**The Economic Outlook**
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It's a pleasure to speak to you today. My topic today is the current economic situation and the outlook for the period ahead. Motivating an interest in this topic has been somewhat easier than usual in recent months. And the appearance of the word "recession" on a popular weekly news magazine only helps. Before we begin, though, let me remind you that the usual disclaimer applies: The views I express are my own and are not necessarily shared by any of my colleagues on the Federal Open Market Committee.[1]

The background for today's economic situation is the remarkable boom in housing that ended a couple of years ago. From 1995 to 2005, new housing starts increased by over 50 percent, and existing home prices increased by over 150 percent (as measured by the Case-Shiller repeat sales index). Over that interval, the homeownership rate increased significantly, from around 64 percent to 69 percent. Eventually, however, prices grew more rapidly than incomes in many major markets, and housing activity peaked in early 2006 across a range of markets. Since then, new housing starts have fallen by 55 percent, and since mid-2006, home prices have fallen by 18 percent.

A deterioration in the housing market of this magnitude was not assigned much probability by many borrowers, lenders or investors, even if, in retrospect, it appears to many observers that it should have been foreseen. The decline in homeowners' equity in many regions has led to an increase in delinquencies and defaults, particularly among mortgages that were made in 2006 and 2007. As a result, we've seen precipitous drops in the prices of many securities backed directly or indirectly by residential mortgage cash flows. The ramifications of those falling asset prices led to dramatic events in wholesale financial markets since last August.

After the housing market peaked, the steady fall in home construction became a sizable drag on growth. Last year, the decline in residential investment subtracted about a percentage point from real GDP growth, and in the first quarter of this year, it lowered growth by 1.2 percentage points. Moreover, swollen inventories of unsold homes continue to depress prices and new construction. The vacancy rate for owner-occupied housing was 2.9 percent in the first quarter, which is the highest value recorded in the 52-year history of that particular data series. Most lenders have eliminated many riskier innovative mortgage products from their line-ups, which makes sense given the recent performance of such products, but which makes homeownership more costly than it was during the boom. Thus, most observers are very hesitant about calling a bottom in housing construction, sales or prices. And even if housing market activity does manage to bottom out later this year, it is likely that any recovery would be exceedingly slow.

The bad news has not been limited to housing. Last year, over 16 million cars and trucks were sold in this country; in the first quarter of 2008, the sales rate fell to 15.3 million units; and in April and May, the sales rate fell to 14.4 million units. Not surprisingly, motor vehicle assemblies have fallen 21 percent this year.

That's a stiff dose of bad news. But a couple of other demand components have provided somewhat brighter news of late. First, the demand for exports has been strong due to robust economic activity abroad and the weakness of the dollar in foreign exchange markets. Exports added 0.9 percent to real GDP growth in 2006 and 2007 and are likely to make a healthy contribution to growth this year as well.

We also have seen surprising indicators of firmness in business investment. At the turn of the year, we began hearing anecdotal reports, both in our District and elsewhere in the country, of commercial development projects being deferred or cancelled outright. Many of us had expected to see a contraction in commercial construction by now, but over the last three months, private nonresidential construction has increased by 4 percent. Still, I think it is reasonable to expect some slowing later this year. Much of the reported activity in recent months reflects projects that were initiated well before the tightening in commercial real estate lending terms that took place at the end of last year. As these projects move through the pipeline, it is likely that fewer new projects will take their place; indeed, we are seeing some good evidence of this in the recent falloff in architectural billings. Thus, it would not surprise me to see the pace of commercial construction soften in coming months.

Business spending on equipment and software has also been firmer than I expected. For example, new orders for non-defense capital goods, excluding aircraft, rose 4 percent in April to their highest level since 2006. This covers a large part of business equipment investment and is a sign that business capital spending is holding up relatively well. The sense I get from our contacts is that most organizations have a large menu of options to improve and rationalize their information technology infrastructure and business processes in valuable ways, and they foresee a continual stream of spending on such projects.

Real consumer spending, the largest component of demand, has been sluggish – for the first four months this year, spending rose by only 0.2 percent. The reason for the slow consumer spending growth is no mystery, since income growth has also been restrained. For example, real disposable personal income increased by only 0.5 percent for the first four months of this year. The retail sales report for May did show a noticeable pick-up in spending, but this could well be attributable to the disbursement of federal stimulus payments, so it's difficult to tell whether it represents a fundamental improvement on household spending trends.

I mentioned how slowly real household income has grown, and a major reason for that is the weak state of labor markets. Job growth was robust in 2006, with payrolls expanding by about 175,000 jobs per month. Job growth tailed off in 2007, as the residential construction industry began shedding workers. And payrolls have fallen every month so far this year, with an average loss of 65,000 jobs per month. Consistent with this picture of a worsening labor market, the unemployment rate has risen from a cyclical low of 4.4 percent in March, 2007, to 5.5 percent this May.

Another factor that has dampened real income growth is the large increases we've seen in food and energy prices. While forecasting such prices is a challenging endeavor, should they follow the relatively flat trajectory implied by futures prices, then they would no longer restrain the *growth in* (as opposed to the level of) real income.

Taking the bad news together with the good, the story that emerges is of an economy that is growing at only a tepid pace overall. Over the last two quarters, real GDP has grown at an annual rate of only three -quarters of a percent, which is about one-fourth of our long-run potential growth rate. Earlier this year, many observers extrapolated this slowdown into an outright decline in economic activity and concluded that the economy was in or about to enter a recession. But the data we've seen since then have not yet shown the sharp, widespread reversals that define a recession, and thus the odds of a severe downturn appear to have diminished. Nevertheless, growth in output and income while positive, clearly has slowed; employment clearly is declining.

Looking ahead, consumer spending is likely to be bolstered by the government's stimulus checks over the next few months. Indeed, as I noted earlier, the May retail sales report suggested as much. But beyond that, there are legitimate concerns on the growth outlook. Most importantly, if the labor market continue to contract, consumer incomes and spending are likely to suffer and restrain overall economic activity going forward. The timing and size of any decline in commercial construction activity is uncertain as well, and it could well hamper growth in the second half.

At the same time, I have followed the economy closely for much of my professional career and have learned two important lessons that are relevant today. First, don't underestimate consumer resilience. People tend to look forward and will often take a temporary shock in stride, even a severe one. And second, don't underestimate the power of monetary policy. The Federal Open Market Committee has lowered the federal funds rate from 5 ¼ to 2 percent in less than eight months, which, in real, inflation-adjusted terms, bring it below zero. There is currently a good deal of monetary stimulus in the pipeline to support activity in the months ahead.

While the growth outlook has improved a bit since the beginning of the year, the same cannot be said for the inflation outlook. The latest figures confirm that inflation is unacceptably high. The price index for personal consumption expenditure, increased 3.2 percent over the 12 months that ended in April, and that figure is likely to rise given Friday's CPI report for May. To put that in perspective, for several years, I have suggested an inflation target of 1.5 percent.

Of course, price increases have been concentrated in the food and energy categories, and taking those out, the conventional PCE core inflation rate has been slightly above 2 percent. Because core inflation has traditionally exhibited a fair amount of persistence, last year's core inflation is often a good forecast of the coming year's core inflation. The conventional approach is to combine that rule-of-thumb with food and energy price projections derived from futures prices. Since futures markets have generally implied flat price paths, the result is an expectation that overall inflation will decline until it converges with core inflation.

Competitive trading markets are impressively effective mechanisms for weighing and amalgamating widely divergent views, and so one shouldn't ignore the information embodied in market prices, and I don't. The implied forecast misses have been predominantly on the high side in recent years, however. The risk for inflation dynamics is that elevated rates of increase in overall price level become embedded in expectations.

We seem to have dodged this risk so far. Despite several years of elevated inflation, the public's expectation of future inflation has not become completely adrift as it was in the 1970s. We have several ways of gauging expectations, none of them perfect, but they agree that inflation expectations are higher than I would like but are relatively stable. That sense of relatively stable expectations is consistent with the behavior of wages. There are no signs now of a wage-price spiral, with wages accelerating in a futile attempt to stay ahead of accelerating prices. In fact, gains in overall compensation have been remarkably stable over the last couple of years.

The apparent stability of inflation expectations does not justify complacency, however. Those expectations build in a sense of how the Fed will tend to react to incoming data. Maintaining credibility depends on continuing to conduct policy in a way that is consistent with the stability of inflation expectations, and acting forcefully should those expectations erode.

Part of the rationale for the speed with which the FOMC brought down the funds rate was the risk that the slowdown we are experiencing would prove to be more severe. While that uncertainty has not entirely disappeared, my sense is that such downside risks have diminished appreciably. And just as easing policy aggressively in response to emerging downside risks made sense, withdrawing some of that stimulus as those risks diminish makes eminent sense as well. Moreover, our attention to risks needs to be two-sided, I believe. As we move through this period of low growth, we need to be attuned to the risk that we emerge from the slowdown with inflation following a higher trend than when we went in. This danger associated with the persistence of elevated inflation warrants an additional measure of vigilance.

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