Economic Research Department

BBVA

Economic Brief

US

Fedwatch: Bernanke's Testimony on *The Economic Outlook*

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Bernanke said that the near-term economic outlook has weakened relative to the projections released at the end of January. He expects that the poor economic performance in recent months will likely extend to the 2Q08 and **GDP will not grow much and could even contract over 1H08** -in line with our forecasts. He still expressed measured optimism on the economic outlook for H208 and beyond, although he acknowledged that **risks remain to the downside** and the uncertainty of this forecast is quite high.

Residential construction is likely to contract somewhat further in coming quarters as builders try to reduce their high inventories of unsold new homes. Although consumer spending has decelerated considerably, Bernanke expects that the fiscal stimulus package together with new measures that Congress may still announce will provide relief. Net exports should continue to provide considerable support in coming quarters. The nonfinancial business sector remains financially sound, with liquid balance sheets and low leverage ratios, and most firms have been able to avoid unwanted buildups in inventories.

On the inflation front, Bernanke said that the recent pickup in inflation has been the result of sharp increases in the prices of crude oil, agricultural products, other globally traded commodities, and some pass-through from dollar weakness. However, core inflation has edged down recently after firming somewhat late. Bernanke expects **both inflation measures to moderate and converge in coming months.** This expectation is partially based on a leveling out of prices for oil and other commodities.

Bernanke's view on financial markets was pessimistic. Although Fed actions have given some breath to **financial markets**, they still **remain under considerable stress**; several financial institutions have reported significant losses and write-downs, limiting credit availability. Financial stress has reached markets that were untouched just a few months ago such as market municipal bonds, student loans, and mortgage backed securities issued by government agencies. In addition, strains continue to be evident in commercial paper.

Bernanke defended the rescue of Bear Stearns arguing that leaving this situation to market forces –which should be case when financial markets are healthy- would have led to *"unpredictable but likely severe"* consequences for market functioning and the overall economy. In the Q&A session, **Bernanke emphasized the importance of Congressional action in helping to stabilize the housing market**, particularly by preventing foreclosures to increase further, mainly through a loan-by-loan approach. In addition, he suggested that the recent rise of capital by some banks was a very positive sign.

Given Fed more pessimistic view on financial markets and its risks to the overall economy, further rate cuts are probable. **We expect an additional rate cut of 25 to 50 bp in April 30th**, depending on how financial markets and economic variables turn out; March's employment figures will be crucial. A more moderate stance is also supported by FOMC intentions to asses the impact of recent rate cuts and additional liquidity actions on the economy before continuing its easing policy.

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