President's Foreword

The U.S. economy is still in the process of recovering from a recession that began over two years ago. The official arbiter of business cycle peaks and troughs, the National Bureau of Economic Research, has not yet decided when the recession ended — or indeed, whether it has ended. Many economists expect the latest recession's trough to be dated near the end of 2001, but considerable uncertainties about the future course of economic activity remain.

The most immediate problem confronting the economy is an issue facing not only our nation, but also the world. Terrorist activities and the strain of military conflict weigh heavily on people everywhere. In the economic realm of our lives, one consequence of these geopolitical tensions is a hesitation to take risks, particularly risks that involve significant capital expenditures. Capital spending requires confidence in the future because the benefits of long-lived investments accrue over time and, once made, are not easily reversed. Because we thrive in a global trading environment, the U.S. economy is especially sensitive to developments around the world.

Once geopolitical tensions ease, we will be in a better position to assess the economy's underlying condition. One aspect of economic performance that has received a great deal of attention in the past few years is price stability — though not for the usual reasons. Rather than worrying about inflation, some analysts have been assessing the likelihood of deflation and its consequences. Because deflation is rarely found in modern economies, its effects are not well understood.

David H. Hoag, chairman; Sandra Pianalto, first vice president; Jerry L. Jordan, president; and Robert W. Mahoney, deputy chairman.

The Great Depression, as well as Japan's more recent experience with outright deflation for four years and a flat price level for eight, have convinced some central bankers that a little inflation is, in fact, desirable. In the essay that follows, we defend deflation as an occasionally acceptable macroeconomic outcome, so long as it is small in magnitude and accompanied by strong productivity growth.

The Bank could not have accomplished all that we did in 2002 without the guidance provided by the directors of our Cincinnati, Cleveland, and Pittsburgh offices and the members of our business and community bank advisory councils. We especially want to thank those directors who completed their terms of service on our boards in 2002. For their oversight and valuable contributions, we are truly grateful.

On our Cleveland Office board of directors, we are appreciative for the leadership of David H. Hoag (retired chairman, LTV Corporation), who served as deputy chairman and then chairman of the board during his term of service. During his tenure, Mr. Hoag was an integral part of the search committee that selected my successor as president, Sandra Pianalto. In addition, Tiney M. McComb (chairman and president, Heartland BancCorp) and David L. Nichols (president and chief operating officer, Rich's/Lazarus/Goldsmith's) completed their service on the Cleveland board.

On our Cincinnati Office board of directors, Mary Ellen Slone (chairman and chief executive officer, Meridian Communications), completed a term as a director. Special acknowledgment goes to George C. Juilfs (chairman and chief executive officer, SENCORP), who served as chairman of that board for two terms. On our Pittsburgh Office board of directors, Georgia Berner (president, Berner International Corporation) and Peter N. Stephans (chairman and chief executive officer, Trigon, Incorporated) each completed their second term as directors. We will miss the valuable contributions of all of our departing board members.

In addition, I wish to express my sincere appreciation to the officers and staff of the Federal Reserve Bank of Cleveland for their service during 2002 and throughout my tenure as president. The employees of the Cleveland Bank have impressed me with their commitment to efficiency, innovation, customer service, and good public policy. Collectively and continuously, they have strengthened our banking and payments systems, served the U.S. Treasury, and championed price stability. For all of these reasons and more, I sincerely thank them.

Jerry L. Jordan
President