

Thank you. It's a pleasure to be among you again. I think it's been just over two years since I was with you last. The timing is fortunate as well--the beginning of the year is a good time to both look backward at the prior year and forward to the prospects for the next. Certainly after such a tumultuous 2001, this process of reflection is a particularly important one.

The past year evokes powerful social, economic and personal memories. The tragedy of September 11 stands out as an historic watershed in terms of its enormous consequences for this country, for the lives of thousands of families who lost loved ones, and for the heroic public servants who continue to labor at ground zero. Truly it was a time when--in the words of one of my colleagues--ordinary people did extraordinary things. Directly in the wake of that horrible day, U.S. financial markets were tested in ways never conceived, and came through, keeping market problems from adding to the

concerns facing this country. Reserve Banks played a key role here, a role of which I am very proud. The Federal Reserve monitored the financial system and supplied sizeable amounts of liquidity in the days after the crisis. This kept the payments system working, eased the markets' reopening, and made a difficult situation easier to deal with. Clearly, the Reserve Banks and the rest of the financial sector were prepared for contingencies--Y2K, if nothing else, had seen to that--but a lot was learned about what else needs to be done to better address contingency situations. So we have our 9/11 projects to complete this year, and I expect many of you do as well.

Beyond the tragedy, however, 2001 also witnessed the beginning of the first recession in about a decade. Obviously September 11 made things worse, but it is also possible that a recession might have occurred in any event given the slowdown that preceded that historic day. Since then, many aspects of the economy--the consumer, the equity markets just to name two--seem to have rebounded from the immediate shock of the

tragedy. But levels of economic activity are still very slow.

Much of the incoming data now suggest there may be some bottoming out and a recovery may be in the works for 2002.

The big question is what that recovery will look like. Will it be the rapid pickup seen by so many forecasters? Or will it be something that takes place more slowly?

As I seek to answer that question, I find myself reflecting on a few lessons drawn from 2001 that will guide my thinking in 2002--call them New Year's resolutions. I'd like to share these resolutions with you this morning, as we all assess what is likely to happen, and where the risks are.

1. First resolution- View Every Economic Forecast as Just That--A Forecast.

Over the last several years economic forecasts have often been wrong, sometimes markedly so. First, nearly all underestimated the economy's potential to grow and overestimated the degree to which inflation might be a problem. Then, just as many were getting the hang of

predicting a high growth, low inflationary economy, growth started to stall. Last year saw errors on the opposite side, at least as it regards growth, with most forecasts of GDP revised downward with every passing month.

In some ways this is no surprise. Economic forecasting is based on the idea that the future will obey the rules of the past. Thus, forecasting is particularly difficult when economic fortunes change direction, or when the rules of the present truly are different from the past. Last year saw an important economic turning point, so it's not surprising that after the longest period of economic expansion in U.S. history, a downturn was hard to predict. But the last several years truly have been different as well. The last half of the decade and the first years of the new millennium were unlike any in thirty years or so. During the late nineties, economic growth was fed by rising levels of productivity. This was spurred in part by large business investments in new technology, accommodative financial markets, and rising consumer and business

confidence and demand that fed on itself to create even faster growth. And, except for periods of oil price increases, this growth occurred without the surge in inflation that accompanied most expansionary periods in post Second World War history.

Remember the last quarter of 1999, when the economy grew at a 8.3% pace? Even with rising productivity, mature economies with slowly growing labor forces cannot maintain that pace for long without severely straining resources. As Herb Stein said-if something can't continue it doesn't.

Businesses saw profits eaten away by rising wages paid to ever harder to come by skilled workers, and by increases in energy costs. They began to cut back by trimming workforces and by cutting costs particularly in the area in which they had spent so much in the last half of the nineties--capital goods, especially high-technology-computers, software and anything to do with telecommunications. As businesses stopped spending in the fall of 2000, economic growth slowed suddenly as well--to remind

you in the first half of that year the economy grew by 4%; by fourth quarter it was growing at a pace about one-half of that. And that pattern of very slow and eventually negative growth continued through 2001.

But even the slowdown has been different from the normal recession. Usually a downturn in business fixed investment follows rather than leads an economic slowdown or a recession. The usual, though simplified, recession timeline goes like this: fast-paced growth strains the economy's resources raising the potential for rapidly rising inflation. The Fed steps in to return the economy to a more sustainable level of growth and the interest sensitive sectors of the economy begin to slow. Consumer spending on houses and other big ticket items contracts and the rest of the economy follows suit. But, in this recession exactly the opposite has happened- consumer spending has maintained some strength but capital spending has been slowing or declining for over a year.

Most forecasts now see what is being termed a short, shallow recession with a resumption of growth at a very solid pace by the last half of 2002. There are good reasons to expect this. After nearly a year of vigorous inventory reductions in the face of weak sales, businesses are likely to ease the pace of inventory trimming, especially if demand strengthens. This could add strength to industrial production. Further, businesses may be poised to resume spending on technology. Signs of this can be seen in data on chip production, new orders for durable goods and in surveys of purchasing managers. If business investment just stops falling, as a result of more stable inventory levels or new technology spending, GDP growth would be nearly 1 percentage point higher, all other things being equal. That alone might bring us back to positive growth territory.

But my New Year's resolution is to take forecasts with a large grain of salt, and I believe this skepticism is warranted. First, for the 1.5 million workers who have lost their jobs as

manufacturing came to a sudden slowdown 18 months ago, this recession hardly seems short and shallow. And for those marginal workers drawn into the workforce as a result of labor shortages, the last in, first out phenomenon has likely destroyed more than a few dreams.

Second, most of the rest of the world is following the U.S. into recession, as well, with forecasts of world growth below 2% for at least the first half of 2002. Growth outside the U.S. had been driven by overheated U.S. demand in the late nineties, rather than by homegrown domestic demand. Thus, it seems unlikely that foreign demand, independent of a resurgence in U.S. growth, will act to cushion U.S. economic activity anytime soon. Finally, one has to be skeptical about whether U.S. business investment will grow at a solid pace if anything should happen to the remarkable resilience of the US consumer. Which takes me to my second New Years resolution:

2. Keep Your Eye on the Consumer.

Consumption is two thirds of gross domestic product-it is very hard for the economy to grow if consumers are not willing to spend. This has never been more evident than in the past year when, despite the recession and September 11, consumers bought autos and new homes at near-record clips. How has this been possible?

First, despite sharp increases in the unemployment rate, the vast majority of the workforce is working and earning incomes that are growing at a solid pace. Second, consumers, while worried about the present, have displayed tremendous resiliency, particularly after September 11. They are relatively more confident about the future and getting more so as time passes. That level of confidence makes purchasing big-ticket items a bit easier in uncertain times. Third, consumers have been able to leverage rising asset values-especially their houses-and use that cash to spend more freely.

In many ways the strength of the consumer is testimony to the efficacy of monetary policy-aggressively easing policy last year has created an environment in which it has been easier for consumers to borrow and spend, thereby putting a floor under a weak economy. If, for example, consumer spending had fallen as it usually does during the early stage of a recession, GDP growth would have been about 1 and a half percentage points weaker than it has been in the relatively mild downturn we have seen, at least to date. So the consumer has really saved the day.

But the real question is whether the consumer will stay the course long enough to revive business investment. And here one can reasonably have doubts. On the positive side, monetary policy has eased considerably and some of the effects of that ease are still in the pipeline. Moreover, there are some signs that the pace of job losses has begun to slow, though the unemployment rate should continue to rise a bit even as the economy recovers. On the negative side, consumer

indebtedness can continue to grow only so long before consumer finances become a drag on spending and overall financial health. Even now, outstanding amounts of consumer debt are at high levels historically, and interest payments as a share of disposable personal income are high and bankruptcies are as well.

And we should remember that the spending spree of the last couple of years really can't continue--just take automobiles as an example. Consumers have been buying new cars at a record 16 million unit a year pace for some time now. One wonders how many cars U.S. consumers can own or how many driveways they have. Mortgage rates have risen recently likely taking a cut out of homebuying. Thus, the pace of consumer spending growth might not continue, bringing with it the potential that such spending will not be the usual source of strength that it has been in a recovery. During the initial stages of recoveries since the Second World War, consumers often respond with pent-up demand--given the pace of big-

ticket spending in 2001, one has to ask whether there is much pent-up demand.

Finally, both consumers and equity markets are displaying a growing optimism about the coming year. One can see this in the long end of the yield curve where yields have fallen little over the past twelve months, despite eleven reductions in overnight funds rates by the Open Market Committee, the onset of the recession in March, and the real contraction in GDP growth by third quarter. These relatively elevated long-term rates don't seem to reflect inflationary concerns--I'll get to that next--but may be a sign that yields will need to be higher to equate the supply and demand for longer term financing as the economy surges. Optimism is also reflected in rising equity price-earnings ratios, which for the S&P 500 are about double their long-run average. And this after a year in which corporate profits plunged about 20%, and profit levels are down to those last seen in 1995. Analysts

are optimistic about 2002, to be sure, but their projections of profit growth in the range of 16-30 percent are eyeopening.

Perhaps this optimism is reasonable; certainly it seems to agree with the thrust of at least the most optimistic economic forecasts. But I have to wonder here as well. If the consumer retrenches a bit in the face of high levels of debt; if the external sector provides no help; and business spending recovers, but only modestly, will corporate profits be that strong? And if corporate profits don't hold up, what happens to equity markets, and to business and consumer confidence?

3. My Final Resolution - Be Wary About Price Movements.

Of course, as a central banker I have to make a resolution to stand firm against inflation every year. But inflation no matter how measured was truly quiescent in 2001, and is expected to decline further this year. Survey-measured inflation expectations have declined as have expectations inferred from the yields on the Treasury's inflation protected

securities. Declining inflation means higher real interest rates, rather than lower, and some have argued that this may be one reason why the aggressive easing of monetary policy over the past year seems less effective than it otherwise might have been. Frankly, I don't agree with that description of the impact of monetary policy, but it has been suggested. In fact, some have argued that avoiding deflation ought to be the Fed's worry right now.

My own view is more measured. With aggregate inflation as low as it is, there is a balancing act going on--not all prices are growing when inflation is rising at 2% or so--particularly if one considers the rapid rate of increase in the price of some things, like medical services. When price growth is this low, prices of some things--like commodities, or computers--are going down, while other prices--for business or medical or other types of services--are going up. Moreover, wages and personal income continue to rise. This is a low inflation environment, and not the downward spiral usually thought of

as deflation. In my view, many factors--the resilience of the U.S. consumer, the willingness of banks and markets to lend, the health of the U.S. banking system, just to name three--all point in the direction of more rather than less stability in price levels and overall economic growth.

One of the biggest--and most pleasant--surprises of the late '90s was the economy's ability to grow at an historically fast pace without inflation taking off. This was at least in part the effect of rising rates of productivity growth that help the overall economic pie to grow without pinching resources. Now, as the recession may be bottoming out, productivity has remained surprisingly strong, with all that that can mean for the longer-run capacity of the economy to enjoy solid rates of non-inflationary growth. Will inflation be a cyclical problem when the recovery is in full swing? That's hard to say, but it is certainly an area that bears some watching.

In sum, my New Year's resolutions--be mindful about forecasts, keep your eye on the consumer, and be wary of

inflation--all point in one direction--the need to make careful choices in the face of economic uncertainty. The American economy has had to absorb some extraordinary shocks over the past year or more. It has done so in remarkable fashion, even in the wake of the tragedy of September 11. There is much that is good news in incoming economic data--glimmers of hope for manufacturers, and a slowing in the pace of job losses--and the New Year has brought a surge of optimism. But in the midst of this optimism it's good to remember that risks remain, and some caution is in order.