For release on delivery
10:00 a.m. EDT
July 17, 2012

Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

July 17, 2012

Chairman Johnson, Ranking Member Shelby, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress*. I will begin with a discussion of current economic conditions and the outlook before turning to monetary policy.

The Economic Outlook

The U.S. economy has continued to recover, but economic activity appears to have decelerated somewhat during the first half of this year. After rising at an annual rate of 2-1/2 percent in the second half of 2011, real gross domestic product (GDP) increased at a 2 percent pace in the first quarter of 2012, and available indicators point to a still-smaller gain in the second quarter.

Conditions in the labor market improved during the latter part of 2011 and early this year, with the unemployment rate falling about a percentage point over that period. However, after running at nearly 200,000 per month during the fourth and first quarters, the average increase in payroll employment shrank to 75,000 per month during the second quarter. Issues related to seasonal adjustment and the unusually warm weather this past winter can account for a part, but only a part, of this loss of momentum in job creation. At the same time, the jobless rate has recently leveled out at just over 8 percent.

Household spending has continued to advance, but recent data indicate a somewhat slower rate of growth in the second quarter. Although declines in energy prices are now providing some support to consumers' purchasing power, households remain concerned about their employment and income prospects and their overall level of confidence remains relatively low.

We have seen modest signs of improvement in housing. In part because of historically low mortgage rates, both new and existing home sales have been gradually trending upward since last summer, and some measures of house prices have turned up in recent months. Construction has increased, especially in the multifamily sector. Still, a number of factors continue to impede progress in the housing market. On the demand side, many would-be buyers are deterred by worries about their own finances or about the economy more generally. Other prospective homebuyers cannot obtain mortgages due to tight lending standards, impaired creditworthiness, or because their current mortgages are underwater--that is, they owe more than their homes are worth. On the supply side, the large number of vacant homes, boosted by the ongoing inflow of foreclosed properties, continues to divert demand from new construction.

After posting strong gains over the second half of 2011 and into the first quarter of 2012, manufacturing production has slowed in recent months. Similarly, the rise in real business spending on equipment and software appears to have decelerated from the double-digit pace seen over the second half of 2011 to a more moderate rate of growth over the first part of this year. Forward-looking indicators of investment demand--such as surveys of business conditions and capital spending plans--suggest further weakness ahead. In part, slowing growth in production and capital investment appears to reflect economic stresses in Europe, which, together with some cooling in the economies of other trading partners, is restraining the demand for U.S. exports.

At the time of the June meeting of the Federal Open Market Committee (FOMC), my colleagues and I projected that, under the assumption of appropriate monetary policy, economic growth will likely continue at a moderate pace over coming quarters and then pick up very gradually. Specifically, our projections for growth in real GDP prepared for the meeting had a central tendency of 1.9 to 2.4 percent for this year and 2.2 to 2.8 percent for 2013.[1] These forecasts are lower than those we made in January, reflecting the generally disappointing tone of the recent incoming data.[2] In addition, financial strains associated with the crisis in Europe have increased since earlier in the year, which--as I already noted--are weighing on both global and domestic economic activity. The recovery in the United States continues to be held back by a number of other headwinds, including still-tight borrowing conditions for some businesses and households, and--as I will discuss in more detail shortly--the restraining effects of fiscal policy and fiscal uncertainty. Moreover, although the housing market has shown improvement, the contribution of this sector to the recovery is less than has been typical of previous recoveries. These headwinds should fade over time, allowing the economy to grow somewhat more rapidly and the unemployment rate to decline toward a more normal level. However, given that growth is projected to be not much above the rate needed to absorb new entrants to the labor force, the reduction in the unemployment rate seems likely to be frustratingly slow. Indeed, the central tendency of participants' forecasts now has the unemployment rate at 7 percent or higher at the end of 2014.

The Committee made comparatively small changes in June to its projections for inflation. Over the first three months of 2012, the price index for personal consumption expenditures (PCE) rose about 3-1/2 percent at an annual rate, boosted by a large increase in retail energy prices that in turn reflected the higher cost of crude oil. However, the sharp drop in crude oil

---

[1] See table 1, "Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2012," of the Summary of Economic Projections, available at the Board of Governors of the Federal Reserve System (2012), "Federal Reserve Board and Federal Open Market Committee Release Economic Projections from the June 19-20 FOMC Meeting," press release, June 20, www.federalreserve.gov/newsevents/press/monetary/20120620b.htm; table 1 is also available in Part 4 of the July *Monetary Policy Report to the Congress*.

[2] Ben S. Bernanke (2012), "Semiannual *Monetary Policy Report to the Congress*," statement before the Committee on Financial Services, U.S. House of Representatives, February 29, www.federalreserve.gov/newsevents/testimony/bernanke20120229a.htm.

prices in the past few months has brought inflation down. In all, the PCE price index rose at an annual rate of 1-1/2 percent over the first five months of this year, compared with a 2-1/2 percent rise over 2011 as a whole. The central tendency of the Committee's projections is that inflation will be 1.2 to 1.7 percent this year, and at or below the 2 percent level that the Committee judges to be consistent with its statutory mandate in 2013 and 2014.

Risks to the Outlook

Participants at the June FOMC meeting indicated that they see a higher degree of uncertainty about their forecasts than normal and that the risks to economic growth have increased. I would like to highlight two main sources of risk: The first is the euro-area fiscal and banking crisis; the second is the U.S. fiscal situation.

Earlier this year, financial strains in the euro area moderated in response to a number of constructive steps by the European authorities, including the provision of three-year bank financing by the European Central Bank. However, tensions in euro-area financial markets intensified again more recently, reflecting political uncertainties in Greece and news of losses at Spanish banks, which in turn raised questions about Spain's fiscal position and the resilience of the euro-area banking system more broadly. Euro-area authorities have responded by announcing a number of measures, including funding for the recapitalization of Spain's troubled banks, greater flexibility in the use of the European financial backstops (including, potentially, the flexibility to recapitalize banks directly rather than through loans to sovereigns), and movement toward unified supervision of euro-area banks. Even with these announcements, however, Europe's financial markets and economy remain under significant stress, with spillover effects on financial and economic conditions in the rest of the world, including the United States.

Moreover, the possibility that the situation in Europe will worsen further remains a significant risk to the outlook.

The Federal Reserve remains in close communication with our European counterparts. Although the politics are complex, we believe that the European authorities have both strong incentives and sufficient resources to resolve the crisis. At the same time, we have been focusing on improving the resilience of our financial system to severe shocks, including those that might emanate from Europe. The capital and liquidity positions of U.S. banking institutions have improved substantially in recent years, and we have been working with U.S. financial firms to ensure they are taking steps to manage the risks associated with their exposures to Europe. That said, European developments that resulted in a significant disruption in global financial markets would inevitably pose significant challenges for our financial system and our economy.

The second important risk to our recovery, as I mentioned, is the domestic fiscal situation. As is well known, U.S. fiscal policies are on an unsustainable path, and the development of a credible medium-term plan for controlling deficits should be a high priority. At the same time, fiscal decisions should take into account the fragility of the recovery. That recovery could be endangered by the confluence of tax increases and spending reductions that will take effect early next year if no legislative action is taken. The Congressional Budget Office has estimated that, if the full range of tax increases and spending cuts were allowed to take effect--a scenario widely referred to as the fiscal cliff--a shallow recession would occur early next year and about 1-1/4 million fewer jobs would be created in 2013.[3] These estimates do not

[3] Congressional Budget Office (2012), *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013* (Washington: CBO, May), available at www.cbo.gov/publication/43262. The effect of the fiscal cliff on real GDP is shown in table 2 (p. 6). The effect of the fiscal cliff on employment, relative to a less restrictive *alternative fiscal scenario* that assumes that most expiring tax provisions are extended and that the spending sequestration does not take effect, is shown in table 3 (p.7).

incorporate the additional negative effects likely to result from public uncertainty about how these matters will be resolved. As you recall, market volatility spiked and confidence fell last summer, in part as a result of the protracted debate about the necessary increase in the debt ceiling. Similar effects could ensue as the debt ceiling and other difficult fiscal issues come into clearer view toward the end of this year.

The most effective way that the Congress could help to support the economy right now would be to work to address the nation's fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery. Doing so earlier rather than later would help reduce uncertainty and boost household and business confidence.

Monetary Policy

In view of the weaker economic outlook, subdued projected path for inflation, and significant downside risks to economic growth, the FOMC decided to ease monetary policy at its June meeting by continuing its maturity extension program (or MEP) through the end of this year. The MEP combines sales of short-term Treasury securities with an equivalent amount of purchases of longer-term Treasury securities. As a result, it decreases the supply of longer-term Treasury securities available to the public, putting upward pressure on the prices of those securities and downward pressure on their yields, without affecting the overall size of the Federal Reserve's balance sheet. By removing additional longer-term Treasury securities from the market, the Fed's asset purchases also induce private investors to acquire other longer-term assets, such as corporate bonds and mortgage backed-securities, helping to raise their prices and lower their yields and thereby making broader financial conditions more accommodative.

Economic growth is also being supported by the exceptionally low level of the target range for the federal funds rate of 0 to 1/4 percent and the Committee's forward guidance regarding the anticipated path of the funds rate. As I reported in my February testimony, the FOMC extended its forward guidance at its January meeting, noting that it expects that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. The Committee has maintained this conditional forward guidance at its subsequent meetings. Reflecting its concerns about the slow pace of progress in reducing unemployment and the downside risks to the economic outlook, the Committee made clear at its June meeting that it is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

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