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Thank you for inviting me to join you again this year to discuss the economic outlook, a task that is distinctly more pleasant now than it was a year ago. When I spoke with you last January, economic activity was contracting quite sharply, and while I thought it was reasonable then to expect positive growth in the second half of last year, there was substantial uncertainty about how the contraction would ultimately play out. In particular, the possibility of a deeper contraction could not be dismissed. In the end, however, positive momentum did indeed return. Third quarter growth in real GDP exceeded 2 percent, and most economists expect to see a determination that the recession ended in the middle of last year. While that is undoubtedly good news, the *level* of economic activity is still far below where it was a couple of years ago; unemployment is quite high and many households and firms are making do with far less than they once did. Moreover, substantial economic challenges lie ahead for the U.S. economy. Having said that, I do believe that growth will continue this year and that incomes will generally improve. In my remarks today I will discuss the outlook for growth and inflation in the year ahead, and will touch on some of the important economic challenges we face. Before I begin, I should note that I speak only for myself and not for my colleagues on the Federal Open Market Committee.[1]

When we spoke last year I spent a fair amount of time on the list of factors that appear to have contributed to the decade-long boom in housing and housing finance that preceded, and appear to have precipitated this recession and the associated financial turmoil.[2] The list included: historicallystrong growth in productivity, which passed through to growth in real income and the demand for housing; low long-term real interest rates; technologically driven improvements in retail credit delivery which lowered borrowing spreads and expanded access to credit; and a regulatory regime which may not have adequately contained the moral hazard associated with perceptions that many large financial institutions, including the government-sponsored housing finance intermediaries Fannie Mae and Freddie Mac, were “too big to fail.” I don’t intend to discuss these at any length today, but I mention them as a warning against mono-causal explanations of what we have just been through.

The recession that appears to have just ended ranks as one of the deepest on record, and was led by the plunge in housing construction that followed the boom. During the boom home prices almost tripled, but by 2005 evidence began to signal that the run-up had gone too far. Vacancy rates began to hit record highs, and measures of home construction and sales activity began to fall precipitously. Home prices also began to decline, reducing equity values and household wealth, and leading to rising defaults and foreclosures. The layoffs in residential construction dampened growth in overall household income and thus household consumption spending. The rest of the economy then slowed and the expansion officially ended in December 2007. The recession that followed was longer and deeper than any we have experienced since the 1930s. I could cite a slew of dismal statistics, but I'll confine myself to one in particular – the number of people employed has fallen by 7.2 million through November, since it peaked at the end of 2007.

As I mentioned earlier, however, the contraction in overall economic activity appears to have ended last summer. The data we've received since then indicate that activity has generally improved. I'll discuss first the sectors where improvement is most evident. Starting with housing, several indicators of sales and construction activity hit low points early last year and have risen modestly since then. For instance, single-family housing starts have increased by 35 percent and new home sales have increased by 8 percent. And there are signs that home prices have bottomed out as well. One widely followed index of existing home prices nationwide rose a seasonally adjusted 3.9 percent from May to October. Even with these welcome gains, however, new housing construction remains well below the pace required to accommodate population and income growth on a sustained basis. That's to be expected, given what with hindsight appears to have been a substantial overinvestment in housing during the boom. As a result, while I expect residential investment will no longer be a drag on GDP growth, a lengthy period of adjustment may be necessary before any growth in residential investment is warranted.

Consumer purchases of cars and trucks also began to tail off in 2007 and then fell very sharply in 2008. Sales hit a low point last February and then increased very gradually before the "Cash for Clunkers" program boosted sales over the summer. The subsequent payback was smaller than many analysts had forecasted, however, and sales have improved steadily in the last four months. Granted, sales are still well below the long-run trend that would be needed to keep the stock of vehicles growing in line with population. But, just as with housing, autos are no longer a drag on GDP growth and should make positive contributions going forward, again in welcome contrast to the last two years.

Real consumer spending apart from autos, which fell slightly during the recession, also resumed an upward path last year. In the third quarter, consumer spending – apart from cars and trucks – increased at a 1.6 percent annual rate, and many economists are expecting a somewhat higher advance to be reported for the fourth quarter. Let me be clear here – consumers are by no means exuberant. The rise in the saving rate – to over 4 percent from under 2 percent in August 2008 – likely reflects a combination of apprehension about future income prospects and a desire to rebuild wealth depleted by the broad erosion in financial asset and home prices. But the recovery in equity prices and the stabilization in home values has no doubt contributed to the modest recent upturn in consumer spending. The ongoing stabilization in labor market conditions, which I will say more about in a minute, also appears to have played a role, by giving consumers a bit more confidence in their future income prospects.

Business spending on new equipment and software, which fell a sharp 21 percent during the recession, also has reversed course and registered positive gains. Firmness in business spending on capital goods may seem incongruous in light of the low levels of measured capacity utilization in many industries, but excess capacity in some sectors does not preclude the emergence of profitable opportunities to deploy new equipment and software elsewhere to reduce costs or improve processes and services.

In addition to these favorable domestic developments, there has been a worldwide rebound in economic activity, which is boosting demand in our export industries. A year ago, real exports were falling at nearly a 30 percent annual rate; in the third quarter, however, real exports increased at almost a 25 percent annual rate.

Toting up all these favorable demand side developments, recent estimates suggest that real GDP grew at roughly a three and three quarters percent annual rate in the second half of last year, its most rapid growth in several years. Part of that growth will reflect the inventory swing – earlier in the year inventory liquidation kept production (that is, GDP) below final sales, and the shift toward inventory accumulation provides a temporary boost to GDP *growth*. That addition to production will necessitate the hiring of new workers, which will add to households' incomes. Consumers, having deferred many purchases during the recession, will respond to growing incomes with higher spending. This is typical of the period immediately following a recession, and this time should be no different.

Indeed, signs of improvement on the supply side are evident. Industrial production has increased significantly since the low point in June 2009. While the mid-summer rebound in auto production was significant, even without autos, industrial production has increased by a solid 2.6 percent over that span. Moreover, a survey-based index published by the Institute for Supply Management rose substantially last year, and indicates that the growth in manufacturing activity is spread broadly across different industries. The new orders component of their index has registered even more impressive growth over that period, and is now at its highest level since December 2004. These particular indexes have a 60-year track record of giving highly reliable signals on recession and recovery, and we have no reason to suspect a break from past form.

One key element supporting the recovery is the significant improvement in financial conditions that occurred last year. Corporate borrowing costs have declined considerably, as interest rates on commercial paper and corporate bonds are now much lower than they were last year. Many major banks have sold stock successfully and now have the capital to support new lending, even if conditions turn out worse than expected. Granted, we frequently hear anecdotal reports of business borrowers being turned down for credit, or having long-standing credit lines cut off. It is important to recognize, however, that many borrowers will naturally face tougher credit terms in a soft economy, because their revenue prospects are likely to be more uncertain. Moreover, the proper benchmark is the ability of the banking system *as a whole* to supply an appropriate quantity of credit, since any one given bank may be shrinking their balance sheet while others are expanding. I am not aware of any evidence that the banking industry as a whole is inappropriately impeding the availability of credit.

I have been focusing thus far on the areas of the economy where improvement is evident. There are other areas in which we still face major economic challenges. In commercial real estate, construction is falling, vacancy rates are rising, and falling property prices are eroding owners' equity positions. Holders of commercial-mortgage-backed securities have already taken sizeable losses, with more on the horizon as numerous projects are scheduled for refinancing. And some community banks have lent heavily to commercial real estate developers and are now facing rising delinquencies and losses. No one expects a quick reversal of these negative trends, and as a result, business investment in nonresidential structures is likely to be a sizable drag on U.S. growth in the near term.

More worrisome is the labor market. The number of people employed fell for 23 straight months through November. The unemployment rate more than doubled, to a 10.0 percent rate in November. Wages are under pressure; average hourly earnings in November were up only 2.2 percent over the previous November, about half the rate of increase we saw in mid-2007. Going forward, as overall economic activity continues to improve, employment will return to an upward trajectory. Indeed, we have seen a few initial signs of improving labor demand, such as an increase in the average workweek in November. Even the more optimistic forecasters, though, do not expect a rapid improvement in national labor market conditions, and we will need to carefully monitor employment and earnings for an extended period. I should note that this section of my remarks was written before this morning's employment report was released.

Putting the whole picture together, I think the most likely outcome is that the economy will grow at a reasonable pace this year – housing should continue to recover from a very depressed state, consumers should gradually expand spending, business investment should make something of a comeback, and these components of demand should overcome a continuing drag from commercial construction.

I am often asked how economists can be so upbeat in light of the obvious economic challenges we face, such as the severe weakness in the jobs market, the low level of residential construction activity, and the declining level of commercial construction activity. My answer begins with the observation that there are obvious, serious problems coming out of *every* recession, and we have a historical record of 31 previous recessions in this country to study. Despite the obvious problems at the end of each recession, we always recover, and quite often more rapidly than many expect. And if you drill down into the details of those 31 recoveries, some common elements are apparent. I already touched on one, the end of the inventory cycle which is boosting production right now. More important, in my view, is the behavior of individual consumers during recessions. While many workers lose their jobs during downturns, a much greater number of workers remain employed. Many of them will take the precaution of cutting back on spending and deferring major purchases, just in case something happens to their job. As the recovery begins to take hold, these workers gradually become more confident about their future job and income prospects and begin to spend a larger fraction of their incomes. Similarly, many firms will find it prudent to reduce capital spending during a recession, but as demand revives, those same firms will see an increasing number of viable investment opportunities. In short, deferred spending in recessions creates pent-up demand by consumers and businesses that will bolster spending once the recession ends. I see no reason for this cycle to be any different. Once again, my outlook is tempered with the recognition that times are tough in many areas, and that a long period of growth will be needed to fully recover from this recession. So while a recovery *is* firmly in place, I believe, it is clear that the *level* of economic activity will disappoint many people for quite some time.

As always, there are some risks around this outlook. The labor market could conceivably recover more slowly than many expect, which would restrain consumer spending and dampen growth. But household incomes and household confidence could conceivably rebound more vigorously than many expect, in which case consumer spending could expand more briskly. It is also worth mentioning a risk that seems particularly prominent in this recovery; firms and individuals are facing major uncertainties surrounding federal policies on trade, the environment, health care and financial services. For a business considering a commitment to new capital spending or new hiring, it can be difficult to estimate after-tax yields for an endeavor in an environment that is so rich with proposals for higher taxes and new regulations. This uncertainty – which I sense has not been so pronounced in previous recoveries – could well bias firms toward deferring new investment and hiring commitments, which would lead to lower productivity growth and hence a slower recovery.

Turning now to the outlook for inflation and monetary policy, a year ago many economists expected the exceptionally low level of economic activity to depress inflation, and perhaps even push it below zero. Things turned out differently. Inflation expectations, which embody projections about the future conduct of monetary policy, have remained fairly stable according to the best available measures. This has had an anchoring effect on core inflation, which averaged 1.5 percent last year. In my view, that's a very good performance, and I hope it continues. Fortunately, the risk of a pronounced reduction in inflation seems to have diminished substantially at this point. During the recovery period ahead we may face an increasing risk of inflation edging upward, which has sometimes occurred during past recoveries. While that risk appears to be minimal at this point, we will have to be careful as the recovery unfolds to keep inflation and inflation expectations from drifting around.

What we will need to be careful about is *when* and *how* to withdraw the considerable monetary policy stimulus now in place. This requires care during every recovery, but this time the Fed will have *two* monetary policy instruments at its disposal, not just one. The Fed traditionally has targeted the overnight federal funds rate, which required appropriately adjusting the supply of monetary liabilities (currency and bank reserves). Varying the fed funds rate affected a broad range of other market interest rates, and thereby influenced growth and inflation. Since October 2008, as the bankers in the room are aware, we have had the authority to pay explicit interest on the reserve balances banks hold. This gives us the ability to vary independently the amount of our monetary liabilities and a critical overnight interest rate. So when the time comes to withdraw monetary stimulus, the FOMC will be able to raise the interest rate on reserves or drain reserve balances, or both.

Despite the added challenges of this new regime, however, the core objective of monetary policy is still price stability. As always, that will require keeping inflation expectations anchored. Since those expectations reflect views about the future conduct of monetary policy, we will need to choose carefully *when* and *how rapidly* to remove monetary stimulus. This is the same difficulty we face after every recession. For my part, I will be looking for the time at which economic growth is strong enough and well-enough established.

While the economic outlook for the coming year appears to be brighter than the year just ended, our economy does face several significant challenges over the longer term, and I'll conclude by briefly mentioning two of these. The first is the path of future federal budget deficits implied by current and planned fiscal policies. It should be self-evident that the government's debt cannot grow indefinitely at a rate much faster than the economy itself grows, as is implied by current law. Ultimately, something has got to change – either taxes are raised, spending is reduced, or the real value of the debt is eroded through inflation. While economists can debate the effects of particular changes in spending and taxes, at some point a government debt that grows relative to GDP inevitably will compete with private borrowing, leading to higher interest rates, slower capital accumulation, and, therefore, less improvement in standards of living. And when the shortfalls get large enough, these effects will be exacerbated by ambiguity about how the fiscal imbalance will ultimately be resolved. Failure to establish credible plans for bringing the fiscal position back into balance could dampen economic growth over the long run.

Another challenge arises in the area of financial regulatory reform. In the wake of the crisis we have just been through, it makes sense to reexamine our approach to financial regulation. I have argued elsewhere that the most important step to ensuring long term financial stability is to establish clear and credible limits to the federal financial safety net – which has grown considerably as a result of the response to the crisis. I believe that the crisis itself was in no small measure the result of our not having clear limits on government support. Leverage and excessive risk-taking were encouraged by the belief that large parts of the financial system were implicitly protected, and those beliefs have been ratified. If we retain a stance of official ambiguity as to when such protection will or will not be forthcoming in the future, then I suspect our susceptibility to disruptive financial crises will continue to grow, and with each crisis, the safety net will become ever more expansive. A more expansive safety net will inevitably require more stringent regulation, but regulatory systems are necessarily limited in their capacity to completely offset the incentive distortions due to the safety net. So just like ambiguity about the path of future fiscal policies, continued ambiguity about the financial safety net could limit our capacity for growth in the long run.

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[1]I am grateful to Roy Webb for assistance in preparing this speech.

[2]Lacker, Jeffrey M. (2009). "Financial Conditions and the Economic Outlook," speech delivered to the Maryland Bankers Association, Linthicum, Md., Jan. 9.