Economic Research Department

BBVA

U.S.

Fed Watch

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Fed Funds: 0 to 0.25%
Next Meeting: August 11-12
Minutes Release: September 2

Semiannual Monetary Policy Report to the Congress

- **Monetary policy will remain accommodative and can be reversed if needed**
- **Bernanke stressed the importance of a strong commitment to fiscal sustainability**
- **In addition, monetary policy independence will help to keep inflation in check and improve financial stability**

Although Bernanke cited some improvement in financial conditions and economic prospects, he believes that household spending could be an important downside risk to the outlook because job insecurity, tight credit and home price declines could limit gains in consumer spending. In terms of inflation, he said that the FOMC participants believe that it will be "somewhat lower this year than in recent years, and most expect it to remain subdued over the next two years."

Bernanke expressed confidence that the Fed has the tools necessary to unwind the policy stimulus when need be. He outlined four tools that the Fed could use: (1) many measures will automatically unwind because the Fed's liquidity facilities are priced at a premium over normal interest rate spreads (2) the Fed has the authority to pay interest on balances held by depository institutions, which will give them leverage over short-term market interest rates (3) the Fed can create reverse repurchase agreements to drain liquidity from the system and (4) the Fed can sell their holdings of longer-term securities.

In regards to fiscal policy, Bernanke called for policymakers to "begin planning now for the restoration of the fiscal balance", stressing that "addressing the country's fiscal problems will require difficult choices, but postponing those choices will only make them more difficult". Finally, Bernanke emphasized the importance of regulatory reform in order to strengthen supervision, improve the resiliency of the financial system, increase the macroprudential orientation of the Fed's oversight and protect consumers.

Bottom-line: The testimony has aimed to alleviate concerns that the Fed's expansionary monetary policy could pose upside risks to inflation. Still there are risks to economic recovery and ongoing economic slack could result in subdued inflation for a prolonged period. We expect interest rates to remain unchanged for several more quarters.

Bernanke Semiannual Monetary Policy Report to the Congress
(Selected quotes)

In light of the substantial economic slack and limited inflation pressures, monetary policy remains focused on fostering economic recovery. Accordingly, as I mentioned earlier, the FOMC believes that a highly accommodative stance of monetary policy will be appropriate for an extended period. However, we also believe that it is important to assure the public and the markets that the extraordinary policy measures we have taken in response to the financial crisis and the recession can be withdrawn in a smooth and timely manner as needed, thereby avoiding the risk that policy stimulus could lead to a future rise in inflation.1 The FOMC has been devoting considerable attention to issues relating to its exit strategy, and we are confident that we have the necessary tools to implement that strategy when appropriate… Nevertheless, should economic conditions warrant a tightening of monetary policy before this process of unwinding is complete, we have a number of tools that will enable us to raise market interest rates as needed.

Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in the costs of Medicare and Medicaid. Addressing the country's fiscal problems will require difficult choices, but postponing those choices will only make them more difficult. Moreover, agreeing on a sustainable long-run fiscal path now could yield considerable near-term economic benefits in the form of lower long-term interest rates and increased consumer and business confidence. Unless we demonstrate a strong commitment to fiscal sustainability, we risk having neither financial stability nor durable economic growth.

Financial markets, in particular, likely would see a grant of review authority in these areas to the GAO as a serious weakening of monetary policy independence. Because GAO reviews may be initiated at the request of members of Congress, reviews or the threat of reviews in these areas could be seen as efforts to try to influence monetary policy decisions. A perceived loss of monetary policy independence could raise fears about future inflation, leading to higher long-term interest rates and reduced economic and financial stability. We will continue to work with the Congress to provide the information it needs to oversee our activities effectively, yet in a way that does not compromise monetary policy independence.