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Thank you and welcome to the Federal Reserve Bank of Richmond's Regional Forum. I suspect that most of you have heard that the recession is over and I also suspect that few of you feel like the recession is over. The unemployment rate is still high nationally and still rising in West Virginia**.** Perhaps the best analogy is to taking a hard foul on the way to the basket; the recession (the way economists define it) is over when you hit the floor. But you don't feel like it's over until you get back up on your feet, and even then you may have some lingering bruises. Well, the consensus is that we hit the floor last summer and have been in the process of getting back on our feet ever since. That represents recovery, but the pain is still with many of us to be sure, and we are a long way from a full recovery. This evening I would like to share with you my views on where our economy stands both at the national and state level and where it seems to be headed, and then hear directly from you about your concerns. Before I begin, I should note that I speak only for myself and not for my colleagues on the Federal Open Market Committee.[1]

The recession that appears to have ended last year ranks as one of the deepest on record, and was led by the plunge in housing construction that followed the boom. As the housing slump became more severe, it started spilling over into the rest of the economy. I could cite a slew of dismal statistics that would characterize the recession, but I'll confine myself to one in particular ─ after peaking at the end of 2007, the total number of people employed in the U.S. fell by over 8 million, wiping out all of the net job gains during the previous recovery and expansion. West Virginia's payrolls peaked in the third quarter of 2008 and have fallen by over 30,000 since, a drop of 4.2% percent.

To put the current national economic conditions in perspective, let me start where the recession really had its origins ─ the housing market, where some stabilization has now become evident. Several indicators of sales and construction activity hit low points early last year and have risen modestly since then. Even one widely followed index of existing home prices in the U.S. rose a seasonally adjusted 4.4 percent from May to January. And housing investment in the fourth quarter of last year made its first positive contribution to growth since the second quarter of 2008. This is an encouraging sign that housing is no longer a drag on the economy. But the significant over-building that occurred during the housing boom is likely to severely limit the ability of this key sector to provide the lift to the economic recovery that was typical in the early stages of past recoveries.

Consumer spending posted solid gains over the second half of last year and is widely expected to have increased in the first quarter of this year. Even new vehicle sales, which were a major factor in the decline in consumer spending during the recession, have increased from a low of 9.1

million units in February of last year to 11.8 million units in March of this year. This was the industry's best performance without the aid of government incentive programs since the recession ended. Let me be clear here ─ consumers are by no means exuberant. The rise in the saving rate ─ to over 3 percent from 1 percent as the recession began in early 2008 – likely reflects a combination of apprehension about income prospects and a desire to pay down debt and to rebuild wealth depleted by the broad erosion in financial asset and home prices from their previous peaks. But the recent recovery in equity prices and the stabilization in home values are no doubt contributing to the upturn in consumer spending.

Business spending on new equipment and software, which fell by over 20 percent during the recession, also has reversed course in the second half of last year. A firming of business spending on capital goods may seem incongruous in light of the low levels of measured capacity utilization in many industries, but excess capacity does not preclude the emergence of profitable opportunities to deploy new equipment and software to reduce costs or improve processes and services. For example, information equipment and software ─ a significant source of hi-tech growth over the last two decades ─ by itself contributed nearly a full percentage point to the 5.6 percent growth in real GDP in the fourth quarter of last year. Even business investment in transportation equipment added over a quarter of a percentage point to GDP that quarter.

Despite all these favorable demand-side developments, the relative vigor of GDP in the fourth quarter actually surprised many analysts. Of course, part of that vigor reflected a substantial swing toward inventory accumulation that provided a significant boost to GDP *growth*. But even excluding inventories from the calculation ─ an adjustment that results in the statistic known as final sales ─ GDP managed a respectable 1.7 percent gain over the previous quarter. Final sales will warrant special attention in the months ahead as we assess how rapidly the recovery strengthens.

I have been focusing thus far on the areas of the economy where improvement is evident. There are other areas in which we still face major economic challenges, however. In commercial real estate, construction is falling, vacancy rates are rising and falling property prices are eroding owners' equity positions. No one expects a quick reversal in either of these negative trends, and as a result, business investment in structures ─ in contrast to the equipment and software category ─ is likely to be a sizable drag on U.S. growth in the near term.

In the struggle between the positive and negative forces on economic growth, the labor market ultimately will play a pivotal role. More jobs mean more income, more consumer confidence, and more consumer spending, which will prompt businesses to continue hiring and investing and help governments raise revenues. If you agree with me on that point, then I think you will agree that our latest employment release was the most encouraging sign we have seen to date regarding the current recovery. In March, we added 162,000 jobs on net, with goods-producing industries adding over 40,000 jobs. Some of those gains represented the hiring of Census workers and some were reversing weather-related losses in February. Even apart from those special factors, however, the month of March made a major contribution to the first positive quarter for the labor market since the fourth quarter of 2007. That was just before we took that hard foul and the recession began. While even the more optimistic forecasters do not expect rapid growth in employment this year, the labor market does seem to be lifting itself off the floor now.

Let me make one final point on the unique challenges that we are facing in this recovery ─ namely the state of small business in America. The recession brought unprecedented job losses to businesses with less than 50 employees. This group represents about 90 percent of all business establishments nationwide and employs 40 percent of all workers, and is even more important in West Virginia, where these small businesses account for more than half of all workers. Tight credit often gets the blame for holding back small business expansion these days, but according to a recent survey by the National Federation of Independent Business, weak sales are by far the number one problem facing small businesses. And it is important to recognize that many businesses of all kinds will naturally face tougher credit terms in a soft economy, because their revenue prospects are likely to be more uncertain. Moreover, the proper benchmark is the ability of the banking system *as a whole* to supply an appropriate quantity of credit, since any one given bank may be shrinking their balance sheet while others are expanding. I am not aware of any evidence that the banking industry as a whole is inappropriately impeding the availability of credit ─ and that seems to be confirmed by recent small business surveys.

Putting the whole picture together, I think the most likely outcome for the rest of 2010 is that the national economy will grow at a moderate rate ─ consumers spending will gradually pick up pace and businesses will continue to expand outlays for equipment and software, and these key components of demand should overcome any drag from commercial construction or state and local government spending.

For West Virginia, the recession arrived later than for the rest of the nation, with job losses only beginning in late 2008 and continuing in recent months. Unemployment also rose later in The Mountain State, jumping from a low 3.8 percent in October of 2008 to more than double that rate in just a few months, continuing its sharp rise to a rate of 9.5 percent today. The strength in energy markets in early 2008 helped delay the onset of the downturn here. In addition, the West Virginia housing market did not experience the outsized gains of some other states, and therefore home prices and residential construction have not declined quite as sharply. While existing home sales in West Virginia have risen consistently in recent months, residential construction remains sluggish. With the late entry into recession, West Virginia seems to be following a somewhat slower path to recovery, yet West Virginia University's Bureau of Business and Economic Research has forecast modest job growth for the second half of this year, consistent with the national jobs outlook.

Of course, there are always risks to any outlook. In the current environment, the labor market could recover more slowly than many expect, which would restrain consumer spending and dampen growth. But household incomes and household confidence could also rebound more vigorously than many expect, in which case consumer spending could pick up more briskly. It is also worth mentioning a risk that seems particularly prominent in this recovery; firms facing major uncertainties surrounding federal policies on trade, the environment, financial services, and until recently, health care. For a business considering a commitment to new capital spending or new hiring, it can be difficult to estimate after-tax yields for an endeavor in an environment that is so rich with proposals for higher taxes and new regulations. This risk could be particularly relevant to West Virginia's coal mining industry, where uncertainty has become especially elevated over the past year. No matter how one stands on the environmental issues involved, the changing regulatory landscape could well have a depressing effect on investment outlays.

Turning now to the outlook for inflation and monetary policy, by all accounts ─ from government data to reports we get from our own surveys ─ inflation remains benign, averaging about one and a half percent since early last year. The risk of a pronounced decline in inflation has diminished substantially in my view. But we will need to be careful as the expansion strengthens to keep inflation and inflation expectations in check because experience has shown that an upward drift in inflation expectations can be very costly to unwind.

To keep inflation contained, we will need to be careful about *when* and *how* to withdraw the considerable monetary policy stimulus now in place. This requires care during any recovery, but this time the Fed will have *two* monetary policy instruments at its disposal, not just one. The Fed traditionally has targeted the overnight federal funds rate, which required appropriately adjusting the supply of monetary liabilities (currency and bank reserves). Varying the fed funds rate affects a broad range of other market interest rates, and thereby influences growth and inflation. Since October 2008, as the bankers in the room are aware, we have had the authority to pay explicit interest on the reserve balances banks hold. This gives us the ability to vary independently the amount of our monetary liabilities and a critical overnight interest rate. So when the time comes to withdraw monetary stimulus, the FOMC will be able to raise the interest rate on reserves or drain reserve balances, or both.

The Fed has been working on two mechanisms by which we could drain bank reserves ─ reverse repurchase agreements and a term deposit facility. Both would amount to issuing Federal Reserve Bank debt to absorb reserves. While these may be useful as contingency measures, my preference would be to rely primarily on sales of the agency debt and agency-guaranteed mortgage-backed securities that we have purchased over the course of the last year. Such an approach would move us more rapidly to a “Treasuries-only” portfolio, and thus more rapidly reduce the extent to which our asset holdings are distorting the allocation of credit. There is no reason why MBS sales at a steady, moderate, pre-announced pace (as with our purchase program) needs to be disruptive to the markets for those securities. In fact, by adding to the floating private sector supply, it should improve market liquidity, which reportedly has been hampered by our large-scale purchases.

Looking beyond the near-term challenges for monetary policy, however, our economy does face several significant challenges over the longer term. I will discuss two. One of these is the path of future federal budget deficits implied by current and planned fiscal policies. The government’s debt cannot grow indefinitely at a rate much faster than the economy itself grows, so ultimately, something has got to change ─ either taxes are raised, spending is reduced, or the real value of the debt is eroded through an increase in inflation, an outcome the Federal Reserve is committed to preventing. Failure to establish credible plans for bringing the fiscal position back into balance is likely to dampen economic growth, since growing government debt relative to GDP would ultimately compete with private borrowing by businesses and households.

Our financial system ─ particularly how it will perform in future financial crises ─ will also pose considerable longer term challenges. I have argued elsewhere that the most important step to containing financial instability is to establish clear and credible limits to the federal financial safety net, which has grown considerably as a result of the crisis. Richmond Fed economists estimate that, given the precedents set in 2008, nearly 59 percent of the liabilities of the financial sector enjoy explicit or implicit government support, up considerably from about 45 percent as of 1999.[2] I believe that this crisis, and the attendant expansion of the financial safety net, was the result of there being no clear limits on the government's legal authority to protect the creditors of failing financial firms.

While the bills that have been passed in the Senate Banking Committee and on the House floor express the desire to see losses imposed on failing firms' creditors, they provide the government with wide-ranging discretion to designate financial firms as "systemically important" and use public funds in their resolution. But the resulting ambiguity about rescue policy is likely to just perpetuate the forces that brought us "too big to fail" to begin with. Improved regulations will contain the risks that brought us the last crisis, but new risk-taking arrangements inevitably will arise that by-pass existing regulatory restraints. If authorities allow creditor losses at one failing firm, then creditors are likely to pull away from other similar firms, fearing that authorities will forgo supporting them as well. Authorities will feel compelled to resolve uncertainty about implicit safety net support by expanding implied commitments. Subsequent regulations will rein in the new arrangements, the danger of which will by then be fully appreciated. But this just sets the stage for another cycle of by-pass, crisis, rescue and regulation.

A discretionary safety net, with no set boundaries, only feeds this cycle by giving market participants reason to believe that new, complex arrangements ultimately will be protected. It requires an ever-growing reach of financial regulation, and undermines the market discipline that helps align financial risk-taking with broader societal interests. It also diverts innovative resources and energies into less-productive channels, like regulatory by-pass, and away from more fundamental improvements to our standard of living. Striking and preserving the right balance between the safety net, regulation, and market discipline, is vital to ensuring that financial markets make positive contributions to the resiliency and growth of our economy over the long run.

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[1] I am grateful to Robert Schnorbus, Ann Macheras, Roy Webb and John Weinberg for assistance in preparing this speech.

[2] See John R. Walter and John A. Weinberg "How Large is the Federal Financial Safety Net?" *Cato Journal*, Winter 2002, vol. 21, no. 3, pp. 369-99; and John R. Walter and Nadezhda Malysheva (2010) "How Large Has the Federal Financial Safety Net Become?" Federal Reserve Bank of Richmond Working Paper No. 10-03, March.