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As you are well aware, we are in the midst of a severe recession. It is likely that, by at least some metrics, this recession will prove to be more severe than any other we have seen in the last 60 years. The recession began at the beginning of last year, and the rate of decline became particularly acute last fall. All economic contractions eventually come to an end, however, and the growth process resumes. Where are we in this process? As I will discuss, while overall activity is still contracting, it now appears as if the pace of contraction is diminishing, and at some point later this year, activity will bottom out and begin expanding again.[1]

Before getting to the outlook, I would like to provide a little background on some notable developments that preceded the recession. As always, the views expressed are my own, and not necessarily the official views of the Federal Reserve System. The most spectacular event was undoubtedly the boom-bust cycle in housing activity. Residential investment rose from 4.1 percent of GDP in 1995 to 6.2 percent of GDP in 2005, which is almost a 50-percent increase in housing's share in overall economic activity. While the popular view is that the expansion was excessive, a large part of that increase reflected solid economic fundamentals, such as strong income and employment gains and low long-term interest rates. Another important supporting factor was the multifaceted public policy commitment to boosting housing activity and home ownership, from the favorable tax treatment of mortgage borrowing to the implicit subsidies flowing through the housing-related government-sponsored enterprises. In addition, genuine innovation in mortgage lending and securitization helped to make home mortgage borrowing more affordable to a wider segment of the population. In retrospect, we can see that this beneficial financial innovation was accompanied by lax underwriting standards by many lenders, overly complex and opaque securitization, and expectations of future housing price appreciation by many borrowers, lenders, investors and analysts. In essence, a housing boom that was driven by economic fundamentals was intensified by mortgage-market participant assessments that were, in hindsight, overly optimistic.

Some commentators have claimed that the housing boom and bust and the resulting turmoil illustrate fundamental flaws in modern financial markets and institutions. Before we jump to such conclusions, however, we need to evaluate the extent to which risk-taking incentives in financial markets have been distorted by actual and perceived government financial safety net protection. It strikes me as quite plausible that the major shortcomings of our system of housing finance are attributable primarily to the distorted behavior of institutions that are viewed as "too big to fail."

By the middle of this decade, evidence began to signal that the boom had gone too far. For example, the number of vacant homes began to rise and, by the end of 2005, the homeowner vacancy rate was 2 percent, which at the time was the highest value that had been seen in that series in several decades. At about the same time, many measures of housing activity recorded their peak values for the cycle. Residential investment has since fallen sharply, from 6.2 percent of GDP in 2005 to 2.7 percent last quarter, and it is not clear when a bottom will be reached. Despite this decline in new construction activity, home vacancies have continued to increase, and the homeowner vacancy rate has been above 2 ½ percent for the last two-and-a-half years. Clearly, a substantial overhang of surplus housing inventory remains.

The boom in construction was accompanied by increasingly large price increases. One measure of home prices increased 192 percent from 1995 to 2006.[2] Similarly, the bust has led to falling prices; the same index has fallen 20 percent over the last two years. Falling home prices have reduced home equity values and household wealth. Falling home prices also have led to rising delinquencies and defaults and substantial reductions in the value of mortgage-backed securities on the books of many financial institutions.

Future economic historians are likely to identify several other forces that contributed to the onset and the intensity of the recession, but are unlikely to revise the assessment the boom-bust cycle in housing and housing finance was the dominant causal force. A relatively rapid decline in residential investment began early in 2006. Manufacturing production began to fall in mid-2007, with pronounced weakness in building materials and autos. This weakness on the supply side spilled over to total spending, which began declining in the final quarter of 2007 – the official peak of the business cycle. After spending began to decline, so did employment; last year we lost over 3 million jobs, and in the first quarter of 2009 we lost an additional 2 million jobs. I could continue, but these dismal statistics should be enough to convey the severity of the current recession. In brief, the declines in economic activity have been large, the declines have been widespread, and the recession already has lasted longer than most post-World War II recessions.

That's the background; now for the outlook. Most prominent forecasters expect the recession to end later this year, and I believe that is a reasonable view, for several reasons. I will begin by highlighting two important stabilizing forces that are often underestimated: one is the resilience of the American consumer, and the other is the power of monetary policy.

With respect to consumers, the key determinant of any family's spending plan is their current income and wealth, coupled with their view on the incomes they will be receiving in the months and years ahead. It is true that consumer wealth has taken a severe beating in this recession. But it is also true that for most households, the present value of future labor income is much larger than their tangible and financial asset holdings. Consumers typically cut back on spending in a recession as their wealth declines and their income prospects darken. But at some point, consumers look ahead and become more confident in their post-recession employment and income prospects, and consequently begin to spend more vigorously than an analyst focused on recent wealth trends might expect. This time is no different, and we are now seeing some evidence of this type of resilience. I should note that real disposable income has actually increased at a 4.4 percent annual rate in the last two quarters, so firmer spending should not be too much of a surprise. Thus, in the first quarter, real consumer spending increased at a solid 2.2 percent annual rate. Since consumer spending accounts for about 70 percent of GDP, this consumer resilience is a major supporting factor in macroeconomic forecasts.

Turning to monetary policy, the Fed has reacted promptly and decisively in the current episode. We lowered our target interest rate, the federal funds rate, from 5 ¼ percent in September 2007 to the current range of 0 to ¼ percent that was first set in December 2008. This reduction in short term interest rates, which is typical of economic downturns, makes current outlays more attractive relative to future outlays for consumers and businesses, and thus helps offset the decline in overall spending. But that's not all. Over the last eight months, we've more than doubled the amount of Federal Reserve monetary liabilities – that is, currency and reserves, a quantity often referred to as the monetary base. That's an extraordinary, unprecedented monetary expansion that will bolster spending in the months ahead.

A set of improving indicators coming from the housing market provides further reason to believe the recession will end by year-end. Single family housing starts hit a low in January and were basically flat in February and March. New and existing home sales each hit a low point in January and are now somewhat higher. One measure of existing home prices has increased, in seasonally-adjusted terms, in both January and February.[3] Anecdotal reports of increased buyer traffic and firming prices in some markets are consistent with the recent statistics. Taken all together, these observations suggest that housing activity may no longer be declining rapidly, as it has been for the last three years.

We also have some evidence that the worst of the decline in manufacturing is behind us. The usual sequence of events in a recession is that demand falters, unwanted inventories build up, and manufacturers then make large production cuts, large enough to lower inventories even with demand very soft. That's where we are now; inventory reduction reduced GDP by 2.8 percent at an annual rate last quarter. This inventory runoff sets the stage for any increase in final demand to lead to prompt increases in production. That's what forecasters see for later this year – as spending flattens out, production will have to keep pace. We have a smidgen of positive evidence of that now, because new orders for nondefense capital goods excluding aircraft increased in February and March. I know that sounds pretty esoteric, but it's actually a widely-followed leading indicator of business investment demand for new equipment. In addition, survey data on manufacturing has also been less gloomy lately. While there are quite a few surveys out there, I'll highlight our Fifth District Survey, which has historically predicted national data pretty well. Our manufacturing shipments index has increased from minus 56 in February to minus 3 in April; similarly, our new orders index has improved from minus 54 to minus 2 over the same period. Other recent survey reports are similar, so it seems like the worst of the manufacturing declines are behind us, and survey respondents actually have positive expectations for business activity six months ahead.

That's the good news, and to be fair and balanced, I have to add that spending in other categories still is contracting at fairly rapid clip. Nonresidential construction has been declining for several months now, and significant further declines are expected in the months ahead. Export demand contracted sharply at the end of last year after economic activity in our major trading partners began slowing down. But the worst news is from the jobs market. We're losing jobs rapidly. The unemployment rate rose from 4.4 percent to 8.5 percent in two years, and the growth of average earnings has slowed.

The recently enacted fiscal stimulus program is aimed in part at boosting economic growth, but I believe many popular accounts overstate the effects of fiscal policy actions. Keep in mind that today's stimulus will have to be paid for at some point in the future, and the prospect of higher taxes can restrain activity as well. Moreover, some spending diverts workers and firms from other uses instead of drawing in unemployed resources. My sense is that the stimulus is likely to have only a marginal effect on the broad contours of the economic recovery.

All in all, then, while economic activity still is contracting overall, some spending components appear to be bottoming out and the overall rate of contraction thus is slowing. If the emerging stability in housing and consumer spending persists, as I expect, some segments of business investment spending should bottom out by the end of the year and economic growth then would turn positive. I expect the labor market to continue to weaken, however, and overall spending is likely to bottom out well before the unemployment rate peaks.

The outlook would not be complete, though, without mention of inflation. Last year, I was concerned that inflation was too high; for the 12 months ending in July 2008, the price index for personal consumption expenditure rose 4.5 percent. With the collapse in oil prices, inflation has receded and for the last 12 months, prices have risen only 0.6 percent. Given the extreme volatility of energy prices, it is useful to look at core inflation, which leaves out food and energy prices. That measure has increased 1.8 percent in the last 12 months, which is down from 2.4 percent in August.

Looking ahead, prognosticators this year have divided into several different camps. Some believe that high unemployment necessarily will lead to continually falling inflation for several years, and they are concerned about the risk of outright deflation. I personally have thought the risk of deflation was overstated, and for the first three months of this year, inflation has averaged 2 ¼ percent – both core prices and overall prices. Another camp places significant weight on the public's expectations, and as near as we can figure, those are fairly well anchored around 2 percent. And finally, a third camp sees the rapid growth in our balance sheet, notes the historical association between rapid money growth and subsequent inflation, and wonders whether inflation will accelerate when the economy begins to recover.

Where do I stand? While I gravitate to the second camp – the one that views stable expectations as likely to anchor inflation in the near term – members of the third camp have identified inflation risks that are quite legitimate. The challenge for us on the Federal Open Market Committee will be to shrink our balance sheet and tighten policy soon enough when the recovery emerges to prevent rising inflation. The danger is that we will not shrink our balance sheet and tighten policy soon enough when the recovery emerges to prevent rising inflation. Choosing the right time to withdraw that stimulus will be a challenge, and I believe it will be very important to avoid the risks of waiting too long or moving too slowly.

[1] I am grateful to Roy Webb and John Weinberg for help in preparing this speech.
[2] S&P/Case-Shiller 10-City Composite Home Price index.
[3] Federal Housing Finance Agency monthly House Price Index.