***The Economic Outlook*, November 2009**
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Thank you for inviting me to speak with you today and discuss the economic outlook. The Commonwealth of Virginia, like many other state governments across our country, faces a very challenging fiscal environment as a result of the contraction in economic activity over the last two years. You have heard the news, no doubt, that most economists have declared that the recession is over. What that means, however, is that the contraction has come to an end, not that all of our economic challenges are behind us. Indeed, this portion of the business cycle often poses the most acute fiscal problems at the state and local level due to the typical lag in incomes. Having said that, I do agree that the national economy has hit bottom and that a recovery is solidly underway, and my remarks today will be focused on the outlook for that recovery. To put the current outlook in context, I'd like to start by briefly reviewing the recent recession and how we got here. Before I begin, however, I should note that these are my own views and should not be attributed to any other person in the Federal Reserve System.[1]

In my view, the boom/bust cycle in housing was the central driving force in this recession. Robust demand increased the fraction of our nation's economic resources devoted to residential investment by about 50 percent from 1995 to 2005. Part of that demand growth can be explained by healthy fundamentals such as strong income gains and low long-term interest rates. Another key driver was the strong public policy commitment to boost home ownership, which was reflected in the favorable tax treatment of homeowners, the implicit subsidies flowing to the government-sponsored housing-finance enterprises, and the mandate they were given to expand low-income mortgage lending. In addition, innovations in mortgage lending and securitization helped to bring home ownership within reach of a wider segment of the population. This expansion in access to credit has benefitted many Americans, but in retrospect we can see that it was accompanied by lax underwriting standards and overly complex and opaque securitization. Moreover, many borrowers, lenders, investors and analysts acted as if housing prices were certain to appreciate over time. In short, the housing boom appears to have been driven by a combination of fundamentals, government incentives and a degree of overshooting.

During the boom home prices almost tripled, but by the middle of this decade evidence began to signal that the boom 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.

After residential investment began to decline, the rest of the economy 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 boatload of dismal statistics, but I'll confine myself to one in particular – the number of people employed has fallen by 7.3 million since it peaked at the end of 2007.

That's the backdrop. The last few months' data indicate that economic activity has begun to improve. Starting with housing, several indicators of sales and construction activity hit low points early this year and have risen modestly since then. For instance, single-family housing starts have increased by 40 percent and new home sales have increased by 22 percent. And there are also signs that home prices have bottomed out as well. One widely followed index of existing home prices nationwide rose a seasonally adjusted 3.3 percent in June, July and August. Even with these welcome gains, however, housing activity remains well below the pace required to accommodate population and income growth on a sustained basis. That's to be expected as we work off the overhang of unsold homes in many parts of the country. But at least housing is no longer a major drag on GDP growth, and in fact it should make positive contributions, in welcome contrast to the last three years.

The boom-bust cycle in Virginia's housing markets was characterized by a somewhat smaller swing in home construction than for the nation as a whole, and a correspondingly larger swing in home prices. That said, housing market activity in the Commonwealth has stabilized at a low level, and should no longer be a drag on growth.

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 this past February and then increased very gradually before the "Cash for Clunkers" program boosted sales in July and August. Clearly that program pulled forward many sales that would have occurred anyway later this year, and so it was not surprising that sales fell back in September to about where they were in the spring. What caught many analysts by surprise, though, was the rebound in the sales rate in October. 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.

Aside from autos, real consumer spending fell 2 percent during the recession. But in the third quarter, consumer spending – apart from cars and trucks – reversed course and increased at a 1.8 percent annual rate. This suggests that many U.S. households have recovered at least a modicum of confidence about their future income prospects.

Business spending on new investments in equipment and software fell a sharp 21 percent during the recession. It also has reversed course and has registered a small positive gain in the third quarter.

In addition to these favorable domestic developments, there has been a worldwide rebound in economic activity, which is boosting demand in our export industries. As recently as the first quarter, real exports were falling at nearly a 30 percent annual rate; in the third quarter, they were increasing at close to a 15 percent annual rate.

Toting up all these favorable demand side developments, the advance estimate of real GDP grew 3.5 percent in the third quarter, its most rapid growth since mid-2007. Prominent academic and industry economists have proclaimed the end of the recession and are looking forward to a lengthy period of sustained growth in overall economic activity. Those forecasts look quite reasonable to me. In the near term, production will receive a boost as a result of the shift underway from inventory liquidation to inventory accumulation. That boost in 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, we are seeing the first signs of improvement on the supply side. Industrial production increased for three straight months leading up to September. While a significant part of the increase was due to a resumption of auto production by GM and Chrysler, even without autos, industrial production has increased by a solid 1.8 percent over those three months. Moreover, a survey-based index published by the Institute for Supply Management has risen substantially this 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. 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 has occurred this 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. Although many borrowers naturally face tougher credit terms in a soft economy, the banking system as a whole appears capable of supporting business investment and expansion.

While the outlook has brightened in recent months, we still face major challenges. 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 substantial drag on U.S. growth in the near term. The outlook for commercial construction in Virginia is similar, though perhaps marginally better due to the stabilizing effect of demand for government and contractor office space around the District of Columbia.

More worrisome is the extremely weak labor market. The number of people employed has fallen for 22 straight months. The unemployment rate has more than doubled, to a 10.2 percent rate. Wages are under pressure; so far this year average hourly earnings have only risen at a 2.1 percent at an annual rate, about half its rate in mid-2007. Going forward, as overall economic activity continues to improve, employment will bottom out and then begin to return to an upward trajectory. 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.

Virginia's labor market has fared somewhat better than the rest of the nation's this year; payroll employment has not fallen as rapidly, and the unemployment rate has topped out already and edged down to 6.7 percent as of September. As a result, total personal income has not fallen as rapidly over the last year for Virginia as it has for the nation as a whole, and I expect labor market conditions to improve a bit sooner and less slowly than the rest of the U.S.

Putting the whole picture together, I think the most likely outcome is that the economy will grow at a reasonable pace next 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. Virginia should continue to track the national trends and may even outperform the nation, as it has in previous expansions.

I'll conclude with some thoughts on inflation and monetary policy. Inflation has been running about 1.5 percent recently, and from my point of view, that's ideal. Earlier this year some economists were highlighting the risk that the low level of economic activity could push the rate of inflation down, perhaps even below zero. I think the risk of a substantial further reduction in inflation has diminished substantially since then. The historical record suggests that the early years of a recovery are when the risk is greatest that confidence in the stability of inflation erodes and we see an upward drift in inflation and inflation expectations. This risk could be particularly pertinent to the current recovery, given the massive and unprecedented expansion in bank reserves that has occurred, and the widespread market commentary expressing uncertainty over whether the Federal Reserve is willing and able to promptly reverse that expansion.

As a technical matter, I do not see any problem – we *do* have the tools to remove as much monetary stimulus as necessary to keep inflation low and stable. The harder problem is the same one that we face after every recession, which is choosing *when* and *how rapidly* to remove monetary stimulus. There is no doubt that we must be aware of the danger of aborting a weak, uneven recovery if we tighten too soon. But if we hope to keep inflation in check, we cannot be paralyzed by patches of lingering weakness, which could persist well into the recovery. In assessing when we will need to begin taking monetary stimulus out, I will be looking for the time at which economic growth is strong enough and well-enough established, even if it is not yet especially vigorous. Although it is hard to predict when that will occur, I *can* confidently predict that economic policymaking, both for you and for me, will remain particularly challenging for some time to come.

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