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Thank you for inviting me to join you again this year to discuss the economic outlook. You have heard the news, no doubt, that most economists have declared that the recession is over. What they mean, however, is merely that the contraction has come to an end, not that all of our economic challenges are behind us. 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. 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]

The backdrop to our current situation is that we have experienced one of the steepest economic contractions on record, driven by the plunge in housing market activity that followed the ten-year housing boom that ended in 2005. 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 33 percent and new home sales have increased by 31 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 3.7 percent from May to September. 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.

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 slightly during the recession. But in the third quarter, consumer spending – apart from cars and trucks – reversed course and increased at a 1.7 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 equipment and software fell a sharp 21 percent during the recession. It also has reversed course and has registered a 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 17 percent annual rate.

Toting up all these favorable demand side developments, the most recent estimate is that real GDP grew 2.8 percent in the third quarter, its most rapid growth since mid-2007. As a result, 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 to 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 has increased for four straight months. 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 1.9 percent over those four 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 economic challenges. In 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.

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 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.

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.

I'll turn now to the outlook for 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. In fact, we have seen that even in the early stage of a recovery, inflation and inflation expectations can drift higher. The perception of inflation 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 monetary policy will remain particularly challenging for some time to come.

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