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It is a pleasure to be here again this year and to be able to see some long-time friends. Many of you regular attendees of this gathering are quite familiar with the background to our current macroeconomic situation. For the past two years, our discussions have been concerned with the financial crisis and its aftermath, and rightfully so, since the 18-month-long recession that ended mid-2009 was the most severe contraction in over 70 years. Since the end of the recession, real GDP has grown at an annual rate of 2.9 percent, which is barely above trend and quite modest when compared to other cyclical recoveries. Moreover, that growth has been irregular, ranging as high as 5 percent to as low as 1.7 percent. Right now we are in something of a soft patch; real GDP grew at a below-trend 2.5 percent annual rate last quarter, and analysts are calling for relatively sluggish growth in the current quarter as well.

Before talking about the outlook, I would like to highlight the main reasons that I believe growth has been relatively sluggish so far. Before I do, however, I should note that, as always, the views I express today are my own and do not necessarily reflect those of my colleagues on the Federal Open Market Committee.[1]

One reason for the sluggishness of this recovery is the residential real estate market. The 10-year housing boom that began in the mid-1990s resulted in significant overbuilding in many regions. As a result, there are a large number of vacant houses that potential homebuyers may see as reasonable substitutes for new construction. This overhang has dampened housing activity in many local markets and kept housing starts barely above a half million units at an annual rate. As a result, residential investment has failed to make a positive contribution to growth in this recovery. This contrasts with the two other severe recessions of the past 60 years, in which residential investment increased an average of 40 percent in the first year of the recovery. Given the significant legacy of overbuilding, unique to this recession, I do not expect housing to contribute significantly to growth over the next two years.

Investment in nonresidential structures, such as stores, office buildings and warehouses, also has been anemic. Spending in this category fell 18 percent during the recession, and has fallen an additional 17 percent since, taking four-tenths off real GDP growth. That’s par for the course though, since nonresidential investment normally lags the rebound in overall economic activity.

What *has* been particularly striking is the behavior of household spending. In a typical recovery, consumers begin to see a brighter future ahead and are willing to ramp up spending ahead of anticipated gains in employment and incomes. That hasn't happened this time. Instead, household spending increased just 1¾ percent in the first year of recovery. In contrast, after each of the other two severe recessions, household spending grew at an average of 6½ percent in the first year of expansion, and added more than 4 percentage points to GDP growth. Thus a major part of the relative weakness of this recovery can be attributed to the cautious pace of household spending.

Fortunately, there are a couple of brighter spots in the outlook. Business investment in equipment and software has grown 20 percent in real terms since the end of the recession, and there are good reasons to expect that growth to continue. Technological innovations continue to provide organizations with new opportunities for streamlining business processes and reducing costs through productivity-enhancing investments. Moreover, the cost of capital is extremely low for a large segment of corporate America, and funds appear to be available for creditworthy firms. All these factors are likely to continue to encourage new business investment going forward.

Investment hasn't been the only bright spot. Exports of goods and services have grown 16 percent since the end of the recession, adding 1¾ percent to GDP growth. This is much better than in the two previous recoveries following severe recessions, in which exports were flat or declining and thus contributed little to growth. While economic growth in some of our major trading partners has slowed somewhat since earlier this year – and recent developments further cloud the outlook for some of them – the robust expansion of many emerging economies is likely to continue to support U.S. export demand.

Taken as a whole, what we've seen is uneven, relatively sluggish growth over the past five quarters. Equipment and software investment and exports have been bright spots, but residential construction has been flat and commercial construction has fallen. Consumer spending, which accounts for over two-thirds of GDP, is obviously key to overall growth prospects, and so far it has been expanding at only a modest pace.

Many consumers have taken steps to improve their battered financial positions. The personal saving rate jumped from around 2 percent of disposable income to 6 percent during the recession, and has hovered around there during the recovery. Outstanding consumer credit has been falling steadily as a result. The combination of a rising stock market and reduced debt has improved household balance sheets, and has contributed to a gradual increase in the pace at which consumer spending is expanding.

While stronger financial positions have helped, the extremely weak labor market has been a restraining influence on consumer spending. The unemployment rate more than doubled during the recession, and has only declined three-tenths of a percentage point from its peak. Given the mediocre pace of GDP growth, that is not surprising; it will take sustained, above-trend GDP growth for unemployment to decline meaningfully. Fortunately, we are beginning to see some indications of better labor market conditions, last Friday's disappointing employment report

notwithstanding. For example, over the last five months the number of private-sector jobs has risen by 116,000 per month. The average workweek has registered gains, and average hourly earnings have grown a bit faster than inflation. These all point to rising incomes, which are likely to bolster further growth in consumer spending.

One final factor contributing to the sluggishness of this recovery has been what seems to be unusually widespread uncertainty regarding government policies. Since the recession bottomed out we've heard forceful and impassioned complaints from many contacts in our District about the dampening effect of policy changes that are in store. At first, I tended to discount these reports as the normal grumbling about Washington politics, but their persistence and plausibility has me giving them more credence. Voluminous rule-writing is required by the health insurance reform legislation and the Dodd-Frank Act, and with less than a month remaining, next year's marginal tax rates are still being debated. Less widely noted are a host of changes in environmental regulations that also appear to be inhibiting firms' willingness to commit to new investment or hiring outlays. Add to these impediments the uncertainty about when – and how – a sustainable fiscal trajectory will be achieved, and you have the recipe for continued apprehension and stifled risk-taking.

So, what lies ahead for next year? The consensus among professional forecasters is that GDP growth will strengthen to about 3 percent next year, and my own projection would be a bit higher. This is a cautious outlook calling for a gradual, measured increase in the pace of economic growth, and a modest decrease in unemployment. Uncertainty is likely to dissipate as the regulatory picture is clarified, and I am encouraged by recent signs that some of our leaders seem willing to meaningfully address the looming federal fiscal imbalance. Also, in the last few months we've seen an improved rate of expansion in consumer spending; suggesting that household spending will grow more rapidly in coming months as confidence regarding income prospects gradually improves. As a result, I expect private sector demand to pick up steam in the year ahead.

Another reason for at least guarded optimism is that inflation is well contained. The price index for personal consumption expenditures has risen 1.3 percent over the last 12 months, which is very close to my own long-run objective of 1½ percent. With many commodity prices spiking, outright deflation is clearly even less of a risk than it was a few months ago.

I would like to conclude by pointing out that this favorable inflation picture should not be taken for granted. During the recession, the Federal Reserve cut short term interest rates to near zero and expanded its balance sheet from around $900 billion to over $2 trillion, which was an appropriate response to a major economic shock. In addition, the FOMC recently decided to further increase the Fed's balance sheet by another $600 billion by the end of the second quarter. While this was motivated mainly by the disappointing pace of employment growth, the provision of further monetary stimulus at this point in the business cycle is not without risks. Historical experience, including the inception of the Great Inflation of the 1970s, suggests that central banks should be careful not to steer monetary policy off-course by targeting the unemployment rate. Moreover, if growth picks up next year, as I and many other FOMC participants expect, the

precautionary demand for liquidity by households, firms and banks will diminish. At some point we will need to respond by reducing the provision of liquidity to the banking system to prevent inflation from accelerating, as it often can when a recovery picks up steam. Further balance sheet expansion now could require more rapid balance sheet reduction later on, complicating the withdrawal of monetary stimulus when it becomes necessary to maintain price stability. It is appropriate, therefore, that the FOMC has committed to "regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed. …"

As we navigate monetary policy challenges in the months ahead, I remain convinced that the fundamental economic prospects for the country are bright. If we can make sufficient progress on the other major policy challenges we face, I believe we can restore confidence in rising living standards for generations to come.

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[1] I am grateful to Richmond Fed Economist Roy Web for his help in preparing this speech.