Testimony

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Semiannual Monetary Policy Report to the Congress

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to present the Federal Reserve's *Monetary Policy Report to the Congress*.

The U.S. economy and financial system have confronted some significant challenges thus far in 2008. The contraction in housing activity that began in 2006 and the associated deterioration in mortgage markets that became evident last year have led to sizable losses at financial institutions and a sharp tightening in overall credit conditions. The effects of the housing contraction and of the financial headwinds on spending and economic activity have been compounded by rapid increases in the prices of energy and other commodities, which have sapped household purchasing power even as they have boosted inflation. Against this backdrop, economic activity has advanced at a sluggish pace during the first half of this year, while inflation has remained elevated.

Following a significant reduction in its policy rate over the second half of 2007, the Federal Open Market Committee (FOMC) eased policy considerably further through the spring to counter actual and expected weakness in economic growth and to mitigate downside risks to economic activity. In addition, the Federal Reserve expanded some of the special liquidity programs that were established last year and implemented additional facilities to support the functioning of financial markets and foster financial stability. Although these policy actions have had positive effects, the economy continues to face numerous difficulties, including ongoing strains in financial markets, declining house prices, a softening labor market, and rising prices of oil, food, and some other commodities. Let me now turn to a more detailed discussion of some of these key issues.

Developments in financial markets and their implications for the macroeconomic outlook have been a focus of monetary policy makers over the past year. In the second half of 2007, the deteriorating performance of subprime mortgages in the United States triggered turbulence in domestic and international financial markets as investors became markedly less willing to bear credit risks of any type. In the first quarter of 2008, reports of further losses and write-downs at financial institutions intensified investor concerns and resulted in further sharp reductions in market liquidity. By March, many dealers and other institutions, even those that had relied heavily on short-term secured financing, were facing much more stringent borrowing conditions.

In mid-March, a major investment bank, The Bear Stearns Companies, Inc., was pushed to the brink of failure after suddenly losing access to short-term financing markets. The Federal Reserve judged that a disorderly failure of Bear Stearns would pose a serious threat to overall financial stability and would most likely have significant adverse implications for the U.S. economy. After discussions with the Securities and Exchange Commission and in consultation with the Treasury, we invoked emergency authorities to provide special financing to facilitate the acquisition of Bear Stearns by JPMorgan Chase & Co. In addition, the Federal Reserve used emergency authorities to establish two new facilities to provide backstop liquidity to primary dealers, with the goals of stabilizing financial conditions and increasing the availability of credit to the broader economy.[1] We have also taken additional steps to address liquidity pressures in the banking system, including a further easing of the terms for bank borrowing at the discount window and increases in the amount of credit made available to banks through the Term Auction Facility. The FOMC also authorized expansions of its currency swap arrangements with the European Central Bank and the Swiss National Bank to facilitate increased dollar lending by those institutions to banks in their jurisdictions.

These steps to address liquidity pressures coupled with monetary easing seem to have been helpful in mitigating some market strains. During the second quarter, credit spreads generally narrowed, liquidity pressures ebbed, and a number of financial institutions raised new capital. However, as events in recent weeks have demonstrated, many financial markets and institutions remain under considerable stress, in part because the outlook for the economy, and thus for credit quality, remains uncertain. In recent days, investors became particularly concerned about the financial condition of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. In view of this development, and given the importance of these firms to the mortgage market, the Treasury announced a legislative proposal to bolster their capital, access to liquidity, and regulatory oversight. As a supplement to the Treasury's existing authority to lend to the GSEs and as a bridge to the time when the Congress decides how to proceed on these matters, the Board of Governors authorized the Federal Reserve Bank of New York to lend to Fannie Mae and Freddie Mac, should that become necessary. Any lending would be collateralized by U.S. government and federal agency securities. In general, healthy economic growth depends on well-functioning financial markets. Consequently, helping the financial markets to return to more normal functioning will continue to be a top priority of the Federal Reserve.

I turn now to current economic developments and prospects. The economy has continued to expand, but at a subdued pace. In the labor market, private payroll employment has declined this year, falling at an average pace of 94,000 jobs per month through June. Employment in the construction and manufacturing sectors has been particularly hard hit, although employment declines in a number of other sectors are evident as well. The unemployment rate has risen and now stands at 5-1/2 percent.

In the housing sector, activity continues to weaken. Although sales of existing homes have been about unchanged this year, sales of new homes have continued to fall, and inventories of unsold new homes remain high. In response, homebuilders continue to scale back the pace of housing starts. Home prices are falling, particularly in regions that experienced the largest price increases earlier this decade. The declines in home prices have contributed to the rising tide of foreclosures; by adding to the stock of vacant homes for sale, these foreclosures have, in turn, intensified the downward pressure on home prices in some areas.

Personal consumption expenditures have advanced at a modest pace so far this year, generally holding up somewhat better than might have been expected given the array of forces weighing on household finances and attitudes. In particular, with the labor market softening and consumer price inflation elevated, real earnings have been stagnant so far this year; declining values of equities and houses have taken their toll on household balance sheets; credit conditions have tightened; and indicators of consumer sentiment have fallen sharply. More positively, the fiscal stimulus package is providing some timely support to household incomes. Overall, consumption spending seems likely to be restrained over coming quarters.

In the business sector, real outlays for equipment and software were about flat in the first quarter of the year, and construction of nonresidential structures slowed appreciably. In the second quarter, the available data suggest that business fixed investment appears to have expanded moderately. Nevertheless, surveys of capital spending plans indicate that firms remain concerned about the economic and financial environment, including sharply rising costs of inputs and indications of tightening credit, and they are likely to be cautious with spending in the second half of the year. However, strong export growth continues to be a significant boon to many U.S. companies.

In conjunction with the June FOMC meeting, Board members and Reserve Bank presidents prepared economic projections covering the years 2008 through 2010. On balance, most FOMC participants expected that, over the remainder of this year, output would expand at a pace appreciably below its trend rate, primarily because of continued weakness in housing markets, elevated energy prices, and tight credit conditions. Growth is projected to pick up gradually over the next two years as residential construction bottoms out and begins a slow recovery and as credit conditions gradually improve. However, FOMC participants indicated that considerable uncertainty surrounded their outlook for economic growth and viewed the risks to their forecasts as skewed to the downside.

Inflation has remained high, running at nearly a 3-1/2 percent annual rate over the first five months of this year as measured by the price index for personal consumption expenditures. And, with gasoline and other consumer energy prices rising in recent weeks, inflation seems likely to move temporarily higher in the near term.

The elevated level of overall consumer inflation largely reflects a continued sharp run-up in the prices of many commodities, especially oil but also certain crops and metals.[2] The spot price of West Texas intermediate crude oil soared about 60 percent in 2007 and, thus far this year, has climbed an additional 50 percent or so. The price of oil currently stands at about five times its level toward the beginning of this decade. Our best judgment is that this surge in prices has been driven predominantly by strong growth in underlying demand and tight supply conditions in global oil markets. Over the past several years, the world economy has expanded at its fastest pace in decades, leading to substantial increases in the demand for oil. Moreover, growth has been concentrated in developing and emerging market economies, where energy consumption has been further stimulated by rapid industrialization and by government subsidies that hold down the price of energy faced by ultimate users.

On the supply side, despite sharp increases in prices, the production of oil has risen only slightly in the past few years. Much of the subdued supply response reflects inadequate investment and production shortfalls in politically volatile regions where large portions of the world's oil reserves are located. Additionally, many governments have been tightening their control over oil resources, impeding foreign investment and hindering efforts to boost capacity and production. Finally, sustainable rates of production in some of the more secure and accessible oil fields, such as those in the North Sea, have been declining. In view of these factors, estimates of long-term oil supplies have been marked down in recent months. Long-dated oil futures prices have risen along with spot prices, suggesting that market participants also see oil supply conditions remaining tight for years to come.

The decline in the foreign exchange value of the dollar has also contributed somewhat to the increase in oil prices. The precise size of this effect is difficult to ascertain, as the causal relationships between oil prices and the dollar are complex and run in both directions. However, the price of oil has risen significantly in terms of all major currencies, suggesting that factors other than the dollar, notably shifts in the underlying global demand for and supply of oil, have been the principal drivers of the increase in prices.

Another concern that has been raised is that financial speculation has added markedly to upward pressures on oil prices. Certainly, investor interest in oil and other commodities has increased substantially of late. However, if financial speculation were pushing oil prices above the levels consistent with the fundamentals of supply and demand, we would expect inventories of crude oil and petroleum products to increase as supply rose and demand fell. But in fact, available data on oil inventories show notable declines over the past year. This is not to say that useful steps could not be taken to improve the transparency and functioning of futures markets, only that such steps are unlikely to substantially affect the prices of oil or other commodities in the longer term.

Although the inflationary effect of rising oil and agricultural commodity prices is evident in the retail prices of energy and food, the extent to which the high prices of oil and other raw materials have been passed through to the prices of non-energy, non-food finished goods and services seems thus far to have been limited. But with businesses facing persistently higher input prices, they may attempt to pass through such costs into prices of final goods and services more aggressively than they have so far. Moreover, as the foreign exchange value of the dollar has declined, rises in import prices have put greater upward pressure on business costs and consumer prices. In their economic projections for the June FOMC meeting, monetary policy makers marked up their forecasts for inflation during 2008 as a whole. FOMC participants continue to expect inflation to moderate in 2009 and 2010, as slower global growth leads to a cooling of commodity markets, as pressures on resource utilization decline, and as longer-term inflation expectations remain reasonably well anchored. However, in light of the persistent escalation of commodity prices in recent quarters, FOMC participants viewed the inflation outlook as unusually uncertain and cited the possibility that commodity prices will continue to rise as an important risk to the inflation forecast. Moreover, the currently high level of inflation, if sustained, might lead the public to revise up its expectations for longer-term inflation. If that were to occur, and those revised expectations were to become embedded in the domestic wage- and price-setting process, we could see an unwelcome rise in actual inflation over the longer term. A critical responsibility of monetary policy makers is to prevent that process from taking hold.

At present, accurately assessing and appropriately balancing the risks to the outlook for growth and inflation is a significant challenge for monetary policy makers. The possibility of higher energy prices, tighter credit conditions, and a still-deeper contraction in housing markets all represent significant downside risks to the outlook for growth. At the same time, upside risks to the inflation outlook have intensified lately, as the rising prices of energy and some other commodities have led to a sharp pickup in inflation and some measures of inflation expectations have moved higher. Given the high degree of uncertainty, monetary policy makers will need to carefully assess incoming information bearing on the outlook for both inflation and growth. In light of the increase in upside inflation risk, we must be particularly alert to any indications, such as an erosion of longer-term inflation expectations, that the inflationary impulses from commodity prices are becoming embedded in the domestic wage- and price-setting process.

I would like to conclude my remarks by providing a brief update on some of the Federal Reserve's actions in the area of consumer protection. At the time of our report last February, I described the Board's proposal to adopt comprehensive new regulations to prohibit unfair or deceptive practices in the mortgage market, using our authority under the Home Ownership and Equity Protection Act of 1994. After reviewing the more-than 4,500 comment letters we received on the proposed rules, the Board approved the final rules yesterday.

The new rules apply to all types of mortgage lenders and will establish lending standards aimed at curbing abuses while preserving responsible subprime lending and sustainable homeownership. The final rules prohibit lenders from making higher-priced loans without due regard for consumers' ability to make the scheduled payments and require lenders to verify the income and assets on which they rely when making the credit decision. Also, for higher-priced loans, lenders now will be required to establish escrow accounts so that property taxes and insurance costs will be included in consumers' regular monthly payments. The final rules also prohibit prepayment penalties for higher-priced loans in cases in which the consumer's payment can increase during the first few years and restrict prepayment penalties on other higher-priced loans Other measures address the coercion of appraisers, servicer practices, and other issues. We believe the new rules will help to restore confidence in the mortgage market.

In May, working jointly with the Office of Thrift Supervision and the National Credit Union Administration, the Board issued proposed rules under the Federal Trade Commission Act to address unfair or deceptive practices for credit card accounts and overdraft protection plans. Credit cards provide a convenient source of credit for many consumers, but the terms of credit card loans have become more complex, which has reduced transparency. Our consumer testing has persuaded us that disclosures alone cannot solve this problem. Thus, the Board's proposed rules would require card issuers to alter their practices in ways that will allow consumers to better understand how their own decisions and actions will affect their costs. Card issuers would be prohibited from increasing interest rates retroactively to cover prior purchases except under very limited circumstances. For accounts having multiple interest rates, when consumers seek to pay down their balance by paying more than the minimum, card issuers would be prohibited from maximizing interest charges by applying excess payments to the lowest rate balance first. The proposed rules dealing with bank overdraft services seek to give consumers greater control by ensuring that they have ample opportunity to opt out of automatic payments of overdrafts. The Board has already received more than 20,000 comment letters in response to the proposed rules.

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

Footnotes

1. Primary dealers are financial institutions that trade in U.S. government securities with the Federal Reserve Bank of New York. On behalf of the Federal Reserve System, the New York Fed's Open Market Desk engages in the trades to implement monetary policy. Return to text

2. The dominant role of commodity prices in driving the recent increase in inflation can be seen by contrasting the overall inflation rate with the so-called core measure of inflation, which excludes food and energy prices. Core inflation has been fairly steady this year at an annual rate of about 2 percent. Return to text

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