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It's a pleasure to return to Charlotte today for this annual gathering. I generally look forward to these occasions with anticipation because of the chance they give me to reconnect with friends in the Charlotte region. This year, however, that feeling of anticipation has been tinged with a bit of apprehension. Our master of ceremonies, Henry Faison, likes to remind me about my previous year's forecast for economic growth, particularly how it compares with what actually happened. Last year, I projected that real gross domestic product, or GDP, growth through the fourth quarter of 2011 would average above 3 percent. Right now, it looks like we'll get something like 1-¾ percent for the year — a fairly sizable miss. So I return to Charlotte this year suitably chastened and mindful of the humility one should always bring to forecasting — and to policymaking, for that matter.

This is a popular time of year to conduct performance appraisals, in which individuals or organizations look back and evaluate past accomplishments. In the modern approach to performance appraisals, the focus is less on criticizing shortcomings and more on identifying "lessons learned" that might be useful going forward. In that spirit, my remarks this afternoon will focus on the lessons one ought to take away from the past year of U.S. macroeconomic performance. As always, my remarks reflect my own independent views and do not necessarily coincide with those of my colleagues on the Federal Open Market Committee (FOMC). [1]

The obvious first candidate for a lesson learned looking back on 2011 is that forecasting is difficult. Indeed, I was in good company in landing so wide of the mark on real GDP growth. Numerous private forecasters, along with many of my FOMC colleagues, were forecasting growth over 3 percent.

Several unanticipated developments contributed to these forecast misses. Commodity prices had already begun rising when we met here last year, but energy and food price increases in the first part of this year significantly outpaced the predictions embodied in futures market prices. That acceleration took a significant bite out of household real income growth, and consumers held back spending as a result. The natural disaster in Japan, which caused so much suffering, also had the effect of disrupting global supply chains and forcing production cutbacks worldwide. These all took their toll on first-half growth in the U.S., which came in at a paltry 0.8 percent.

One would expect such transitory factors to have only limited implications for future growth. Indeed, auto production has recovered, and commodity prices have peaked and are trending downward, reversing the earlier dampening effect on household real income growth.

The more significant lessons learned over the course of this past year, in my view, concern the importance of *relatively persistent* impediments to economic expansion in the U.S. While the pace of growth has rebounded since the first half of the year, most analysts are still only expecting real GDP growth to average a bit above 2-½ percent at an annual rate over the second half. Moreover, growth has averaged only 2-½ percent over the 2-½ years since the recession bottomed out in the second quarter of 2009. As I noted last year, this post-recession expansion is lagging significantly behind the pace of the expansions that followed other severe U.S. recessions.

The still-overbuilt housing market tops the list of persistent factors that continue to impede growth. Residential construction typically expands robustly in a recovery, but has been basically flat this time. The soft state of demand for new homes, despite record-low mortgage rates, suggests that home building is likely to remain depressed for some time to come. What gains we've seen in residential construction have been in multi-unit rental properties, reflecting the continuing shift, at the margin, away from home ownership. This could represent a beneficial consequence of a retreat — at least for the time being — from federal policies that have long subsidized housing debt.

U.S. households also have been adjusting their financial positions to adapt to their post-recession circumstances. Diminished income prospects and tighter credit terms have given consumers ample reason to focus on paying down debt and building up savings. As a result, consumer spending is expanding at a more moderate pace than in past recoveries.

Labor market conditions, which are so critical in shaping consumer spending trends, improved at a disappointingly slow pace this year. Evidence suggests that one impediment to more rapid employment gains is the magnitude of the skills mismatch between the unemployed and the needs of the growing segments of the economy. Recessions and recoveries all involve shifting resources from some economic sectors to others because the composition of the expansion seldom perfectly mirrors that of the contraction. Many of the workers that exit declining industries in the downturn eventually find work in newly expanding industries in the recovery. That search process can take some time and might require some additional training, since the skills of those released from contracting sectors may not line up with the skills required in expanding sectors. The frictions associated with this process of sectoral and occupational reallocation appear to be empirically significant, accounting in one recent estimate for about one percentage point of the increase in unemployment in this recession.[2]

Another impediment to growth cited by a wide range of observers is the array of changes in tax and regulatory policy, both actual and anticipated. The list of significant recent and prospective policy changes includes the enactment of far-reaching health care and financial reform bills in the last 2-½ years, as well as significant shifts in environmental and labor regulations over that period. While it is inherently difficult to model and estimate such effects with any confidence, we continue to receive widespread and persistent anecdotal reports from our Fifth Federal Reserve District contacts about how uncertainty about regulatory policy changes is discouraging firms from making new hiring or investment commitments. It seems plausible to me that such effects could be having a noticeable effect on measured growth rates.

Apart from regulatory changes, the murky federal budget outlook also imposes significant uncertainties on consumers and businesses. Realistic projections under current law show federal debt outpacing our national income for decades to come, with no bound on the ratio of debt to GDP. This simply is not feasible, and the experience of southern Europe demonstrates that the real world ultimately will constrain our debt issuance if our own government fails to do so. Any sustainable configuration of fiscal policy implies adjustments that are bound to affect a broad range of citizens in economically relevant ways, either through higher marginal tax rates, cuts in programs' benefits or reductions in government payrolls and supplier contracts. Uncertainty about the nature of the adjustments appears to be impeding some firms' willingness to commit to new hiring or investments. For example, the cloudy outlook for federal spending is having a noticeable effect on economic activity in the greater Washington area.

I should note that one component of economic activity *has* been living up to our usual expectations of robust growth following a recession. Business investment in equipment and software — our broadest measure of business capital formation apart from structures — grew at an average annual rate of about 10 percent in the first three quarters. Even with demand growing less rapidly than in the typical recovery, firms continue to identify profitable opportunities to deploy technology to reduce costs or improve business processes. The fact that firms are finding such opportunities suggests that the underlying forces of innovation and creativity — forces responsible for over 150 years of economic growth — are still at work.

The impediments to growth though — the housing stock overhang, consumer deleveraging, skills deficits and uncertainty regarding regulatory and tax policy — have had the upper hand this year. They represent difficult economic challenges that are not likely to cure themselves quickly over time. My takeaway from 2011 is the lesson that the impediments to more rapid U.S. growth are likely to be deeper and more persistent than we thought a year ago.

A related macroeconomic lesson learned by many this past year — perhaps I should say relearned — is that inflation can accelerate despite elevated levels of unemployment. As of last December, the (12-month) inflation rate was 1.4 percent.[3] To date this year, inflation has averaged a 2.8 percent annual rate. Obviously the run-up in energy and food prices earlier this year played a big role in this year-over-year acceleration. But the pickup in inflation this year has been broad based. Core inflation — which strips out food and energy prices — was 0.9 percent last December, but has averaged 1.9 percent so far this year. The doubling of inflation this year, despite unemployment averaging 9 percent, undercuts the hoary notion that "slack" in the labor market can be counted on to keep inflation contained. As I noted a moment ago, however, this lesson is not new; we learned this all too well during the disastrous inflation of the 1970s.

Despite this year's run-up, I believe the inflation outlook is reasonably good right now. Recent price trends have been quite favorable, and indeed, headline inflation has been quite low in recent months. Having said that, my sense is that the current slowdown is likely to prove as transitory, as did the acceleration we saw earlier in the year. The most likely outcome this year, in my view, is for overall inflation to average close to 2 percent. Deceleration to a rate noticeably below 2 percent *is* a risk to that projection, particularly if global growth should soften enough to further ease pressures on commodity prices. But I still view the risks to inflation as tilted to the upside. A comparison of 2011 with the experience of 2004 through 2007, for example, suggests that an upswing in inflation at this stage of the business cycle is typically long-lasting. As for real growth, taking on board the lessons learned in 2011, I am expecting real GDP to expand next year at a pace between 2 and 2-½.

That projection is predicated on continued expansion in payroll employment and consumers gradually acquiring more confidence in their labor market prospects. Business investment in equipment and software, which, as I've noted, has been a key driver in the recovery, should continue to expand, though perhaps at a less torrid pace. Growth in export demand is likely to slow somewhat, given significantly weakening growth in the euro area. Home construction is likely to remain relatively dormant, and like government spending, is unlikely to make much noticeable contribution to growth.

This is a forecast of growth at a moderate pace — not as rapid as some past expansions, but positive growth nonetheless. I see the major risks to such an outlook as threefold. The accretion of consumer confidence in their economic prospects could proceed either more or less rapidly than projected. The dependence of consumer expectations on subjective assessments makes them difficult to forecast, but I see risks there on both sides. Second, the pace at which businesses have invested in equipment and software has surprised on the upside throughout the recovery. While some moderation in the rate at which that investment is expanding seems likely, we could easily miss on that forecast.

And third, the trajectory of economic activity in Europe is likely to hold significant implications for U.S. growth in the coming year. Euro area governments are grappling with the financial market volatility that inevitably follows from ambiguous commitments to protect creditors using taxpayer funds. In this case, the ambiguity surrounds protection that might be forthcoming, both for sovereign debt holders and the creditors of large European banks. The rapid fiscal and balance sheet adjustments, and the accompanying uncertainty regarding prospective tax policy, appear to be dampening euro zone growth, and that is likely to cut into U.S. export demand in the year ahead. My projection for U.S. GDP growth of between 2 and 2-½ percent, however, already builds in a substantial slowdown in Europe.

Having shared with you my outlook for 2012 and having discussed two lessons learned in 2011 — namely, that real impediments to growth are more persistent than we thought and that inflation can rise even with high unemployment — I would like to conclude by sharing with you one final lesson I think the past year provides. It's that monetary policy is often credited with entirely too much influence on real growth. Monetary policy is about inflation — that is, the value of money. The effects of changes in monetary policy on real output and employment are largely the transitory by-products of frictions that delay the timely adjustment of prices to changes in monetary conditions. Over time, these effects dissipate, and growth is governed almost entirely by the evolution of a society's technology, skills, resources and trading opportunities. Yes, the stance of monetary policy varies substantially with real economic conditions. But that is essentially because the monetary policy stance that is required to keep inflation stable fluctuates with real economic conditions.

The macroeconomic experience of 2011 provides vivid illustration. Despite large-scale efforts to provide more monetary stimulus, growth has disappointed and inflation has ratcheted upward. In some sense, this third lesson is merely the corollary of the first two, since it reflects the fact that growth is governed predominantly by nonmonetary phenomena, which implies that monetary stimulus can at times move inflation more than employment.

This lesson leads me back to the apprehension I mentioned at the outset of my remarks — my discomfort with last year's GDP forecast miss. Now I know that my friend Henry Faison understands all too well the importance of the Fed maintaining low and stable inflation. Henry served as chairman of the Richmond Fed's Board of Directors in the 1990s and strongly supported the struggle for price stability. That makes it a bit puzzling to me that he would hold me accountable for my growth forecast each year, rather than my inflation forecast. After all, a classic precept in modern performance management is that an organization's objectives should be within their ability to control. A central bank's ability to elevate its economy's growth rate over a sustained period, while preserving price stability, is quite limited. I would suggest accordingly, Henry, that in the future you hold me accountable for inflation outcomes, not growth outcomes.

Thank you all for your attention, and I look forward to returning to discuss inflation in 2012.

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[1] I am grateful to John Weinberg for his assistance in preparing this speech.

[2] Ayşegül Şahin, Joseph Song, Giorgio Topa and Giovanni L. Violante, "Measuring Mismatch in the U.S. Labor Market," Federal Reserve Bank of New York, working paper, July 2011.

[3] This refers to the price index for personal consumption expenditures, through December 2010.