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It's a pleasure to speak on the economy today. Like many of you, I almost dread picking up a newspaper in the morning and seeing headlines about natural disasters and new outbreaks of fighting around the world. And even when the subject is the economy, the news is full of risks, surging oil prices and a broken Federal budget. I don't want to minimize these risks, which are real. But I also don't want to lose sight of an economy that is firmly in recovery mode, and the fundamentals for future growth are strong. Before we look at the economic outlook in more detail, I would like to emphasize that these remarks are my own and the views expressed are not necessarily shared by my colleagues in the Federal Reserve System.[1]

Let me begin by setting the stage. In 2008 and through the first half of 2009, we experienced the worst recession since the Great Depression. We saw growth turn positive again in July 2009. Our best measure of overall economic activity, gross domestic product or GDP, increased at a modest 2.9 percent annual rate over the next six quarters. Many observers were disappointed with that modest growth, which was barely above the long-run trend rate that results from population growth and productivity growth. But at least real GDP *has* improved, since its level is now above its previous peak in the fourth quarter of 2007. Other important indicators of growth have not recovered. The number of employees on nonfarm payrolls has risen by 1.4 million persons in the last 15 months, but that increase is dwarfed by the 8.7 million jobs that were lost in the previous two years. It's fair to say that we have a ways to go before we will fully recover from what many are calling the Great Recession.

A natural question is whether growth could be stronger. After all, we can remember other times when the recovery from a recession was much more rapid than this current recovery. Consider the recoveries from the other two deep recessions in the postwar period, the recessions of 1981-82 and 1974-75. In the first six quarters after those recessions ended, real GDP growth averaged a 6.3 percent annual rate. Accompanying that output growth, job growth averaged 4.5 million persons in those two recoveries.

Two factors account for much of the sluggishness of this first stage of the recovery. The most obvious is the collapse of housing construction. We built too many houses in the boom years from 1995 to 2005, and many of those houses are now vacant and are pretty good substitutes for new construction. As a consequence, residential investment fell by 57 percent from the end of the housing boom to the end of the recession, and has fallen further in this recovery. In contrast, residential investment increased an average of 40 percent in the first year of recovery following the two recessions I mentioned earlier.

While housing is the most obvious factor dampening this recovery, residential investment accounts for only 2.4 percent of GDP at this point. A much larger factor is consumer spending, which accounts for over 70 percent of GDP. In the first five quarters of this recovery, consumer expenditures increased at an annual rate just below 2 percent. This is in contrast to the two other recessions, where household spending grew by an average of 6-½ percent in the first year of expansion.

Thus a key to the outlook is consumer behavior. At over two-thirds of GDP, it is impossible to imagine a robust recovery without a substantial advance in consumer spending. And it is easy to understand why consumers were cautious at the beginning of the recovery. A large number of households experienced unemployment during the recession, and many more were uncertain about their job security. Wage growth fell during the recession. Housing prices declined, in many cases unexpectedly, significantly reducing the value of housing equity on the consumer balance sheet. Stock prices declined sharply during the recession. It should not be too surprising that consumers responded to this adversity by deferring nonessential spending and rebuilding their balance sheets. That behavior is reflected in statistics such as personal saving, which was slightly below 2 percent of income in mid-2007 but was slightly above 6 percent of income at the end of the recession.

Some important fundamentals underlying household spending plans have improved significantly since the recession's end. New claims for unemployment insurance have trended down since last summer. The unemployment rate has fallen by 1.3 percentage points from its peak, and as a result, those who *are* employed have reason to be more confident in their job security. Employment has picked up, with growth in the last two months averaging slightly better than 200,000 jobs per month. The employment components of the Institute for Supply Management's monthly surveys of manufacturing and nonmanufacturing activity are at extremely high levels, signaling broad gains in labor market conditions. The stock market has more than doubled from its recession low point, and the net worth of households has increased by $8 trillion since early 2009. As these fundamentals have improved, so has consumer spending. Retail sales rose 5.2 percent in the first year of recovery, and in the next nine months improved at a 9.9 percent annualized growth rate.

I would stress that this higher pace of consumer spending is solidly grounded in improving fundamentals. Thus I expect robust growth to persist, as consumers see continuing improvements in job markets, incomes and wealth. Moreover, households have deferred nonessential spending for several years and a stock of pent-up demand has built up; as they gain confidence, it is likely they will draw down that stock and boost spending as a result.

Thus I see consumer spending as an important part of the recovery, but there are other areas of strength as well. Exports of goods and services have risen 18 percent since the end of the recession, adding 2 percent to real GDP growth. Yes, exports fell in February, as reported yesterday by the U.S. Bureau of Economic Analysis, but they remain well ahead of the fourth quarter's pace. Moreover, the key fundamental factor for export demand is growth abroad, and here the prospects are excellent. Although growth in the highly industrialized economies has been similar to domestic growth, many less developed economies are growing very rapidly. Especially notable are the two most populous countries; China's GDP grew 9.7 percent last year and India's GDP grew 8.3 percent. Again, this growth is solidly based, as these countries are deploying a large labor base more effectively. Japan's growth miracle following World War II lasted for several decades, and the current crop of rapidly growing economies can look forward to several decades on the fast track. As they grow, they will buy more of our products. Consumers who join their middle class will buy goods we make that were formerly luxuries, from pharmaceuticals to motion pictures. Demand for our agricultural products will rise. Most importantly, newly industrializing economies will want to acquire more capital goods in order to allow workers to move into more productive activities. For all of these reasons, export demand is likely to contribute strongly to U.S. growth for the foreseeable future as we produce goods and services that the world wants to buy, especially the most rapidly growing parts of the world.

Business expansion also should make a significant contribution to growth this year. Investment in equipment and software has grown 22 percent since the end of the recession. Opportunities to streamline business processes and reduce costs through productivity-enhancing investments appear to be widespread. The pickup in demand growth also is providing further encouragement for capital spending plans. All told, the economy has a lot going for it.

At the same time, there are still substantial challenges ahead. Housing activity remains depressed. Given the large inventory of vacant homes and the ongoing foreclosure wave, home prices are likely to remain under pressure, and the best case for residential construction would be a slow, uneven advance.

Another challenge comes from the recent run up in energy prices. The world price of crude oil has risen more than 60 percent since last summer, and the economy is facing large increases in the prices of gasoline and other petroleum products. Consumer spending growth is likely to be somewhat restrained for a time as households adjust to these higher prices. I would be concerned if I expected further price increases. But at this juncture, futures markets are pricing in modest declines in petroleum products. If the markets are right, the effect of energy prices on consumer spending should only be temporary.

A longer-run challenge is fiscal policy. The trajectories of federal government spending and taxes have diverged, leaving us with a budget deficit that was above 10 percent of GDP last year. The amount of government borrowing is therefore rising more rapidly than GDP, with no relief in sight under current legislation. Of course, borrowing cannot grow faster than our ability to repay forever. That is simply not feasible and most definitely will not happen. The real question is whether our elected officials make timely adjustments to the paths of spending and taxes, or whether a crisis forces hasty decisions. Until credible changes are made to align spending and taxes, an overhang of uncertainty will make long-term planning more difficult for households and firms.

Despite these challenges, most forecasters predict that overall economic activity will grow at a pace that is well above trend for the next few years, and I would sign on to that forecast. Under that forecast, unemployment would continue to decline and income growth would improve.

The improvement in U.S. economic activity will translate into a continued strengthening of the Maryland economy. As a result of its diverse private sector, strong education and health sectors, and hefty federal spending within the state, the Maryland economy fared better than the national economy during the recession. This assessment includes Maryland's labor markets, where the unemployment rate, though still elevated, is well below the national average at 7.1 percent, and payroll employment has grown by 1.8 percent over the past 12 months. The same is true of the Baltimore metropolitan area, where hiring also has increased. As a result of the improving labor market, wage and salary growth has rebounded, which has helped support consumer spending. For example, in 2010, new car sales in Maryland increased for the first time since prior to the recession. Over the next several years, the state's economy should benefit from the Base Realignments at Aberdeen Proving Ground and Fort Meade, which will bring new residents and demand for ancillary services. The presence of an array of strong research institutions, particularly in the life sciences, should also contribute to the economic vitality of the state. Maryland is home to more than 400 life-science businesses, one of the largest life science clusters in the nation. It has demonstrated the capability of world-class scientific research to generate the type of innovations that lead to start-up firms and job creation. Abundant evidence suggests that such innovation is the foundation for long-run growth in any economy.

One reason that the consensus of forecasters is so positive about the national economy is that they believe that the inflation environment will remain benign. Over the 12 months ending in February, the price index for personal consumption expenditure has risen 1.6 percent. In the absence of further energy price increases most forecasters do not foresee a significant acceleration in prices this year. We should not take that outcome for granted, however. Commodity price increases have squeezed profit margins for many firms, and we are increasingly hearing that some are looking for an opportunity to raise prices. If firms see robust demand growth, they will be increasingly willing to pass input price increases through to their customers. Such increases can be common in this stage of the business cycle.

Businesses thus far have absorbed input price increases, presumably believing that competitors would not follow suit, which suggests that they believe that overall inflation will remain low. The responsibility of the Federal Open Market Committee (FOMC) is to validate these expectations by conducting monetary policy in such a way that inflation does not accelerate. That's not always an easy task at this point in a recovery. In the last cycle, the economy began to grow more rapidly at the end of 2003. Although energy prices showed growth spurts, unemployment had not yet begun to fall and the core inflation measure that excludes energy and food prices was still just 1-½ percent. As a result, many forecasters expected inflation to diminish, and the FOMC kept the funds rate at a very low level well into 2004. Instead of falling, overall inflation soon rose to 3 percent, where it stayed, on average, through the end of the expansion in 2007. Core inflation averaged 2-¼ percent over that horizon. With hindsight, I think it is fair to say that policymakers overestimated the extent to which high unemployment would keep inflation from accelerating, and as a result, waited too long to withdraw monetary stimulus. Four years of 3 percent inflation may not have been the worst of all possible outcomes, but I do not consider it a success. I hope we do better this time. In particular, I believe we need to heed the lesson of the last recovery that inflation is capable of rising even if the level of economic activity has not returned to its pre-recession trend.

In conclusion, let me say that we've come through an extraordinary period in our nation's history. Despite all the challenges, there are good reasons for an affirmative view of the future, as long as policymakers follow coherent, sustainable long-term policy plans. I look forward to working with my colleagues in the Federal Reserve to meet the unique monetary policy challenges we face this year.

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