For release on delivery
9:30 a.m EST
January 7, 2011

Statement by

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before the

Committee on the Budget

United States Senate

Washington, D.C.

January 7, 2011

Chairman Conrad, Senator Sessions, and other members of the Committee, thank you for this opportunity to offer my views on current economic conditions, recent monetary policy actions, and issues related to the federal budget.

The Economic Outlook

The economic recovery that began a year and a half ago is continuing, although, to date, at a pace that has been insufficient to reduce the rate of unemployment significantly.[1] The initial stages of the recovery, in the second half of 2009 and in early 2010, were largely attributable to the stabilization of the financial system, expansionary monetary and fiscal policies, and a powerful inventory cycle. Growth slowed somewhat this past spring as the impetus from fiscal policy and inventory building waned and as European sovereign debt problems led to increased volatility in financial markets.

More recently, however, we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold. In particular, real consumer spending rose at an annual rate of 2-1/2 percent in the third quarter of 2010, and the available indicators suggest that it likely expanded at a somewhat faster pace in the fourth quarter. Business investment in new equipment and software has grown robustly in recent quarters, albeit from a fairly low level, as firms replaced aging equipment and made investments that had been delayed during the downturn. However, the housing sector remains depressed, as the overhang of vacant houses continues to weigh heavily on both home prices and construction, and nonresidential construction is also quite weak. Overall, the pace of economic recovery seems likely to be moderately stronger in 2011 than it was in 2010.

[1] This testimony was submitted before this morning's employment report for December, which will provide an important update on the state of the labor market.

Although recent indicators of spending and production have generally been encouraging, conditions in the labor market have improved only modestly at best. After the loss of nearly 8-1/2 million jobs in 2008 and 2009, private payrolls expanded at an average of only about 100,000 per month in 2010--a pace barely enough to accommodate the normal increase in the labor force and, therefore, insufficient to materially reduce the unemployment rate.[2] On a more positive note, a number of indicators of job openings and hiring plans have looked stronger in recent months, and initial claims for unemployment insurance declined through November and December. Notwithstanding these hopeful signs, with output growth likely to be moderate in the next few quarters and employers reportedly still reluctant to add to payrolls, considerable time likely will be required before the unemployment rate has returned to a more normal level. Persistently high unemployment, by damping household income and confidence, could threaten the strength and sustainability of the recovery. Moreover, roughly 40 percent of the unemployed have been out of work for six months or more. Long-term unemployment not only imposes exceptional hardships on the jobless and their families, but it also erodes the skills of those workers and may inflict lasting damage on their employment and earnings prospects.

Recent data show consumer price inflation continuing to trend downward. For the 12 months ending in November, prices for personal consumption expenditures rose 1.0 percent, and inflation excluding the relatively volatile food and energy components--which tends to be a better gauge of underlying inflation trends--was only 0.8 percent, down from 1.7 percent a year earlier and from about 2-1/2 percent in 2007, the year before the recession began. The downward trend in inflation over the past few years is no surprise, given the low rates of resource utilization that have prevailed over that time. Indeed, as a result of the weak job market, wage growth has slowed along with inflation; over the 12 months ending in November,

[2] Average job gains for 2010 are through November.

average hourly earnings have risen only 1.6 percent. Despite the decline in inflation, long-run inflation expectations have remained stable; for example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With inflation expectations stable, and with levels of resource utilization expected to remain low, inflation is likely to be subdued for some time.

Monetary Policy

Although it is likely that economic growth will pick up this year and that the unemployment rate will decline somewhat, progress toward the Federal Reserve's statutory objectives of maximum employment and stable prices is expected to remain slow. The projections submitted by Federal Open Market Committee (FOMC) participants in November showed that, notwithstanding forecasts of increased growth in 2011 and 2012, most participants expected the unemployment rate to be close to 8 percent two years from now. At this rate of improvement, it could take four to five more years for the job market to normalize fully.

FOMC participants also projected inflation to be at historically low levels for some time. Very low rates of inflation raise several concerns: First, very low inflation increases the risk that new adverse shocks could push the economy into deflation, that is, a situation involving ongoing declines in prices. Experience shows that deflation induced by economic slack can lead to extended periods of poor economic performance; indeed, even a significant perceived risk of deflation may lead firms to be more cautious about investment and hiring. Second, with short-term nominal interest rates already close to zero, declines in actual and expected inflation increase, respectively, both the real cost of servicing existing debt and the expected real cost of new borrowing. By raising effective debt burdens and by inhibiting new household spending and business investment, higher real borrowing costs create a further drag on growth. Finally, it is important to recognize that periods of very low inflation generally involve very slow growth in nominal wages and incomes as well as in prices. (I have already alluded to the recent deceleration in average hourly earnings.) Thus, in circumstances like those we face now, very low inflation or deflation does not necessarily imply any increase in household purchasing power. Rather, because of the associated deterioration in economic performance, very low inflation or deflation arising from economic slack is generally linked with reductions rather than gains in living standards.

In a situation in which unemployment is high and expected to remain so and inflation is unusually low, the FOMC would normally respond by reducing its target for the federal funds rate. However, the Federal Reserve's target for the federal funds rate has been close to zero since December 2008, leaving essentially no scope for further reductions. Consequently, for the past two years the FOMC has been using alternative tools to provide additional monetary accommodation. Notably, between December 2008 and March 2010, the FOMC purchased about $1.7 trillion in longer-term Treasury and agency-backed securities in the open market. The proceeds of these purchases ultimately find their way into the banking system, with the result that depository institutions now hold a high level of reserve balances with the Federal Reserve.

Although longer-term securities purchases are a different tool for conducting monetary policy than the more familiar approach of managing the overnight interest rate, the goals and transmission mechanisms of the two approaches are similar. Conventional monetary policy works by changing market expectations for the future path of short-term interest rates, which, in turn, influences the current level of longer-term interest rates and other financial conditions. These changes in financial conditions then affect household and business spending. By contrast, securities purchases by the Federal Reserve put downward pressure directly on longer-term interest rates by reducing the stock of longer-term securities held by private investors.[3] These actions affect private-sector spending through the same channels as conventional monetary policy. In particular, the Federal Reserve's earlier program of asset purchases appeared to be successful in influencing longer-term interest rates, raising the prices of equities and other assets, and improving credit conditions more broadly, thereby helping stabilize the economy and support the recovery.

In light of this experience, and with the economic outlook still unsatisfactory, late last summer the FOMC began to signal to financial markets that it was considering providing additional monetary policy accommodation by conducting further asset purchases. At its meeting in early November, the FOMC formally announced its intention to purchase an additional $600 billion in Treasury securities by the end of the second quarter of 2011, about one-third of the value of securities purchased in its earlier programs. The FOMC also maintained its policy, adopted at its August meeting, of reinvesting principal received on the Federal Reserve's holdings of securities.

The FOMC stated that it will review its asset purchase program regularly in light of incoming information and will adjust the program as needed to meet its objectives. Importantly, the Committee remains unwaveringly committed to price stability and, in particular, to maintaining inflation at a level consistent with the Federal Reserve's mandate from the Congress.[4] In that regard, it bears emphasizing that the Federal Reserve has all the tools it needs

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[3] More specifically, the Fed's purchases should tend to reduce term premiums, a component of the yield to longer-term securities. Longer-term interest rates are also influenced by market expectations of the future path for short-term interest rates, which in turn depend on the outlook for the economy and so for the target federal funds rate.

[4] Most Committee participants judge that, in the longer term, inflation in the range of 2 percent or a bit less appropriately balances the risk that adverse economic shocks could tip the economy into deflation against the benefits of low and stable inflation. An inflation rate modestly above zero also reduces the probability that monetary policymakers will be constrained from easing policy when necessary by the zero lower bound on nominal

to ensure that it will be able to smoothly and effectively exit from this program at the appropriate time. Importantly, the Federal Reserve's ability to pay interest on reserve balances held at the Federal Reserve Banks will allow it to put upward pressure on short-term market interest rates and thus to tighten monetary policy when needed, even if bank reserves remain high. Moreover, the Fed has invested considerable effort in developing methods to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation when conditions warrant. If necessary, the Committee could also tighten policy by redeeming or selling securities on the open market.

As I am appearing before the Budget Committee, it is worth emphasizing that the Fed's purchases of longer-term securities are not comparable to ordinary government spending. In executing these transactions, the Federal Reserve acquires financial assets, not goods and services. Ultimately, at the appropriate time, the Federal Reserve will normalize its balance sheet by selling these assets back into the market or by allowing them to mature. In the interim, the interest that the Federal Reserve earns from its securities holdings adds to the Fed's remittances to the Treasury; in 2009 and 2010, those remittances totaled about $120 billion.

Fiscal Policy

Fiscal policymakers also face a challenging policy environment. Our nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. To a significant extent, this deterioration is the result of the effects of the weak economy on revenues and outlays, along with the actions that were taken to ease the recession and steady financial markets. In their planning for the near term, fiscal policymakers will need to continue

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interest rates. Many central banks around the world have come to similar quantitative judgments about the long-run level of inflation that best fosters growth and stability.

to take into account the low level of economic activity and the still-fragile nature of the economic recovery.

However, an important part of the federal budget deficit appears to be structural rather than cyclical; that is, the deficit is expected to remain unsustainably elevated even after economic conditions have returned to normal. For example, under the Congressional Budget Office's (CBO) so-called alternative fiscal scenario, which assumes that most of the tax cuts enacted in 2001 and 2003 are made permanent and that discretionary spending rises at the same rate as the gross domestic product (GDP), the deficit is projected to fall from its current level of about 9 percent of GDP to 5 percent of GDP by 2015, but then to rise to about 6-1/2 percent of GDP by the end of the decade. In subsequent years, the budget outlook is projected to deteriorate even more rapidly, as the aging of the population and continued growth in health spending boost federal outlays on entitlement programs. Under this scenario, federal debt held by the public is projected to reach 185 percent of the GDP by 2035, up from about 60 percent at the end of fiscal year 2010.

The CBO projections, by design, ignore the adverse effects that such high debt and deficits would likely have on our economy. But if government debt and deficits were actually to grow at the pace envisioned in this scenario, the economic and financial effects would be severe. Diminishing confidence on the part of investors that deficits will be brought under control would likely lead to sharply rising interest rates on government debt and, potentially, to broader financial turmoil. Moreover, high rates of government borrowing would both drain funds away from private capital formation and increase our foreign indebtedness, with adverse long-run effects on U.S. output, incomes, and standards of living.

It is widely understood that the federal government is on an unsustainable fiscal path. Yet, as a nation, we have done little to address this critical threat to our economy. Doing nothing will not be an option indefinitely; the longer we wait to act, the greater the risks and the more wrenching the inevitable changes to the budget will be. By contrast, the prompt adoption of a credible program to reduce future deficits would not only enhance economic growth and stability in the long run, but could also yield substantial near-term benefits in terms of lower long-term interest rates and increased consumer and business confidence. Plans recently put forward by the President's National Commission on Fiscal Responsibility and Reform and other prominent groups provide useful starting points for a much-needed national conversation about our medium- and long-term fiscal situation. Although these various proposals differ on many details, each gives a sobering perspective on the size of the problem and offers some potential solutions.

Of course, economic growth is affected not only by the levels of taxes and spending, but also by their composition and structure. I hope that, in addressing our long-term fiscal challenges, the Congress will seek reforms to the government's tax policies and spending priorities that serve not only to reduce the deficit but also to enhance the long-term growth potential of our economy--for example, by encouraging investment in physical and human capital, by promoting research and development, by providing necessary public infrastructure, and by reducing disincentives to work and to save. We cannot grow out of our fiscal imbalances, but a more productive economy would ease the tradeoffs that we face.

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