

Chairman Ben S. Bernanke

Current economic and financial conditions and the federal budget

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Chairman Conrad, Senator Gregg, and members of the Committee, I am pleased to be here today to offer my views on current economic and financial conditions, the federal budget, and related issues.

Recent Financial and Economic Developments and the Policy Responses

Over the past 18 months, the global economy has experienced a period of extraordinary turbulence. The collapse of a global credit boom, triggered by the end of housing booms in the United States and other countries and the associated problems in mortgage markets, has led to a deterioration of asset values and credit conditions and taken a heavy toll on business and consumer confidence.

The financial crisis intensified considerably in the fall. In the United States, the government-sponsored enterprises, Fannie Mae and Freddie Mac, were placed into conservatorship, and Lehman Brothers Holdings and several other large financial institutions either failed, nearly failed, or were acquired by competitors under distressed circumstances. Losses at money market mutual funds led to large withdrawals by their investors, and those outflows undermined both the stability of short-term funding markets, particularly the commercial paper market, and confidence in wholesale bank funding markets.

In early October, the loss of investor confidence in financial institutions around the world raised the prospect of an international financial collapse, an event that would have been devastating for global economic prospects. Using authorities granted by the Emergency Economic Stabilization Act, on October 14, the Treasury announced a plan to inject \$250 billion in capital into U.S. financial institutions. The Treasury's actions were complemented by the Federal Deposit Insurance Corporation's expansion of bank liability guarantees and by the expansive provision of liquidity by the Federal Reserve. Together with similar measures in other countries, these steps averted a collapse and restored a degree of stability to the financial system. Nevertheless, the cumulative effect of the financial stress was to precipitate a sharp downturn in economic activity around the world.

The Federal Reserve responded forcefully to the significant deterioration in financial market conditions and the substantial worsening of the economic outlook by continuing to ease monetary policy aggressively late last year. By December, the Federal Open Market Committee (FOMC) had brought its target for the federal funds rate to a historically low range of 0 to 1/4 percent, where it remains today. The FOMC anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

With the federal funds rate close to zero, the Federal Reserve has focused on alternative tools to ease conditions in credit markets. We have established new lending facilities and expanded existing facilities that aim to enhance the flow of credit to businesses and households: We increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers; we expanded our network of swap lines with foreign central banks to help ease conditions in global dollar markets that were spilling over into our own funding markets; we established facilities to promote the functioning of money market mutual funds and the commercial paper market; and we introduced the Term Asset-Backed Securities Loan Facility, or TALF, which is designed to facilitate the renewed issuance of consumer and small business asset-backed securities. In addition, to improve the functioning of the mortgage market and to support housing markets and economic activity more broadly, the Federal Reserve has begun to purchase large amounts of agency debt and agency mortgage-backed securities.

The measures taken since September by the Federal Reserve, other U.S. government entities, and foreign governments have helped improve conditions in some financial markets. In particular, strains in short-term funding markets have eased notably since last fall, and London interbank offered rates, or Libor--which influence the interest rates faced by many U.S. households and businesses--have decreased sharply. Conditions in the commercial paper market also have improved, even for lower-rated borrowers, and the sharp outflows from money market mutual funds in September have been replaced by modest inflows. In the market for conforming mortgages, interest rates have fallen nearly 1 percentage point since the announcement of our intention to purchase agency debt and agency mortgage-backed securities. Corporate risk spreads have also declined somewhat from extraordinarily high levels, although bond spreads remain elevated by historical standards. Likely spurred by the improvements in pricing and liquidity, issuance of investment-grade corporate bonds has been strong, and speculative-grade issuance, which was near zero in the fourth quarter, has picked up somewhat more recently. Nevertheless, significant stresses persist in many markets. For example, most securitization markets remain closed, and some financial institutions remain under pressure.

As I noted, the ongoing stresses in the financial markets have been accompanied by a sharp contraction in economic activity. After edging down during the summer, real gross domestic product (GDP) is reported by the Commerce Department to have declined at an annual rate of 6.2 percent in the fourth quarter of last year, with nearly every major category of final sales contributing to the drop.

The recent near-term indicators show little sign of improvement. Businesses shed 600,000 jobs in January, about the same pace of job loss as in November and December, and the unemployment rate jumped to 7.6 percent. Moreover, the number of claims for unemployment insurance has moved higher since mid-January, suggesting that labor market conditions may have worsened further in recent weeks. In reaction to the deteriorating job market, the sizable losses of equity and housing wealth, and the tightening of credit conditions, households have continued to rein in their spending. Home sales and new construction have continued to decline despite lower mortgage rates, reflecting the uncertain economic environment and the expectation of many potential buyers that home prices have further to fall.

The manufacturing sector has also deteriorated further so far this year. Manufacturing output fell sharply again in January, bringing the rate of capacity utilization to its lowest level in the post-World War II period. Orders and shipments of durable goods, which dropped in the fourth quarter, fell markedly further in January, and most survey-based measures of business conditions are at or near record low levels. Given the weak economic environment, many businesses have apparently cut back their plans for capital expenditures significantly. Moreover, exports, which had provided a welcome offset to the weakness in domestic demand through the middle of 2008, fell sharply in the final months of last year, and the incoming news suggests a widespread contraction in activity abroad.

Despite the considerable decline in final demand in the United States, businesses have managed to trim inventories in recent quarters. Still, with sales anticipated to remain poor for a while longer, many businesses are carrying more inventories than they desire and, consequently, are likely to cut production further in the months ahead.

Meanwhile, overall consumer price inflation has slowed considerably, primarily because of the steep drop in energy prices in the second half of last year. The PCE price index was up just 0.7 percent in January from its year-earlier level, after having risen 3-1/2 percent over the preceding 12-month period. Core PCE price inflation, which excludes the direct effects of food and energy prices, has also slowed, decreasing to 1-1/2 percent for the 12 months ending in January from 2-1/4 percent in the year-earlier period. Wide margins of economic slack and reduced cost pressures suggest that inflation is likely to remain quite low over the next couple of years.

Although the near-term outlook for the economy is weak, over time, a number of factors should promote the return of solid gains in economic activity in the context of low and stable inflation. The effectiveness of the policy actions taken by the Federal Reserve, the Treasury, and other government entities in restoring a reasonable degree of financial stability will be critical determinants of the timing and strength of the recovery. If financial conditions improve, the economy will be increasingly supported by fiscal and monetary stimulus, the beneficial effects of the steep decline in energy prices since last summer, and the better alignment of business inventories and final sales, as well as the increased availability of credit.

Fiscal Policy in the Current Economic and Financial Environment

As you are well aware, the Congress recently passed a major fiscal package, which is aimed at strengthening near-term economic activity. The package includes personal tax cuts and increases in transfer payments intended to stimulate household spending, incentives for business investment, federal grants for state and local governments to reduce their need to cut services or cancel building projects, and increases in federal purchases. By supporting public and private spending, the fiscal package should provide a boost to demand and production over the next two years as well as mitigate the overall loss of employment and income that would otherwise occur.

That said, the timing and the magnitude of the macroeconomic effects of the fiscal program are subject to considerable uncertainty, reflecting both the state of economic knowledge and the unusual economic circumstances that we face. For example, households confronted with declining incomes and limited access to credit might be expected to spend most of their tax cuts; then again, heightened economic uncertainties and the desire to increase precautionary saving or pay down debt might reduce households' propensity to spend. Likewise, it is difficult to judge how quickly funds dedicated to infrastructure needs and other longer-term projects will be spent and how large any follow-on effects will be. The Congressional Budget Office (CBO) has constructed a range of estimates of the effects of the stimulus package on real GDP and employment that appropriately reflects these uncertainties. According to the CBO's estimates, the effect of the stimulus package on the level of real GDP at the end of 2010 could range from about 1 percent to a little more than 3 percent, relative to a baseline forecast that does not include the stimulus. They estimate that these effects on output would leave the corresponding

unemployment rate between 1/2 percentage point and 2 percentage points lower at the end of next year than in the baseline forecast.

The goal of the fiscal package is not just to provide a one-time boost to the economy, but to lay the groundwork for a self-sustaining, broad-based recovery. Historical experience strongly suggests that without a reasonable degree of financial stability, a sustainable recovery will not occur. Although progress has been made on the financial front since last fall, more needs to be done. As you know, in response to ongoing concerns about the health of financial institutions, the Treasury recently announced plans for further steps to ensure the strength and soundness of the financial system and to promote a more smooth flow of credit to households and businesses. The plan would use the remaining resources appropriated to the Treasury under the Emergency Economic Stabilization Act--approximately \$350 billion--and also involve additional spending to support the activities of Fannie Mae and Freddie Mac. Whether further funds will be needed depends on the results of the current supervisory assessment of banks, the evolution of the economy, and other factors. The Administration has included a placeholder in its budget for more funding for financial stabilization, should it be necessary.

Unfortunately, the spending for financial stabilization, the increases in spending and reductions in taxes associated with the fiscal package, and the losses in revenues and increases in income-support payments associated with the weak economy will widen the federal budget deficit substantially this year. Taking into account these factors, the Administration recently submitted a proposed budget that projects the federal deficit to increase to about \$1.8 trillion this fiscal year and to remain around \$1 trillion in 2010 and 2011. As a consequence of this elevated level of borrowing, the ratio of federal debt held by the public to nominal GDP is likely to move up from about 40 percent before the onset of the financial crisis to more than 60 percent over the next several years--its highest level since the early 1950s, in the years following the massive debt buildup during World War II.

Of course, all else equal, this is a development that all of us would have preferred to avoid. But our economy and financial markets face extraordinary challenges, and a failure by policymakers to address these challenges in a timely way would likely be more costly in the end. We are better off moving aggressively today to solve our economic problems; the alternative could be a prolonged episode of economic stagnation that would not only contribute to further deterioration in the fiscal situation, but would also imply lower output, employment, and incomes for an extended period.

With such large near-term deficits, it may seem too early to be contemplating the necessary return to fiscal sustainability. To the contrary, maintaining the confidence of the financial markets requires that we begin planning now for the restoration of fiscal balance. As the economy recovers and resources become more fully employed, we will need to withdraw the temporary components of the fiscal stimulus. Spending on financial stabilization also must wind down; if all goes well, the disposition of assets acquired by the Treasury in the process of stabilization will be a source of added revenue for the Treasury in the out years. Determining the pace of fiscal normalization will entail some difficult judgments. In particular, the Congress will need to weigh the costs of running large budget deficits for a time against the possibility of a premature removal of fiscal stimulus that could blunt the recovery. We at the Federal Reserve will face similar difficult judgment calls regarding monetary policy.

As I mentioned earlier, the President has recently submitted a budget, and it proposes an ambitious agenda, including new initiatives for energy, health care, education, and tax policy. These are all complex policy issues in which the specific design of each program is as important as the budgetary amount allocated to it. The Congress will have considerable work in evaluating how to proceed in each of these areas.

As part of that evaluation, it will be critical to consider the formidable challenges and tradeoffs needed to simultaneously achieve an economic and financial recovery, fiscal responsibility, and program reforms that accomplish their desired goals effectively and efficiently. In particular, policymakers must remain prepared to take the actions necessary in the near term to restore stability to the financial system and to put the economy on a sustainable path to recovery. But the near-term imperative of achieving economic recovery and the longer-run desire to achieve programmatic objectives should not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Without fiscal sustainability, in the longer term we will have neither financial stability nor healthy economic growth.