

Ben S Bernanke: The economic recovery and economic policy

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the New York Economic Club, New York, New York, 20 November 2012.

* * *

Good afternoon. I am pleased to join the New York Economic Club for lunch today. I know that many of you and your friends and neighbors are still recovering from the effects of Hurricane Sandy, and I want to let you know that our thoughts are with everyone who has suffered during the storm and its aftermath.

My remarks today will focus on the reasons for the disappointingly slow pace of economic recovery in the United States and the policy actions that have been taken by the Federal Open Market Committee (FOMC) to support the economy. In addition, I will discuss some important economic challenges our country faces as we close out 2012 and move into 2013 – in particular, the challenge of putting federal government finances on a sustainable path in the longer run while avoiding actions that would endanger the economic recovery in the near term.

The recovery from the financial crisis and recession

The economy has continued to recover from the financial crisis and recession, but the pace of recovery has been slower than FOMC participants and many others had hoped or anticipated when I spoke here about three years ago. Indeed, since the recession trough in mid-2009, growth in real gross domestic product (GDP) has averaged only a little more than 2 percent per year.

Similarly, the job market has improved over the past three years, but at a slow pace. The unemployment rate, which peaked at 10 percent in the fall of 2009, has since come down 2 percentage points to just below 8 percent. This decline is obviously welcome, but it has taken a long time to achieve that progress, and the unemployment rate is still well above both its level prior to the onset of the recession and the level that my colleagues and I think can be sustained once a full recovery has been achieved. Moreover, many other features of the jobs market, including the historically high level of long-term unemployment, the large number of people working part time because they have not been able to find full-time jobs, and the decline in labor force participation, reinforce the conclusion that we have some way to go before the labor market can be deemed healthy again.

Meanwhile, inflation has generally remained subdued. As is often the case, inflation has been pushed up and down in recent years by fluctuations in the price of crude oil and other globally traded commodities, including the increase in farm prices brought on by this summer's drought. But with longer-term inflation expectations remaining stable, the ebbs and flows in commodity prices have had only transitory effects on inflation. Indeed, since the recovery began about three years ago, consumer price inflation, as measured by the personal consumption expenditures (PCE) price index, has averaged almost exactly 2 percent, which is the FOMC's longer-run objective for inflation.¹ Because ongoing slack in labor and product markets should continue to restrain wage and price increases, and with the public's inflation expectations continuing to be well anchored, inflation over the next few years is likely to remain close to or a little below the Committee's objective.

As background for our monetary policy decisionmaking, we at the Federal Reserve have spent a good deal of effort attempting to understand the reasons why the economic recovery

¹ Inflation excluding food and energy has averaged a little less, about 1–1/2 percent, over this period.

has not been stronger. Studies of previous financial crises provide one helpful place to start.² This literature has found that severe financial crises – particularly those associated with housing booms and busts – have often been associated with many years of subsequent weak performance. While this result allows for many interpretations, one possibility is that financial crises, or the deep recessions that typically accompany them, may reduce an economy’s potential growth rate, at least for a time.

The accumulating evidence does appear consistent with the financial crisis and the associated recession having reduced the potential growth rate of our economy somewhat during the past few years. In particular, slower growth of potential output would help explain why the unemployment rate has declined in the face of the relatively modest output gains we have seen during the recovery. Output normally has to increase at about its longer-term trend just to create enough jobs to absorb new entrants to the labor market, and faster-than-trend growth is usually needed to reduce unemployment. So the fact that unemployment has declined in recent years despite economic growth at about 2 percent suggests that the growth rate of potential output must have recently been lower than the roughly 2–1/2 percent rate that appeared to be in place before the crisis.³

There are a number of ways in which the financial crisis could have slowed the rate of growth of the economy’s potential. For example, the extraordinarily severe job losses that followed the crisis, especially in housing-related industries, may have exacerbated for a time the extent of mismatch between the jobs available and the skills and locations of the unemployed. Meanwhile, the very high level of long-term unemployment has probably led to some loss of skills and labor force attachment among those workers. These factors may have pushed up to some degree the so-called natural rate of unemployment – the rate of unemployment that can be sustained under normal conditions – and reduced labor force participation as well. The pace of productivity gains – another key determinant of growth in potential output – may also have been restrained by the crisis, as business investment declined sharply during the recession; and increases in risk aversion and uncertainty, together with tight credit conditions, may have impeded the commercial application of new technologies and slowed the pace of business formation.

Importantly, however, although the nation’s potential output may have grown more slowly than expected in recent years, this slowing seems at best a partial explanation of the disappointing pace of the economic recovery. In particular, even though the natural rate of unemployment may have increased somewhat, a variety of evidence suggests that any such increase has been modest, and that substantial slack remains in the labor market. For example, the slow pace of employment growth has been widespread across industries and

² See Carmen M. Reinhart and Kenneth S. Rogoff (2009), *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press); Moritz Schularick and Alan M. Taylor (2012), “Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870–2008,” *American Economic Review*, vol. 102 (April), pp. 1029–61; Valerie Cerra and Sweta Chaman Saxena (2008), “Growth Dynamics: The Myth of Economic Recovery,” *American Economic Review*, vol. 98 (March), pp. 439–57; Greg Howard, Robert Martin, and Beth Anne Wilson (2011), “Are Recoveries from Banking and Financial Crises Really So Different?” International Finance Discussion Papers 1037 (Washington: Board of Governors of the Federal Reserve System, November); and Michael D. Bordo and Joseph G. Haubrich (2012), “Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record,” Working Paper 12–14 (Cleveland: Federal Reserve Bank of Cleveland, June).

³ That said, GDP growth in excess of potential is probably not the whole explanation for the decline in unemployment. Some of the decline in unemployment during the recovery could also reflect a reversal of the especially large increases that occurred during the deepest part of the recession, when firms appeared to cut their workforces by greater numbers than would normally be associated with the decline in GDP. (For a discussion, see Ben S. Bernanke (2012), “Recent Developments in the Labor Market,” speech delivered at the National Association for Business Economics 28th Annual Economic Policy Conference, Arlington, Va., March 26.) A reduction in the number of people receiving extended or emergency unemployment insurance benefits may have contributed to the decline in unemployment as well.

regions of the country. That pattern suggests a broad-based shortfall in demand rather than a substantial increase in mismatch between available jobs and workers, because greater mismatch would imply that the demand for workers would be strong in some regions and industries, not weak almost across the board. Likewise, if a mismatch of jobs and workers is the predominant problem, we would expect to see wage pressures developing in those regions and industries where labor demand is strong; in fact, wage gains have been quite subdued in most industries and parts of the country.⁴ Indeed, as I indicated earlier, the consensus among my colleagues on the FOMC is that the unemployment rate is still well above its longer-run sustainable level, perhaps by 2 to 2-1/2 percentage points or so.⁵

A critical question, then, is why significant slack in the job market remains three years after the recovery began. A likely explanation, which I will discuss further, is that the economy has been faced with a variety of headwinds that have hindered what otherwise might have been a stronger cyclical rebound. If so, we may take some encouragement from the likelihood that there are potentially two sources of faster GDP growth in the future. First, the effects of the crisis on potential output should fade as the economy continues to heal.⁶ And second, if the headwinds begin to dissipate, as I expect, growth should pick up further as many who are currently unemployed or out of the labor force find work.

Headwinds affecting the recovery

What are the headwinds that have slowed the return of our economy to full employment? Some have come from the housing sector. Previous recoveries have often been associated with a vigorous rebound in housing, as rising incomes and confidence and, often, a decline in mortgage interest rates led to sharp increases in the demand for homes.⁷ But the housing bubble and its aftermath have made this episode quite different. In the first half of the past decade, both housing prices and construction rose to what proved to be unsustainable levels, leading to a subsequent collapse: House prices declined almost one-third nationally from 2006 until early this year, construction of single-family homes fell two-thirds, and the number of construction jobs decreased by nearly one-third. And, of course, the associated surge in delinquencies on mortgages helped trigger the broader financial crisis.

Recently, the housing market has shown some clear signs of improvement, as home sales, prices, and construction have all moved up since early this year. These developments are encouraging, and it seems likely that, on net, residential investment will be a source of economic growth and new jobs over the next couple of years. However, while historically low

⁴ In addition, while the changing relationship between job vacancies and unemployment – the shift in the Beveridge curve – probably does point to some greater difficulty matching jobs with workers, factors other than mismatch likely explain some of that shift. For example, evidence suggests that firms tend to become more selective in hiring when their hiring needs are not urgent. For further discussion of these labor market issues, see Bernanke, “Recent Developments,” in note 3 and the references cited therein. See also Edward P. Lazear and James R. Spletzer (2012), “The United States Labor Market: Status Quo or a New Normal? (PDF)” paper delivered at “The Changing Policy Landscape,” a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 30–September 1.

⁵ In the September 2012 Summary of Economic Projections (SEP), the central tendency of FOMC participants’ estimates of the long-run normal rate of unemployment ranged from 5.2 to 6 percent. The SEP is an addendum to the FOMC minutes and is available at Board of Governors of the Federal Reserve System (2012), “Minutes of the Federal Open Market Committee, September 12–13, 2012,” press release, October 4.

⁶ For example, mismatch problems in the labor market should fade as the economy strengthens, a further rise in business investment would contribute to faster growth in the capital stock, and an improving economy should cause investors to become less risk averse.

⁷ In the recoveries following the 1975 and 1982 recessions, for example, residential construction directly contributed about 1 percentage point to GDP growth during the two years following the recession trough; indirect effects – through the effect of home prices on consumer spending or through multiplier effects – no doubt added to the contribution.

mortgage interest rates and the drop in home prices have made housing exceptionally affordable, a number of factors continue to prevent the sort of powerful housing recovery that has typically occurred in the past. Notably, lenders have maintained tight terms and conditions on mortgage loans, even for potential borrowers with relatively good credit.⁸ Lenders cite a number of factors affecting their decisions to extend credit, including ongoing uncertainties about the course of the economy, the housing market, and the regulatory environment. Unfortunately, while some tightening of the terms of mortgage credit was certainly an appropriate response to the earlier excesses, the pendulum appears to have swung too far, restraining the pace of recovery in the housing sector.

Other factors slowing the recovery in housing include the fact that many people remain unable to buy homes despite low mortgage rates; for example, about 20 percent of existing mortgage borrowers owe more on their mortgages than their houses are worth, making it more difficult for them to refinance or sell their homes. Also, a substantial overhang of vacant homes, either for sale or in the foreclosure pipeline, continues to hold down house prices and reduce the need for new construction. While these headwinds on both the supply and demand sides of the housing market have clearly started to abate, the recovery in the housing sector is likely to remain moderate by historical standards.

A second set of headwinds stems from the financial conditions facing potential borrowers in credit and capital markets. After the financial system seized up in late 2008 and early 2009, global economic activity contracted sharply, and credit and capital markets suffered significant damage. Although dramatic actions by governments and central banks around the world helped these markets to stabilize and begin recovering, tight credit and a high degree of risk aversion have restrained economic growth in the United States and in other countries as well.

Measures of the condition of U.S. financial markets and institutions suggest gradual but significant progress has been achieved since the crisis. For example, credit spreads on corporate bonds and syndicated loans have narrowed considerably, and equity prices have recovered most of their losses. In addition, indicators of market stress and illiquidity – such as spreads in short-term funding markets – have generally returned to levels near those seen before the crisis. One gauge of the overall improvement in financial markets is the National Financial Conditions Index maintained by the Federal Reserve Bank of Chicago. The index shows that financial conditions, viewed as a whole, are now about as accommodative as they were in the spring of 2007.

In spite of this broad improvement, the harm inflicted by the financial crisis has yet to be fully repaired in important segments of the financial sector. One example is the continued weakness in some categories of bank lending. Banks' capital positions and overall asset quality have improved substantially over the past several years, and, over time, these balance sheet improvements will position banks to extend considerably more credit to bank-dependent borrowers. Indeed, some types of bank credit, such as commercial and industrial loans, have expanded notably in recent quarters. Nonetheless, banks have been conservative in extending loans to many consumers and some businesses, likely even beyond the restrictions on the supply of mortgage lending that I noted earlier. This caution in lending by banks reflects, among other factors, their continued desire to guard against the risks of further economic weakness.

A prominent risk at present – and a major source of financial headwinds over the past couple of years – is the fiscal and financial situation in Europe. This situation, of course, was not

⁸ For example, according to the April 2012 Senior Loan Officer Opinion Survey on Bank Lending, about one-half of lenders reported that they were “somewhat less likely” or “much less likely” than in 2006 to originate a mortgage to a borrower with a FICO score of 680 and a 10 percent down payment. The complete survey is available on the Board's website.

anticipated when the U.S. recovery began in 2009. The elevated levels of stress in European economies and uncertainty about how the problems there will be resolved are adding to the risks that U.S. financial institutions, businesses, and households must consider when making lending and investment decisions. Negative sentiment regarding Europe appears to have weighed on U.S. equity prices and prevented U.S. credit spreads from narrowing even further. Weaker economic conditions in Europe and other parts of the world have also weighed on U.S. exports and corporate earnings.

Policymakers in Europe have taken some important steps recently, and in doing so have contributed to some welcome easing of financial conditions. In particular, the European Central Bank's new Outright Monetary Transactions program, under which it could purchase the sovereign debt of vulnerable euro-area countries who agree to meet prescribed conditions, has helped ease market concerns about those countries. European governments have also taken steps to strengthen their financial firewalls and to move toward greater fiscal and banking union. Further improvement in global financial conditions will depend in part on the extent to which European policymakers follow through on these initiatives.

A third headwind to the recovery – and one that may intensify in force in coming quarters – is U.S. fiscal policy. Although fiscal policy at the federal level was quite expansionary during the recession and early in the recovery, as the recovery proceeded, the support provided for the economy by federal fiscal actions was increasingly offset by the adverse effects of tight budget conditions for state and local governments. In response to a large and sustained decline in their tax revenues, state and local governments have cut about 600,000 jobs on net since the third quarter of 2008 while reducing real expenditures for infrastructure projects by 20 percent.

More recently, the situation has to some extent reversed: The drag on economic growth from state and local fiscal policy has diminished as revenues have improved, easing the pressures for further spending cuts or tax increases. In contrast, the phasing-out of earlier stimulus programs and policy actions to reduce the federal budget deficit have led federal fiscal policy to begin restraining GDP growth. Indeed, under almost any plausible scenario, next year the drag from federal fiscal policy on GDP growth will outweigh the positive effects on growth from fiscal expansion at the state and local level. However, the overall effect of federal fiscal policy on the economy, both in the near term and in the longer run, remains quite uncertain and depends on how policymakers meet two daunting fiscal challenges – one by the start of the new year and the other no later than the spring.

Upcoming fiscal challenges

What are these looming challenges? First, the Congress and the Administration will need to protect the economy from the full brunt of the severe fiscal tightening at the beginning of next year that is built into current law – the so-called fiscal cliff. The realization of all of the automatic tax increases and spending cuts that make up the fiscal cliff, absent offsetting changes, would pose a substantial threat to the recovery – indeed, by the reckoning of the Congressional Budget Office (CBO) and that of many outside observers, a fiscal shock of that size would send the economy toppling back into recession. Second, early in the new year it will be necessary to approve an increase in the federal debt limit to avoid any possibility of a catastrophic default on the nation's Treasury securities and other obligations. As you will recall, the threat of default in the summer of 2011 fueled economic uncertainty and badly damaged confidence, even though an agreement ultimately was reached. A failure to reach a timely agreement this time around could impose even heavier economic and financial costs.

As fiscal policymakers face these critical decisions, they should keep two objectives in mind. First, as I think is widely appreciated by now, the federal budget is on an unsustainable path. The budget deficit, which peaked at about 10 percent of GDP in 2009 and now stands at about 7 percent of GDP, is expected to narrow further in the coming years as the economy

continues to recover. However, the CBO projects that, under a plausible set of policy assumptions, the budget deficit would still be greater than 4 percent of GDP in 2018, assuming the economy has returned to its potential by then. Moreover, under the CBO projection, the deficit and the ratio of federal debt to GDP would subsequently return to an upward trend.⁹ Of course, we should all understand that long-term projections of ever-increasing deficits will never actually come to pass, because the willingness of lenders to continue to fund the government can only be sustained by responsible fiscal plans and actions. A credible framework to set federal fiscal policy on a stable path – for example, one on which the ratio of federal debt to GDP eventually stabilizes or declines – is thus urgently needed to ensure longer-term economic growth and stability.

Even as fiscal policymakers address the urgent issue of longer-run fiscal sustainability, they should not ignore a second key objective: to avoid unnecessarily adding to the headwinds that are already holding back the economic recovery. Fortunately, the two objectives are fully compatible and mutually reinforcing. Preventing a sudden and severe contraction in fiscal policy early next year will support the transition of the economy back to full employment; a stronger economy will in turn reduce the deficit and contribute to achieving long-term fiscal sustainability. At the same time, a credible plan to put the federal budget on a path that will be sustainable in the long run could help keep longer-term interest rates low and boost household and business confidence, thereby supporting economic growth today.

Coming together to find fiscal solutions will not be easy, but the stakes are high. Uncertainty about how the fiscal cliff, the raising of the debt limit, and the longer-term budget situation will be addressed appears already to be affecting private spending and investment decisions and may be contributing to an increased sense of caution in financial markets, with adverse effects on the economy. Continuing to push off difficult policy choices will only prolong and intensify these uncertainties. Moreover, while the details of whatever agreement is reached to resolve the fiscal cliff are important, the economic confidence of both market participants and the general public likely will also be influenced by the extent to which our political system proves able to deliver a reasonable solution with a minimum of uncertainty and delay. Finding long-term solutions that can win sufficient political support to be enacted may take some time, but meaningful progress toward this end can be achieved now if policymakers are willing to think creatively and work together constructively.

Monetary policy

Let me now turn briefly to monetary policy.

Monetary policy can do little to reverse the effects that the financial crisis may have had on the economy's productive potential. However, it has been able to provide an important offset to the headwinds that have slowed the cyclical recovery. As you know, the Federal Reserve took strong easing measures during the financial crisis and recession, cutting its target for the federal funds rate – the traditional tool of monetary policy – to nearly zero by the end of 2008. Since that time, we have provided additional accommodation through two nontraditional policy tools aimed at putting downward pressure on longer-term interest rates: asset purchases that reduce the supply of longer-term securities outstanding in the market, and communication about the future path of monetary policy.

Most recently, after the September FOMC meeting, we announced that the Federal Reserve would purchase additional agency mortgage-backed securities (MBS) and continue with the

⁹ This projection is the alternative fiscal scenario in a CBO report from August of this year. See Congressional Budget Office (2012), *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (Washington: CBO, August).

program to extend the maturity of our Treasury holdings.¹⁰ These additional asset purchases should put downward pressure on longer-term interest rates and make broader financial conditions more accommodative.¹¹ Moreover, our purchases of MBS, by bringing down mortgage rates, provide support directly to housing and thereby help mitigate some of the headwinds facing that sector. In announcing this decision, we also indicated that we would continue purchasing MBS, undertake additional purchases of longer-term securities, and employ our other policy tools until we judge that the outlook for the labor market has improved substantially in a context of price stability.

Although it is still too early to assess the full effects of our most recent policy actions, yields on corporate bonds and agency MBS have fallen significantly, on balance, since the FOMC's announcement. More generally, research suggests that our previous asset purchases have eased overall financial conditions and provided meaningful support to the economic recovery in recent years.¹²

In addition to announcing new purchases of MBS, at our September meeting we extended our guidance for how long we expect that exceptionally low levels for the federal funds rate will likely be warranted at least through the middle of 2015. By pushing the expected period of low rates further into the future, we are not saying that we expect the economy to remain weak until mid-2015; rather, we expect – as we indicated in our September statement – that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.¹³ In other words, we will want to be sure that the recovery is established before we begin to normalize policy. We hope that such assurances will reduce uncertainty and increase confidence among households and businesses, thereby providing additional support for economic growth and job creation.

¹⁰ See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Issues FOMC Statement," press release, September 13.

¹¹ One way in which our asset purchases affect the economy is through the so-called portfolio balance channel. Because different classes of financial assets are not perfect substitutes in investors' portfolios, changes in the supplies of various assets available to private investors may affect the prices and yields of those assets. Thus, the Federal Reserve's purchases of Treasury securities, for example, should raise the prices and lower the yields of those securities; moreover, as investors rebalance their portfolios by replacing the Treasury securities sold to the Federal Reserve with other assets, the prices of those other assets should rise and their yields decline as well. An increase in our asset purchases may also act as a signal that we intend to pursue a persistently more accommodative policy stance than previously thought, thereby lowering investors' expectations for the future path of the federal funds rate and putting additional downward pressure on longer-term interest rates.

¹² See Ben S. Bernanke (2012), "Monetary Policy since the Onset of the Crisis," speech delivered at "The Changing Policy Landscape," a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 30-September 1. For simulation results showing the effects of the FOMC's asset purchases, see Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams (2012), "Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?" *Journal of Money, Credit and Banking*, vol. 44 (February supplement), pp. 47–82. For a study focusing only on the second large-scale asset purchase program that finds comparable effects, attributing to that program a bit less than a 1 percent increase in output and 700,000 new jobs, see Jeffrey C. Fuhrer and Giovanni P. Olivei (2011), "The Estimated Macroeconomic Effects of the Federal Reserve's Large-Scale Treasury Purchase Program," Public Policy Briefs 11–02 (Boston: Federal Reserve Bank of Boston, April). For a study using different methodologies that finds significantly smaller effects, see Michael T. Kiley (2012), "The Aggregate Demand Effects of Short- and Long-Term Interest Rates," Finance and Economics Discussion Series 2012–54 (Washington: Board of Governors of the Federal Reserve System, August); and for one that finds larger effects, see Christiane Baumeister and Luca Benati (2010), "Unconventional Monetary Policy and the Great Recession: Estimating the Impact of a Compression in the Yield Spread at the Zero Lower Bound, (PDF)" European Central Bank Working Paper Series 1258 (Frankfurt: European Central Bank, October).

¹³ See Board of Governors, "FOMC Statement," in note 10.

Conclusion

In sum, the U.S. economy continues to be hampered by the lingering effects of the financial crisis on its productive potential and by a number of headwinds that have hindered the normal cyclical adjustment of the economy. The Federal Reserve is doing its part by providing accommodative monetary policy to promote a stronger economic recovery in a context of price stability. As I have said before, however, while monetary policy can help support the economic recovery, it is by no means a panacea for our economic ills. Currently, uncertainties about the situation in Europe and especially about the prospects for federal fiscal policy seem to be weighing on the spending decisions of households and businesses as well as on financial conditions. Such uncertainties will only be increased by discord and delay. In contrast, cooperation and creativity to deliver fiscal clarity – in particular, a plan for resolving the nation’s longer-term budgetary issues without harming the recovery – could help make the new year a very good one for the American economy.