7-21-2010

UA36I/29 Gary Ransdell - Federal Reserve Board - Chairman Bernanke's Semiannual Monetary Policy Report

St. Louis Federal Reserve Board

FedDigest, July 21, 2010: Chairman Bernanke's Semiannual Monetary Policy Report

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate
This document is not an official transcript. The text is selectively drawn from the original and summarized. Full text:
http://www.federalreserve.gov/newsevents/testimony/bernanke20100721a.htm

Economic and Financial Developments
The economic expansion that began in the middle of last year is proceeding at a moderate pace, supported by stimulative monetary and fiscal policies. Although fiscal policy and inventory restocking will likely be providing less impetus to the recovery than in recent quarters, rising demand from households and businesses should help sustain growth. However, the housing market remains weak, with the overhang of vacant or foreclosed houses weighing on home prices and construction.

An important drag on household spending is the slow recovery in the labor market and the attendant uncertainty about job prospects. Private payrolls expanded at an average of about 100,000 per month during the first half of this year, a pace insufficient to reduce the unemployment rate materially. In all likelihood, a significant amount of time will be required to restore the nearly 8-1/2 million jobs that were lost over 2008 and 2009.

Investment in equipment and software appears to have increased rapidly in the first half of the year, in part reflecting capital outlays that had been deferred during the downturn and the need of many businesses to replace aging equipment. In contrast, spending on nonresidential structures--weighed down by high vacancy rates and tight credit--has continued to contract, though the rate of decline may be slowing. Both U.S. exports and U.S. imports have been expanding, reflecting growth in the global economy and the recovery of world trade.

Inflation has remained low. The price index for personal consumption expenditures appears to have risen at an annual rate of less than 1 percent in the first half of the year. Underlying inflation has trended down over the past two years. The slack in labor and product markets has damped wage and price pressures, and rapid increases in productivity have further reduced producers' unit labor costs.

My colleagues on the Federal Open Market Committee (FOMC) and I expect continued moderate growth, a gradual decline in the unemployment rate, and subdued inflation over the next several years. Progress in reducing unemployment is now expected to be somewhat slower than we previously projected, and near-term inflation now looks likely to be a little lower. Most FOMC participants expect real GDP growth of 3 to 3-1/2 percent in 2010, and roughly 3-1/2 to 4-1/2 percent in 2011 and 2012. The unemployment rate is expected to decline to between 7 and 7-1/2 percent by the end of 2012. Most participants projected that inflation will average only about 1 percent in 2010 and that it will remain low during 2011 and 2012.

One factor underlying the Committee's somewhat weaker outlook is that financial conditions--though much improved since the depth of the financial crisis--have become less supportive of economic growth in recent months. Notably, concerns about the ability of Greece and a number of other euro-area countries to manage their sizable budget deficits and high levels of public debt spurred a broad-based withdrawal from risk-taking in global financial markets in the spring, resulting in lower stock prices and wider risk spreads in the United States. In response to these fiscal pressures, European leaders put in place a number of strong measures, including an assistance package for Greece and €500 billion of funding to backstop the near-term financing needs of euro-area countries. To help ease strains in U.S. dollar funding markets, the Federal Reserve reestablished temporary dollar liquidity swap lines with the ECB and several other major central banks. To date, drawings under the swap lines have been limited, but we believe that the existence of these lines has increased confidence in dollar funding markets, helping to maintain credit availability in our own financial system.

Like financial conditions generally, the state of the U.S. banking system has also improved significantly since the worst of the crisis. However, many banks continue to have a large volume of troubled loans on their books, and bank lending standards remain tight. With credit demand weak and with banks writing down problem credits, bank loans outstanding have continued to contract. Small businesses, which depend importantly on bank credit, have been particularly hard hit. At the Federal Reserve, we have been working to facilitate the flow of funds to creditworthy small businesses. We issued guidance to banks and examiners emphasizing that lenders should do all they can to meet the needs of creditworthy borrowers, including small businesses. We also have conducted extensive training for examiners, with the message that lending to viable small businesses is good for the safety and soundness of our banking system as well as for our economy. We continue to seek feedback from both banks and potential borrowers about credit conditions. A conference on addressing the credit needs of small businesses was held at the Board of Governors last week. This testimony includes an addendum that summarizes the findings and possible next steps.

Federal Reserve Policy

The Federal Reserve's response to the financial crisis and the recession has involved several components. First, in response to the periods of intense illiquidity and dysfunction in financial markets that characterized the crisis, the Federal set up emergency programs designed to provide liquidity to financial institutions and markets in the form of fully secured, mostly short-term loans. Over time, these programs helped to stem the panic and to restore normal functioning in a number of key financial markets, supporting the flow of credit to the economy. As financial markets stabilized, the Federal Reserve shut down most of these programs during the first half of this year and took steps to normalize the terms on which it lends to depository institutions. The only such programs currently open to provide new liquidity are the recently reestablished dollar liquidity swap lines with major central banks. All of the loans extended through the multiborrower facilities that have come due have been repaid in full, with interest. In addition, the Board does not expect the Federal Reserve to incur a net loss on any of the secured loans provided during the crisis to help prevent the disorderly failure of systemically significant financial institutions.

A second major component of the Federal Reserve's response to the financial crisis and recession has involved monetary policy. Over the course of the crisis, the FOMC aggressively reduced its target for the federal funds rate to a range of 0 to 1/4 percent, which has been maintained since the end of 2008. The FOMC continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

In addition to the very low federal funds rate, the FOMC has provided monetary policy stimulus through large-scale asset purchases. These purchases helped improve conditions in private credit markets and put downward pressure on longer-term private borrowing rates and spreads.

Compared with the period just before the financial crisis, the System's portfolio of domestic securities has increased from about $800 billion to $2 trillion and has shifted from consisting of 100 percent Treasury securities to having almost two-thirds of its investments in agency-related securities. In addition, the average maturity of the Treasury portfolio nearly doubled. The FOMC plans to return the System's portfolio to a more normal size and composition over the longer term, and has been discussing alternative approaches to accomplish that objective.

One approach is for the Committee to adjust its reinvestment policy--that is, its policy for handling repayments of principal on the securities--to gradually normalize the portfolio over time. Currently, repayments of principal from agency debt and MBS are not being reinvested, allowing the holdings of those securities to run off as the repayments are received. By contrast, the proceeds from maturing Treasury securities are being reinvested in new issues of Treasury securities with similar maturities. At some point, the Committee may want to shift its reinvestment of the proceeds from maturing Treasury securities to shorter-term issues, so as to gradually reduce the average maturity of our Treasury holdings. However, no decision to change reinvestment policy has been made.

A second way to normalize the size and composition of the Federal Reserve's securities portfolio would be to sell some holdings of agency debt and MBS. Selling agency securities, rather than simply letting them run off, would shrink the portfolio and return it to a composition of all Treasury securities more quickly. FOMC participants broadly agree that sales of agency-related securities should eventually be used as part of the strategy to normalize the portfolio. Such sales will be communicated well in advance and at a gradual pace. Any decisions regarding the commencement or pace of asset sales will be made in light of the outlook for employment and inflation.

As I noted earlier, the FOMC continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. At some point, however, the Committee will need to begin to remove monetary policy accommodation to prevent the buildup of inflationary pressures. When that time comes, the Federal Reserve will act to increase short-term interest rates by raising the interest rate it pays on reserve balances that depository institutions hold at Federal Reserve Banks. The Federal Reserve may also drain reserves from the banking system. Tools for draining reserves from the system are being developed and tested and will be ready when needed.

Of course, we also recognize that the economic outlook remains unusually uncertain. We remain prepared to take further policy actions as needed to foster a return to full utilization of our nation's productive potential in a context of price stability.

Financial Reform Legislation

Last week, the Congress passed landmark legislation to reform the financial system and financial regulation, and the President signed the bill into law this morning. That legislation represents significant progress toward reducing the likelihood of future financial crises and strengthening the capacity of financial regulators to respond to risks that may emerge. Importantly, the legislation encourages an approach to supervision designed to foster the stability of the financial system as a whole as well as the safety and soundness of individual institutions. Within the Federal Reserve, we have already taken steps to strengthen our analysis and supervision of the financial system and systemically important financial firms in ways consistent with the new legislation. In particular, we have significantly changed our supervisory framework to improve our consolidated supervision of large, complex bank holding companies, and we are enhancing the tools we use to monitor the financial sector and to identify potential systemic risks. In addition, briefings for the FOMC are now providing increased coverage and analysis of potential risks to the financial system.

I believe that the legislation, together with stronger regulatory standards for bank capital and liquidity now being developed, will place our financial system on a sounder foundation and minimize the risk of a repetition of the devastating events of the past three years.