

A LETTER FROM THE PRESIDENT

The Economy in 2001

For a year that was eclipsed by the September 11 tragedy, the economy ended 2001 on a positive note. While the economy weakened in late 2000 and limped into 2001, overall growth was positive for almost nine months before the terrorist attacks soured the third quarter and turned it negative.

The good news is that the economic expansion lasted a record 10 years. The National Bureau of Economic Research put its peak at March 2001, which means the recession began in April when total employment turned down. Growth resumed in the fourth quarter—surprising most forecasters—which means the recession had only one negative quarter.

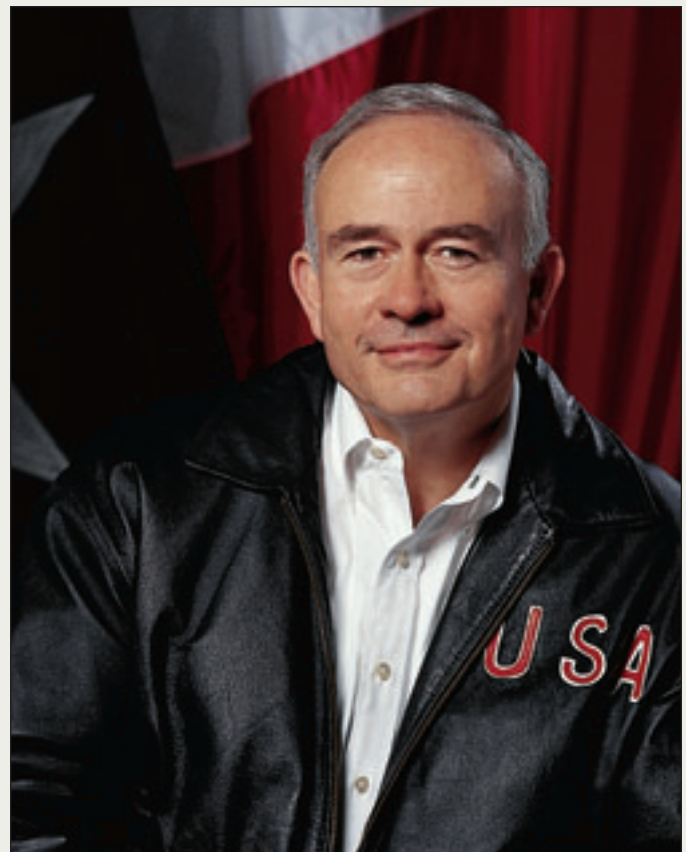
Monetary Policy

The early recovery resulted largely from the most aggressive easing of U.S. monetary policy in history. The Fed pumped up money growth last year, cut the target federal funds rate from 6.5 percent to 1.75 percent and reduced the discount rate from 6 percent to 1.25 percent. While the recovery has already begun, its strength and durability remain uncertain. Inflation declined during the recession and seems poised to decline further as growth accelerates in an economy with considerable slack. Talk that monetary policy had become ineffective—and was like pushing on a string—subsided as fourth-quarter numbers came in. The lag in monetary policy makes it more like sipping vodka than pushing on a string.

Paradigm Lost? Or Paradigm Regained?

We can't know yet whether the economy, once recovered, will get its mojo back and resume the enhanced growth rates of the late 1990s—the New Economy period—or whether growth will retreat to the glacial pace of the previous two decades. The hallmark of the New Economy was an acceleration in productivity growth that made other good things possible—faster output and employment growth and lower unemployment rates with less inflation.

Even during the recession, productivity continued to grow nicely, an encouraging sign for the future. Productivity increased about 2 percent last year on average and at a rate exceeding 5 percent in the fourth quarter. Aside from its favorable implications for our standard of living in the long



run, productivity growth in the near term reduces unit labor costs and should help restore the profitability needed for a sustained recovery without stoking inflation.

If the new economic paradigm was lost—which I doubt—I expect it to be regained. My new-paradigm frog, the unofficial mascot of the New Economy, may be in hibernation, but it hasn't croaked. Looking toward the future, let me just say that I'm up to my hip boots in tadpoles.

The Fed in the Payments System

In addition to easing monetary policy, the Federal Reserve helped sustain the nation's payments system in the crucial days following September 11. With the other Fed governors traveling, Vice Chairman Roger Ferguson exercised leadership that would have made Walter Bagehot proud. Bagehot's 1873 book, *Lombard Street*, recommended lending freely at high interest rates when the central bank needed to act as lender of last resort. We improved on that by lending freely at low interest rates and by pushing rates down further.

In addition to providing substantial reserves through open market operations, the Fed opened the discount window to keep large-dollar payments flowing despite some firms' tem-



porary inability to make payments because of physical damage to the payments infrastructure.

Donning my Reserve Bank hat, however, I am proudest of the Fed's decision to credit banks for deposited checks based on normal schedules despite our inability to deliver and collect those checks while the airports were closed. The substantial increase in check float that resulted must be recovered through check service fees and is a financial burden to us. But it illustrates the benefits of central bank participation in the payments system with a public service goal more important than the bottom line.

The Dallas Fed in 2001

The Dallas Fed had another good year. Services to banks, other financial institutions and the Treasury grew, and the banks we supervise remain healthy and viable. We believe our research, public information and education activities continue to make valuable contributions to economic education and financial literacy and will aid in the public understanding and support of sound economic policies. On the management side of things, I didn't gain much ground in my lonely campaign for the use of larger fonts within the bank—especially in e-mails to me.

The Essay

The swift recovery from the economic repercussions of September 11 demonstrates once again the vitality and resilience of the U.S. economy and the American people. That resilience and some of the reasons for it are the theme of this year's annual report essay, "Taking Stock in America: Resiliency, Redundancy and Recovery in the U.S. Economy."

A Personal Footnote

2001 was a good year for me personally. I came out of the closet as an aspiring drugstore cowboy poet. I made new friends, and since September 11, I've changed my attitude toward New York City. It is now one of my favorite places. I like our renewed sense of patriotism and am delighted that wearing and displaying the American flag is no longer politically incorrect.

I met two Texas cowboy-poet icons last year, Red Steagall and Alan Damron, and my personal honky-tonk hero, Billy Joe Shaver. Billy Joe had a heart attack but is still packing them in. His buddy Waylon Jennings died recently of complications from diabetes, a malady I share. I also have a personal interest and stake in a couple of others. This has focused my mind more on the biotech industry than it might otherwise have been. Biotech is the great hope of the future and will likely play the same role in this decade that information and communications technology played in the last. So, let's get going, biotech. Time's a'wasting!

I've decided that Alan Damron speaks for many of us old boys in the large-font stage of life:

"... for the bleached blondes and the broncos, we try to stand tall."

Amen to that.



Robert D. McTeer, Jr.