

For release on delivery
10:00 a.m. EST
February 15, 2006

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Chairman
Board of Governors of the Federal Reserve System
before the
Committee on Financial Services
U.S. House of Representatives

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Mr. Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress. I look forward to working closely with the members of this Committee on issues of monetary policy as well as on matters regarding the other responsibilities with which the Congress has charged the Federal Reserve System.

The U.S. economy performed impressively in 2005. Real gross domestic product (GDP) increased a bit more than 3 percent, building on the sustained expansion that gained traction in the middle of 2003. Payroll employment rose 2 million in 2005, and the unemployment rate fell below 5 percent. Productivity continued to advance briskly.

The economy achieved these gains despite some significant obstacles. Energy prices rose substantially yet again, in response to increasing global demand, hurricane-related disruptions to production, and concerns about the adequacy and reliability of supply. The Gulf Coast region suffered through severe hurricanes that inflicted a terrible loss of life; destroyed homes, personal property, businesses, and infrastructure on a massive scale; and displaced more than a million people. The storms also damaged facilities and disrupted production in many industries, with substantial effects on the energy and petrochemical sectors and on the region's ports. Full recovery in the affected areas is likely to be slow. The hurricanes left an imprint on aggregate economic activity as well, seen, in part, in the marked deceleration of real GDP in the fourth quarter. However, the most recent evidence--including indicators of production, the flow of new orders to businesses, weekly data on initial claims for unemployment insurance, and the payroll employment and retail sales figures for January--suggests that the economic expansion remains on track.

Inflation pressures increased in 2005. Steeply rising energy prices pushed up overall inflation, raised business costs, and squeezed household budgets. Nevertheless, the increase in prices for personal consumption expenditures excluding food and energy, at just below 2 percent, remained moderate, and longer-term inflation expectations appear to have been contained.

With the economy expanding at a solid pace, resource utilization rising, cost pressures increasing, and short-term interest rates still relatively low, the Federal Open Market Committee (FOMC) over the course of 2005 continued the process of removing monetary policy accommodation, raising the federal funds rate 2 percentage points in eight increments of 25 basis points each. At its meeting on January 31 of this year, the FOMC raised the federal funds rate another 1/4 percentage point, bringing its level to 4-1/2 percent.

At that meeting, monetary policymakers also discussed the economic outlook for the next two years. The central tendency of the forecasts of members of the Board of Governors and the presidents of Federal Reserve Banks is for real GDP to increase about 3-1/2 percent in 2006 and 3 percent to 3-1/2 percent in 2007. The civilian unemployment rate is expected to finish both 2006 and 2007 at a level between 4-3/4 percent and 5 percent. Inflation, as measured by the price index for personal consumption expenditures excluding food and energy, is predicted to be about 2 percent this year and 1-3/4 percent to 2 percent next year. While considerable uncertainty surrounds any economic forecast extending nearly two years, I am comfortable with these projections.

In the announcement following the January 31 meeting, the Federal Reserve pointed to risks that could add to inflation pressures. Among those risks is the possibility that, to an extent greater than we now anticipate, higher energy prices may pass through into the prices of non-energy goods and services or have a persistent effect on inflation expectations. Another factor

bearing on the inflation outlook is that the economy now appears to be operating at a relatively high level of resource utilization. Gauging the economy's sustainable potential is difficult, and the Federal Reserve will keep a close eye on all the relevant evidence and be flexible in making those judgments. Nevertheless, the risk exists that, with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately--in the absence of countervailing monetary policy action--to further upward pressure on inflation. In these circumstances, the FOMC judged that some further firming of monetary policy may be necessary, an assessment with which I concur.

Not all of the risks to the economy concern inflation. For example, a number of indicators point to a slowing in the housing market. Some cooling of the housing market is to be expected and would not be inconsistent with continued solid growth of overall economic activity. However, given the substantial gains in house prices and the high levels of home construction activity over the past several years, prices and construction could decelerate more rapidly than currently seems likely. Slower growth in home equity, in turn, might lead households to boost their saving and trim their spending relative to current income by more than is now anticipated. The possibility of significant further increases in energy prices represents an additional risk to the economy; besides affecting inflation, such increases might also hurt consumer confidence and thereby reduce spending on non-energy goods and services.

Although the outlook contains significant uncertainties, it is clear that substantial progress has been made in removing monetary policy accommodation. As a consequence, in coming quarters the FOMC will have to make ongoing, provisional judgments about the risks to both inflation and growth, and monetary policy actions will be increasingly dependent on incoming data.

In assessing the prospects for the economy, some appreciation of recent circumstances is essential, so let me now review key developments of 2005 and discuss their implications for the outlook. The household sector was a mainstay of the economic expansion again last year, and household spending is likely to remain an important source of growth in aggregate demand in 2006. The growth in household spending last year was supported by rising employment and moderate increases in wages. Expenditures were buoyed as well by significant gains in household wealth that reflected further increases in home values and in broad equity prices. However, sharply rising bills for gasoline and heating reduced the amount of income available for spending on other consumer goods and services.

Residential investment also expanded considerably in 2005, supported by a strong real estate market. However, as I have already noted, some signs of slowing in the housing market have appeared in recent months: Home sales have softened, the inventory of unsold homes has risen, and indicators of homebuilder and homebuyer sentiment have turned down. Anecdotal information suggests that homes typically are on the market somewhat longer than they were a year or so ago, and the frequency of contract offers above asking prices reportedly has diminished. Financial market conditions seem to be consistent with some moderation in housing activity. Interest rates on thirty-year, fixed-rate mortgages, which were around 5-3/4 percent over much of 2005, rose noticeably in the final months of the year to their current level of around 6-1/4 percent. Rates on adjustable-rate mortgages have climbed more considerably. Still, despite the recent increases, mortgage rates remain relatively low. Low mortgage rates, together with expanding payrolls and incomes and the need to rebuild after the hurricanes, should continue to support the housing market. Thus, at this point, a leveling out or a modest softening of housing activity seems more likely than a sharp contraction, although significant uncertainty

attends the outlook for home prices and construction. In any case, the Federal Reserve will continue to monitor this sector closely.

Overall, the financial health of households appears reasonably good. Largely reflecting the growth in home mortgages, total household debt continued to expand rapidly in 2005. But the value of household assets also continued to climb strongly, driven by gains in home prices and equity shares. To some extent, sizable increases in household wealth, as well as low interest rates, have contributed in recent years to the low level of personal saving. Saving last year was probably further depressed by the rise in households' energy bills. Over the next few years, saving relative to income is likely to rise somewhat from its recent low level.

In the business sector, profits continued to rise last year at a solid pace, boosted in part by continuing advances in productivity. Strong corporate balance sheets combined with expanding sales and favorable conditions in financial markets fostered a solid increase in spending on equipment and software last year. Investment in high-tech equipment rebounded, its increase spurred by further declines in the prices of high-tech goods. Expenditures for communications equipment, which had fallen off earlier this decade, showed particular strength for the year as a whole. In contrast, nonresidential construction activity remained soft.

Although the financial condition of the business sector is generally quite strong, several areas of structural weakness are evident, notably in the automobile and airline industries. Despite these problems, however, favorable conditions in the business sector as a whole should encourage continued expansion of capital investment.

For the most part, the financial situation of state and local governments has improved noticeably over the past couple of years. Rising personal and business incomes have buoyed tax revenues, affording some scope for increases in state and local government expenditures. At the

federal level, the budget deficit narrowed appreciably in fiscal 2005. Outlays rose rapidly, but receipts climbed even more sharply as the economy expanded. However, defense expenditures, hurricane relief, and increasing entitlement costs seem likely to worsen the deficit in fiscal 2006.

Outside the United States, economic activity strengthened last year, and at present global growth seems to be on a good track. The economies of our North American neighbors, Canada and Mexico, appear to be expanding at a solid pace. Especially significant have been signs that Japan could be emerging from its protracted slump and its battle with deflation. In the euro area, expansion has been somewhat modest by global standards, but recent indicators suggest that growth could be strengthening there as well. Economies in emerging Asia generally continue to expand strongly. In particular, growth in China remained vigorous in 2005.

Expanding foreign economic activity helped drive a vigorous advance in U.S. exports in 2005, while the growth of real imports slowed. Nonetheless, the nominal U.S. trade deficit increased further last year, exacerbated in part by a jump in the value of imported petroleum products that almost wholly reflected the sharply rising price of crude oil.

Surging energy prices also were the dominant factor influencing U.S. inflation last year. For the second year in a row, overall consumer prices, as measured by the chain-type index for personal consumption expenditures, rose about 3 percent. Prices of consumer energy products jumped more than 20 percent, with large increases in prices of natural gas, gasoline, and fuel oil. Food prices, however, rose only modestly. And core consumer prices (that is, excluding food and energy) increased a moderate 1.9 percent.

The relatively benign performance of core inflation despite the steep increases in energy prices can be attributed to several factors. Over the past few decades, the U.S. economy has become significantly less energy intensive. Also, rapid advances in productivity as well as

increases in nominal wages and salaries that, on balance, have been moderate have restrained unit labor costs in recent years.

Another key factor in keeping core inflation low has been confidence on the part of the public and investors in the prospects for price stability. Maintaining expectations of low and stable inflation is an essential element in the Federal Reserve's effort to promote price stability. And, thus far, the news has been good: Survey measures of longer-term inflation expectations have responded only a little to the larger fluctuations in energy prices that we have experienced, and for the most part, they were low and stable last year. Inflation compensation for the period five to ten years ahead, derived from spreads between nominal and inflation-indexed Treasury securities, has remained well anchored.

Restrained inflation expectations have also been an important reason that long-term interest rates have remained relatively low. At roughly 4-1/2 percent at year-end, yields on ten-year nominal Treasury issues increased only slightly on balance over 2005 even as short-term rates rose 2 percentage points. As previous reports and testimonies from the Federal Reserve indicated, a decomposition of long-term nominal yields into spot and forward rates suggests that it is primarily the far-forward components that account for the low level of long rates. The premiums that investors demand as compensation for the risk of unforeseen changes in real interest rates and inflation appear to have declined significantly over the past decade or so. Given the more stable macroeconomic climate in the United States and in the global economy since the mid-1980s, some decline in risk premiums is not surprising. In addition, though, investors seem to expect real interest rates to remain relatively low. Such a view is consistent with a hypothesis I offered last year--that, in recent years, an excess of desired global saving over

the quantity of global investment opportunities that pay historically normal returns has forced down the real interest rate prevailing in global capital markets.

Inflation prospects are important, not just because price stability is in itself desirable and part of the Federal Reserve's mandate from the Congress, but also because price stability is essential for strong and stable growth of output and employment. Stable prices promote long-term economic growth by allowing households and firms to make economic decisions and undertake productive activities with fewer concerns about large or unanticipated changes in the price level and their attendant financial consequences. Experience shows that low and stable inflation and inflation expectations are also associated with greater short-term stability in output and employment, perhaps in part because they give the central bank greater latitude to counter transitory disturbances to the economy. Similarly, the attainment of the statutory goal of moderate long-term interest rates requires price stability, because only then are the inflation premiums that investors demand for holding long-term instruments kept to a minimum. In sum, achieving price stability is not only important in itself; it is also central to attaining the Federal Reserve's other mandated objectives of maximum sustainable employment and moderate long-term interest rates.

As always, however, translating the Federal Reserve's general economic objectives into operational decisions about the stance of monetary policy poses many challenges. Over the past few decades, policymakers have learned that no single economic or financial indicator, or even a small set of such indicators, can provide reliable guidance for the setting of monetary policy.

Rather, the Federal Reserve, together with all modern central banks, has found that the successful conduct of monetary policy requires painstaking examination of a broad range of economic and financial data, careful consideration of the implications of those data for the likely

path of the economy and inflation, and prudent judgment regarding the effects of alternative courses of policy action on prospects for achieving our macroeconomic objectives. In that process, economic models can provide valuable guidance to policymakers, and over the years substantial progress has been made in developing formal models and forecasting techniques. But any model is by necessity a simplification of the real world, and sufficient data are seldom available to measure even the basic relationships with precision. Monetary policymakers must therefore strike a difficult balance--conducting rigorous analysis informed by sound economic theory and empirical methods while keeping an open mind about the many factors, including myriad global influences, at play in a dynamic modern economy like that of the United States. Amid significant uncertainty, we must formulate a view of the most likely course of the economy under a given policy approach while giving due weight to the potential risks and associated costs to the economy should those judgments turn out to be wrong.

During the nearly three years that I previously spent as a member of the Board of Governors and of the Federal Open Market Committee, the approach to policy that I have just outlined was standard operating procedure under the highly successful leadership of Chairman Greenspan. As I indicated to the Congress during my confirmation hearing, my intention is to maintain continuity with this and the other practices of the Federal Reserve in the Greenspan era. I believe that, with this approach, the Federal Reserve will continue to contribute to the sound performance of the U.S. economy in the years to come.