions about the evolution of the economy and budget under current policies, show the structural budget gap increasing significantly further over time and the ratio of outstanding federal debt to GDP rising rapidly. This dynamic is clearly unsustainable.

These structural fiscal imbalances did not emerge overnight. To a significant extent, they are the result of an aging population and, especially, fast-rising health-care costs, both of which have been predicted for decades. Notably, the Congressional Budget Office projects that net federal outlays for health-care entitlements – which were about 5 percent of GDP in fiscal 2011 – could rise to more than 9 percent of GDP by 2035.[3] Although we have been warned about such developments for many years, the time when projections become reality is coming closer.

Having a large and increasing level of government debt relative to national income runs the risk of serious economic consequences. Over the longer term, the current trajectory of federal debt threatens to crowd out private capital formation and thus reduce productivity growth. To the extent that increasing debt is financed by borrowing from abroad, a growing share of our future income would be devoted to interest payments on foreign-held federal debt. High levels of debt also impair the ability of policymakers to respond effectively to future economic shocks and other adverse events.

---

2 The Congressional Budget Office (CBO) reported an "alternative fiscal scenario" (Table 1–7, p. 22) that assumed that most expiring tax cuts and the Medicare "doc fix" would be extended and also that the automatic spending reductions required by the Budget Control Act (BCA) would not take effect; under this scenario the deficit would be about 5 percent of GDP in fiscal 2017. If the automatic spending cuts from the BCA, however, are assumed to be put in place (the effects of which are shown in Table 1–6, p. 18) then the deficit would be more than 4 percent in fiscal 2017. See Congressional Budget Office (2012), *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*. Washington: Congressional Budget Office, January.

3 This projection is under the alternative fiscal scenario developed by the Congressional Budget Office, which assumes most current policies are extended. See Congressional Budget Office (2011). *The Long-Term Budget Outlook*. Washington: Congressional Budget Office.

Even the prospect of unsustainable deficits has costs, including an increased possibility of a sudden fiscal crisis. As we have seen in a number of countries recently, interest rates can soar quickly if investors lose confidence in the ability of a government to manage its fiscal policy. Although historical experience and economic theory do not indicate the exact threshold at which the perceived risks associated with the U.S. public debt would increase markedly, we can be sure that, without corrective action, our fiscal trajectory will move the nation ever closer to that point.

To achieve economic and financial stability, U.S. fiscal policy must be placed on a sustainable path that ensures that debt relative to national income is at least stable or, preferably, declining over time. Attaining this goal should be a top priority.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, they should take care not to unnecessarily impede the current economic recovery. Fortunately, the two goals of achieving long-term fiscal sustainability and avoiding additional fiscal headwinds for the current recovery are fully compatible – indeed, they are mutually reinforcing. On the one hand, a more robust recovery will lead to lower deficits and debt in coming years. On the other hand, a plan that clearly and credibly puts fiscal policy on a path to sustainability could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

Fiscal policymakers can also promote stronger economic performance in the medium term through the careful design of tax policies and spending programs. To the fullest extent possible, our nation's tax and spending policies should increase incentives to work and save, encourage investments in the skills of our workforce, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. Although we cannot expect our economy to grow its way out of our fiscal imbalances, a more productive economy will ease the tradeoffs that we face and increase the likelihood that we leave a healthy economy to our children and grandchildren.