Board of Governors of the Federal Reserve System

Testimony

Chairman Ben S. Bernanke

Semiannual Monetary Policy Report to the Congress

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

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Chairman Bernanke presented identical remarks before the Committee on Financial Services, U.S. House of Representatives on February 27, 2013

Chairman Johnson, Ranking Member Crapo, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report*. I will begin with a short summary of current economic conditions and then discuss aspects of monetary and fiscal policy.

Current Economic Conditions
Since I last reported to this Committee in mid-2012, economic activity in the United States has continued to expand at a moderate if somewhat uneven pace. In particular, real gross domestic product (GDP) is estimated to have risen at an annual rate of about 3 percent in the third quarter but to have been essentially flat in the fourth quarter.[1] The pause in real GDP growth last quarter does not appear to reflect a stalling-out of the recovery. Rather, economic activity was temporarily restrained by weather-related disruptions and by transitory declines in a few volatile categories of spending, even as demand by U.S. households and businesses continued to expand. Available information suggests that economic growth has picked up again this year.

Consistent with the moderate pace of economic growth, conditions in the labor market have been improving gradually. Since July, nonfarm payroll employment has increased by 175,000 jobs per month on average, and the unemployment rate declined 0.3 percentage point to 7.9 percent over the same period. Cumulatively, private-sector payrolls have now grown by about 6.1 million jobs since their low point in early 2010, and the unemployment rate has fallen a bit more than 2 percentage points since its cyclical peak in late 2009. Despite these gains, however, the job market remains generally weak, with the unemployment rate well above its longer-run normal level. About 4.7 million of the unemployed have been without a job for six months or more, and millions more would like full-time employment but are able to find only part-time work. High unemployment has substantial costs, including not only the hardship faced by the unemployed and their families, but also the harm done to the vitality and productive potential of our economy as a whole. Lengthy periods of unemployment and underemployment can erode workers' skills and attachment to the labor force or prevent young people from gaining skills and experience in the first place--developments that could significantly reduce their productivity and earnings in the longer term. The loss of output and earnings associated with high unemployment also reduces government revenues and increases spending, thereby leading to larger deficits and higher levels of debt.

The recent increase in gasoline prices, which reflects both higher crude oil prices and wider refining margins, is hitting family budgets. However, overall inflation remains low. Over the second half of 2012, the price index for personal consumption expenditures rose at an annual rate of 1-1/2 percent, similar to the rate of increase in the first half of the year. Measures of longer-term inflation expectations have remained in the narrow ranges seen over the past several years. Against this backdrop, the Federal Open Market Committee (FOMC) anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

Monetary Policy

With unemployment well above normal levels and inflation subdued, progress toward the Federal Reserve's mandated objectives of maximum employment and price stability has required a highly accommodative monetary policy. Under normal circumstances, policy accommodation would be provided through reductions in the FOMC's target for the federal funds rate--the interest rate on overnight loans between banks. However, as this rate has been close to zero since December 2008, the Federal Reserve has had to use alternative policy tools.

These alternative tools have fallen into two categories. The first is "forward guidance" regarding the FOMC's anticipated path for the federal funds rate. Since longer-term interest rates reflect market expectations for shorter-term rates over time, our guidance influences longer-term rates and thus supports a stronger recovery. The formulation of this guidance has evolved over time. Between August 2011 and December 2012, the Committee used calendar dates to indicate how long it expected economic conditions to warrant exceptionally low levels for the federal funds rate. At its December 2012 meeting, the FOMC agreed to shift to providing more explicit guidance on how it expects the policy rate to respond to economic developments. Specifically, the December postmeeting statement indicated that the current exceptionally low range for the federal funds rate "will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."[2] An advantage of the new formulation, relative to the previous date-based guidance, is that it allows market participants and the public to update their monetary policy expectations more accurately in response to new information about the economic outlook. The new guidance also serves to underscore the Committee's intention to maintain accommodation as long as needed to promote a stronger economic recovery with stable prices.[3]

The second type of nontraditional policy tool employed by the FOMC is large-scale purchases of longer-term securities, which, like our forward guidance, are intended to support economic growth by putting downward pressure on longer-term interest rates. The Federal Reserve has engaged in several rounds of such purchases since late 2008. Last September the FOMC announced that it would purchase agency mortgage-backed securities at a pace of $40 billion per month, and in December the Committee stated that, in addition, beginning in January it would purchase longer-term Treasury securities at an initial pace of $45 billion per month.[4] These additional purchases of longer-term Treasury securities replace the purchases we were conducting under our now-completed maturity extension program, which lengthened the maturity of our securities portfolio without increasing its size. The FOMC has indicated that it will continue purchases until it observes a substantial improvement in the outlook for the labor market in a context of price stability.

The Committee also stated that in determining the size, pace, and composition of its asset purchases, it will take appropriate account of their likely efficacy and costs. In other words, as with all of its policy decisions, the Committee continues to assess its program of asset purchases within a cost-benefit framework. In the current economic environment, the benefits of asset purchases, and of policy accommodation more generally, are clear: Monetary policy is providing important support to the recovery while keeping inflation close to the FOMC's 2 percent objective. Notably, keeping longer-term interest rates low has helped spark recovery in the housing market and led to increased sales and production of automobiles and other durable goods. By raising employment and household wealth--for example, through higher home prices--these developments have in turn supported consumer sentiment and spending.

Highly accommodative monetary policy also has several potential costs and risks, which the

Committee is monitoring closely. For example, if further expansion of the Federal Reserve's balance sheet were to undermine public confidence in our ability to exit smoothly from our accommodative policies at the appropriate time, inflation expectations could rise, putting the FOMC's price-stability objective at risk. However, the Committee remains confident that it has the tools necessary to tighten monetary policy when the time comes to do so. As I noted, inflation is currently subdued, and inflation expectations appear well anchored; neither the FOMC nor private forecasters are projecting the development of significant inflation pressures.

Another potential cost that the Committee takes very seriously is the possibility that very low interest rates, if maintained for a considerable time, could impair financial stability. For example, portfolio managers dissatisfied with low returns may "reach for yield" by taking on more credit risk, duration risk, or leverage. On the other hand, some risk-taking--such as when an entrepreneur takes out a loan to start a new business or an existing firm expands capacity--is a necessary element of a healthy economic recovery. Moreover, although accommodative monetary policies may increase certain types of risk-taking, in the present circumstances they also serve in some ways to reduce risk in the system, most importantly by strengthening the overall economy, but also by encouraging firms to rely more on longer-term funding, and by reducing debt service costs for households and businesses. In any case, the Federal Reserve is responding actively to financial stability concerns through substantially expanded monitoring of emerging risks in the financial system, an approach to the supervision of financial firms that takes a more systemic perspective, and the ongoing implementation of reforms to make the financial system more transparent and resilient. Although a long period of low rates could encourage excessive risk-taking, and continued close attention to such developments is certainly warranted, to this point we do not see the potential costs of the increased risk-taking in some financial markets as outweighing the benefits of promoting a stronger economic recovery and more-rapid job creation.[5]

Another aspect of the Federal Reserve's policies that has been discussed is their implications for the federal budget. The Federal Reserve earns substantial interest on the assets it holds in its portfolio, and, other than the amount needed to fund our cost of operations, all net income is remitted to the Treasury. With the expansion of the Federal Reserve's balance sheet, yearly remittances have roughly tripled in recent years, with payments to the Treasury totaling approximately $290 billion between 2009 and 2012.[6] However, if the economy continues to strengthen, as we anticipate, and policy accommodation is accordingly reduced, these remittances would likely decline in coming years. Federal Reserve analysis shows that remittances to the Treasury could be quite low for a time in some scenarios, particularly if interest rates were to rise quickly.[7] However, even in such scenarios, it is highly likely that average annual remittances over the period affected by the Federal Reserve's purchases will remain higher than the pre-crisis norm, perhaps substantially so. Moreover, to the extent that monetary policy promotes growth and job creation, the resulting reduction in the federal deficit would dwarf any variation in the Federal Reserve's remittances to the Treasury.

Thoughts on Fiscal Policy

Although monetary policy is working to promote a more robust recovery, it cannot carry the entire burden of ensuring a speedier return to economic health. The economy's performance both over the near term and in the longer run will depend importantly on the course of fiscal policy. The challenge for the Congress and the Administration is to put the federal budget on a sustainable long-run path that promotes economic growth and stability without unnecessarily impeding the current recovery.

Significant progress has been made recently toward reducing the federal budget deficit over the next few years. The projections released earlier this month by the Congressional Budget Office (CBO) indicate that, under current law, the federal deficit will narrow from 7 percent of GDP last year to 2-1/2 percent in fiscal year 2015.[8] As a result, the federal debt held by the public (including that held by the Federal Reserve) is projected to remain roughly 75 percent of GDP through much of the current decade.

However, a substantial portion of the recent progress in lowering the deficit has been concentrated in near-term budget changes, which, taken together, could create a significant headwind for the economic recovery. The CBO estimates that deficit-reduction policies in current law will slow the pace of real GDP growth by about 1-1/2 percentage points this year, relative to what it would have been otherwise. A significant portion of this effect is related to the automatic spending sequestration that is scheduled to begin on March 1, which, according to the CBO's estimates, will contribute about 0.6 percentage point to the fiscal drag on economic growth this year. Given the still-moderate underlying pace of economic growth, this additional near-term burden on the recovery is significant. Moreover, besides having adverse effects on jobs and incomes, a slower recovery would lead to less actual deficit reduction in the short run for any given set of fiscal actions.

At the same time, and despite progress in reducing near-term budget deficits, the difficult process of addressing longer-term fiscal imbalances has only begun. Indeed, the CBO projects that the federal deficit and debt as a percentage of GDP will begin rising again in the latter part of this decade, reflecting in large part the aging of the population and fast-rising health-care costs. To promote economic growth in the longer term, and to preserve economic and financial stability, fiscal policymakers will have to put the federal budget on a sustainable long-run path that first stabilizes the ratio of federal debt to GDP and, given the current elevated level of debt, eventually places that ratio on a downward trajectory. Between 1960 and the onset of the financial crisis, federal debt averaged less than 40 percent of GDP. This relatively low level of debt provided the nation much-needed flexibility to meet the economic challenges of the past few years. Replenishing this fiscal capacity will give future Congresses and Administrations greater scope to deal with unforeseen events.

To address both the near- and longer-term issues, the Congress and the Administration should consider replacing the sharp, frontloaded spending cuts required by the sequestration with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run. Such an approach could lessen the near-term fiscal headwinds facing the recovery while more effectively addressing the longer-term imbalances in the federal budget.

The sizes of deficits and debt matter, of course, but not all tax and spending programs are created equal with respect to their effects on the economy. To the greatest extent possible, in their efforts to achieve sound public finances, fiscal policymakers should not lose sight of the need for federal tax and spending policies that increase incentives to work and save, encourage investments in workforce skills, advance private capital formation, promote research and development, and provide necessary and productive public infrastructure. Although economic growth alone cannot eliminate federal budget imbalances, in either the short or longer term, a more rapidly expanding economic pie will ease the difficult choices we face.

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1. Data for the fourth quarter of 2012 from the national income and product accounts reflect the advance estimate released on January 30, 2013. Return to text

2. See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Issues FOMC Statement," press release, December 12. Return to text

3. The numerical values for unemployment and inflation included in the guidance are thresholds, not triggers; that is, depending on economic circumstances at the time, the Committee may judge that it is not appropriate to begin raising its target for the federal funds rate as soon as one or both of the thresholds is reached. The 6-1/2 percent threshold for the unemployment rate should not be interpreted as the Committee's longer-term objective for unemployment; because monetary policy affects the economy with a lag, the first increase in the target for the funds rate will likely have to occur when the unemployment rate is still above its longer-run normal level. Likewise, the Committee has not altered its longer-run goal for inflation of 2 percent, and it neither seeks nor

expects a persistent increase in inflation above that target. Return to text

4. See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Issues FOMC Statement," press release, September 13; and Board of Governors, "FOMC Statement," December 12, in note 2. Return to text

5. The Federal Reserve is also monitoring financial markets to ensure that asset purchases do not impair their functioning. Return to text

6. See Board of Governors of the Federal Reserve System (2013), "Reserve Bank Income and Expense Data and Transfers to the Treasury for 2012," press release, January 10. Return to text

7. See Carpenter, Seth B., Jane E. Ihrig, Elizabeth C. Klee, Daniel W. Quinn, and Alexander H. Boote (2013), "The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections (PDF)," Finance and Economics Discussion Series 2013-01 (Washington: Federal Reserve Board, January). Return to text

8. See Congressional Budget Office (2013), *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (Washington: CBO, February). Return to text

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