

For release on delivery
10:00 a.m. EDT
June 9, 2010

Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on the Budget

U.S. House of Representatives

Washington, D.C.

June 9, 2010

Chairman Spratt, Ranking Member Ryan, and other members of the Committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the federal budget.

The Economic Outlook

The recovery in economic activity that began in the second half of last year has continued at a moderate pace so far this year. Moreover, the economy--supported by stimulative monetary policy and the concerted efforts of policymakers to stabilize the financial system--appears to be on track to continue to expand through this year and next. The latest economic projections of Federal Reserve Governors and Reserve Bank presidents, which were made near the end of April, anticipate that real gross domestic product (GDP) will grow in the neighborhood of 3-1/2 percent over the course of 2010 as a whole and at a somewhat faster pace next year.¹ This pace of growth, were it to be realized, would probably be associated with only a slow reduction in the unemployment rate over time. In this environment, inflation is likely to remain subdued.

Although the support to economic growth from fiscal policy is likely to diminish in the coming year, the incoming data suggest that gains in private final demand will sustain the recovery in economic activity. Real consumer spending has risen at an annual rate of nearly 3-1/2 percent so far this year, with particular strength in the highly cyclical category of durable goods. Consumer spending is likely to increase at a moderate pace going forward, supported by a gradual pickup in employment and income, greater consumer confidence, and some improvement in credit conditions.

¹ See "Summary of Economic Projections," an addendum to the April Federal Open Market Committee minutes, available at Board of Governors of the Federal Reserve System (2010), "Minutes of the Federal Open Market Committee, April 27-28, 2010," press release, May 19, www.federalreserve.gov/newsevents/press/monetary/20100519a.htm.

In the business sector, real outlays for equipment and software posted another solid gain in the first quarter, and the increases were more broadly based than in late 2009; the available indicators point to continued strength in the second quarter. Looking forward, investment in new equipment and software is expected to be supported by healthy corporate balance sheets, relatively low costs of financing of new projects, increased confidence in the durability of the recovery, and the need of many businesses to replace aging equipment and expand capacity as sales prospects brighten. More generally, U.S. manufacturing output, which has benefited from strong export demand, rose at an annual rate of 9 percent over the first four months of the year.

At the same time, significant restraints on the pace of the recovery remain. In the housing market, sales and construction have been temporarily boosted lately by the homebuyer tax credit. But looking through these temporary movements, underlying housing activity appears to have firmed only a little since mid-2009, with activity being weighed down, in part, by a large inventory of distressed or vacant existing houses and by the difficulties of many builders in obtaining credit. Spending on nonresidential buildings also is being held back by high vacancy rates, low property prices, and strained credit conditions. Meanwhile, pressures on state and local budgets, though tempered somewhat by ongoing federal support, have led these governments to make further cuts in employment and construction spending.

As you know, the labor market was hit particularly hard by the recession, but we have begun to see some modest improvement recently in employment, hours of work, and labor income. Payroll employment rose by 431,000 in May, but that figure importantly reflected an increase of 411,000 in hiring for the decennial census. Private payroll employment has risen an average of 140,000 per month for the past three months, and expectations of both businesses and households about hiring prospects have improved since the beginning of the year. In all

likelihood, however, a significant amount of time will be required to restore the nearly 8-1/2 million jobs that were lost over 2008 and 2009.

On the inflation front, recent data continue to show a subdued rate of increase in consumer prices. For the three months ended in April, the price index for personal consumption expenditures rose at an annual rate of just 1/2 percent, as energy prices declined and the index excluding food and energy rose at an annual rate of about 1 percent. Over the past two years, overall consumer prices have fluctuated in response to large swings in energy and food prices. But aside from these volatile components, a moderation in inflation has been clear and broadly based over this period. To date, long-run inflation expectations have been stable, with most survey-based measures remaining within the narrow ranges that have prevailed for the past few years. Measures based on nominal and indexed Treasury yields have decreased somewhat of late, but at least part of these declines reflect market responses to changes in the financial situation in Europe, to which I now turn.

Developments in Europe

Since late last year, market concerns have mounted over the ability of Greece and a number of other euro-area countries to manage their sizable budget deficits and high levels of public debt. By early May, financial strains had increased significantly as investors focused on several interrelated issues, including whether the fiscally stronger euro-area governments would provide financial support to the weakest members, the extent to which euro-area growth would be slowed by efforts at fiscal consolidation, and the extent of exposure of major European financial institutions to vulnerable countries.

U.S. financial markets have been roiled in recent weeks by these developments, which have triggered a reduction in demand for risky assets: Broad equity market indexes have

declined, and implied volatility has risen considerably. Treasury yields have fallen as much as 50 basis points since late April, primarily as a result of safe-haven flows that boosted the demand for Treasury securities. Corporate spreads have widened over the same period, and some issuance of corporate bonds has been postponed, especially by speculative-grade issuers.

In response to these concerns, European leaders have put in place a number of strong measures. Countries under stress have committed to address their fiscal problems. A major assistance package has been established jointly by the European Union (EU) and the International Monetary Fund (IMF) for Greece. To backstop near-term financing needs of its members more generally, the EU has established a European Financial Stabilization Mechanism with up to 500 billion euros in funding, which could be used in tandem with significant bilateral support from the IMF. EU leaders are also discussing proposals to tighten surveillance of members' fiscal performance and improve the design of the EU's fiscal support mechanisms.

In addition, to address strains in European financial markets, the European Central Bank (ECB) has begun purchasing debt securities in markets that it sees as malfunctioning, and has resumed auctions of three- and six-month loans of euros in unlimited quantities to borrowers with appropriate collateral. To help ease strains in U.S. dollar funding markets, the Federal Reserve has reestablished temporary U.S. dollar liquidity swap lines with the ECB and other major central banks. To date, drawings under these swap lines remain quite limited and far below their peaks reached at the height of the financial crisis in late 2008, but they are nevertheless providing an important backstop for the functioning of dollar funding markets. More generally, our ongoing international cooperation sends an important signal to global financial markets that we will take the actions necessary to ensure stability and continued economic recovery.

The actions taken by European leaders represent a firm commitment to resolve the prevailing stresses and restore market confidence and stability. If markets continue to stabilize, then the effects of the crisis on economic growth in the United States seem likely to be modest. Although the recent fall in equity prices and weaker economic prospects in Europe will leave some imprint on the U.S. economy, offsetting factors include declines in interest rates on Treasury bonds and home mortgages as well as lower prices for oil and some other globally traded commodities. The Federal Reserve will remain highly attentive to developments abroad and to their potential effects on the U.S. economy.

Fiscal Sustainability

Ongoing developments in Europe point to the importance of maintaining sound government finances. In many ways, the United States enjoys a uniquely favored position. Our economy is large, diversified, and flexible; our financial markets are deep and liquid; and, as I have mentioned, in the midst of financial turmoil, global investors have viewed Treasury securities as a safe haven. Nevertheless, history makes clear that failure to achieve fiscal sustainability will, over time, sap the nation's economic vitality, reduce our living standards, and greatly increase the risk of economic and financial instability.

Our nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. The exceptional increase in the deficit has in large part reflected the effects of the weak economy on tax revenues and spending, along with the necessary policy actions taken to ease the recession and steady financial markets. As the economy and financial markets continue to recover, and as the actions taken to provide economic stimulus and promote financial stability are phased out, the budget deficit should narrow over the next few years.

Even after economic and financial conditions have returned to normal, however, in the absence of further policy actions, the federal budget appears to be on an unsustainable path. A variety of projections that extrapolate current policies and make plausible assumptions about the future evolution of the economy show a structural budget gap that is both large relative to the size of the economy and increasing over time.

Among the primary forces putting upward pressure on the deficit is the aging of the U.S. population, as the number of persons expected to be working and paying taxes into various programs is rising more slowly than the number of persons projected to receive benefits. Notably, this year about 5 individuals are between the ages of 20 and 64 for each person aged 65 or older. By the time most of the baby boomers have retired in 2030, this ratio is projected to have declined to around 3. In addition, government expenditures on health care for both retirees and non-retirees have continued to rise rapidly as increases in the costs of care have exceeded increases in incomes. To avoid sharp, disruptive shifts in spending programs and tax policies in the future, and to retain the confidence of the public and the markets, we should be planning now how we will meet these looming budgetary challenges.

Achieving long-term fiscal sustainability will be difficult. But unless we as a nation make a strong commitment to fiscal responsibility, in the longer run, we will have neither financial stability nor healthy economic growth.