The Economic Outlook
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As you are well aware, we are suffering through a severe recession. It is likely that, by at least some measures, this recession will prove to be more severe than any other recession in the last 60 years. The beginning of last year marked the onset of the recession, 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.

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 undoubtedly was 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 of overall economic activity. It is important to remember that a large part of that increase reflected solid fundamentals, such as strong income and employment gains and low long-term interest rates. Another important factor in the housing boom was the multifaceted commitment to use public policy to boost housing activity and home ownership, from favorable tax treatment of home ownership to the implicit subsidies flowing through the housing-related government sponsored enterprises. In addition, genuine innovation in mortgage lending and securitization helped to bring home ownership 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 the expectation of future housing price appreciation by almost every borrower, lender, investor and analyst. In essence, a housing boom that was based on solid economic fundamentals was intensified by the assessments of mortgage-market participants that, in hindsight, were 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 and finance more generally are attributable primarily to the distorted behavior of institutions that are often 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 2.0 percent, which at the time was the highest value seen in several decades. At about that time, many measures of housing activity recorded their peak values for the cycle. Residential investment has fallen sharply since then, from 6.2 percent of GDP in 2005 to 2.7 percent last quarter, and it is not clear that a bottom in housing construction has been 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. Similarly, the bust has led to falling prices; that particular index has fallen by more than 30 percent in the last two years. These falling prices have reduced home equity values and household wealth. Falling home prices have also led to rising delinquencies and defaults and substantial reductions in the value of mortgage-backed securities on the books of many financial institutions.

Here in North Carolina, evidence of the housing boom was seen in the rapid rise in housing starts that began in early 2003 and continued through 2005, a period in which housing starts rose by 42 percent. Since early 2006, however, housing starts have fallen by 76 percent, and the homeowner vacancy rate has now reached 3.6 percent. Although home prices have not declined in North Carolina to the same extent that they have in other parts of the nation, home price growth has slowed dramatically since early in 2006. Existing home sales, which have started to rise in some real estate markets around the country, have yet to bottom out in North Carolina.

While future economic historians are likely to identify other forces that contributed to the onset and the intensity of the recession, they are not likely to change the assessment that this boom/bust cycle in housing and housing finance was the dominant causal factor. An extremely large 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, which is 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. The job loss in North Carolina has been deep and has accelerated through the first four months of 2009 as well, during which time 101,000 jobs were lost, following a decline of over 124,000 jobs in all of 2008. I could continue, but these dismal statistics should be enough to emphasize the severity of the current recession. In brief, the declines in economic activity have been large, the declines have been widespread, and the recession has already lasted longer than most post-World War II recessions.

That's the background, and 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 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 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 consumer 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 1.5 percent annual rate. Since consumer spending accounts for about 70 percent of GDP, this consumer resilience is a key factor in macroeconomic forecasts. And consumers' outlooks do seem brighter. For example, the Conference Board's index of consumer expectations of economic activity fell from a level of 94 in early 2007 to 27 in February 2009, but the index has since rebounded to a level of 72 in May.

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 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 bolster spending. But that's not all. Since mid-September last year, we've more than doubled the amount of Federal Reserve monetary liabilities – that is, currency and bank reserves, a quantity often referred to as the monetary base. That's an extraordinary, unprecedented expansion that will further bolster spending in the months ahead.

A set of improving indicators coming from the housing market provides further reason to believe that the recession will end by year-end. Single family housing starts hit a low in January and have risen slightly since then. New and existing home sales each hit a low point in January and are now somewhat higher. Some measures of home prices have improved a bit this year as well. Taken all together, these statistics suggest that housing activity is in transition, moving away from the rapid declines of recent years toward a bottoming-out process later this year.

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, 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 took 2.3 percent off of GDP growth last quarter. This inventory runoff implies that any increase in final demand will tend to require prompt increases in production. That's what forecasters see for later this year – as spending firms, production will have to keep pace. We now have a smidgen of evidence in support of that forecast. New orders for manufactured products have been basically flat so far this year, in contrast to significant declines last year. In addition, survey data on manufacturing have also been less gloomy lately. While there's quite a bit of data, I'll just mention our Fifth District Survey, which has historically predicted national manufacturing conditions pretty well. Our composite index of manufacturing activity was at a level of minus 51 in February, which simply means that most respondents had reported weaker manufacturing activity, with only a few reporting improvements. For May, however, that index has recovered to a reading of plus 4, indicating that reports of expanding activity slightly outnumbered reports of declining activity. This is the first positive reading in a year, and the substantial improvement can also be seen in key areas such as manufacturing shipments and new orders. Our more narrowly focused business activity index for the Carolinas turned positive in April, and although it edged back into negative territory in May, it is still above the low levels registered in the latter half of 2008 and early 2009.

Signs of moderation in economic conditions also can be seen in financial markets, which have been roiled in the past two years by uncertainty around the ultimate size and incidence of credit losses stemming from mortgage lending and securitization. Credit market conditions have eased generally, especially in commercial paper and interbank lending markets. While this is no doubt due in part to the broader moderation in economic conditions, I think it also stems partly from a decline in the underlying uncertainty about credit losses and the conditions of our larger banking organizations. The recently completed "stress test" for the 19 largest banks also contributed to the improvement in financial market conditions. While many of these banks still face significant losses, the stress test results dispelled some concerns about gloomier loss estimates and greater government ownership, and required banks to create plans to ensure that they have enough capital to absorb those losses. A number of banks appear to have made substantial progress already in bolstering their capital.

That's the good news, but to be even-handed I have to add that other news is still pretty dismal. Private nonresidential construction has fallen 3.7 percent since last June, and most analysts expect larger declines in the months ahead. Export volumes also have declined significantly as the economies of our trading partners have slowed. And we continue to receive bad news from the jobs market. Even though the decline in payroll employment was only 345,000 in May, down from a pace of over a half-million a month that we saw over the previous six months, the unemployment rate is up sharply, and the growth of average earnings has slowed. As you know, the rise in unemployment has been particularly sharp here in North Carolina, reaching 10.8 percent, the highest rate recorded since the Bureau of Labor Statistics began reporting these statistics at the state level in 1976.

The recently enacted fiscal stimulus program is aimed in part at boosting economic growth, but I believe many 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 is thus 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 would then 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 ended 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 only risen 0.4 percent. Given the extreme volatility of energy prices, it may be useful to look at core inflation, which leaves out food and energy prices. That measure has increased 1.9 percent in the last 12 months, which is down from 2.4 percent in August.

Looking ahead, prognosticators have divided into several different camps. Some believe that high unemployment will necessarily 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 so far this year inflation has averaged 1.8 percent overall and 2.5 percent for core prices. Another camp places a significant weight on the public's expectations, and until recently, those were fairly well-anchored around 2 percent. And finally, a third camp sees the rapid growth in our balance sheet, notes the historical association between 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 and the view that stable expectations are likely to anchor inflation, 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 will be that we will not shrink our balance sheet 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.