CURRENT ECONOMIC CONDITIONS AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Vice Chairman Jim Saxton

Data as of July 7, 2004

Joint Economic Committee
1537 House Office Building
Washington, DC 20515
Phone: 202-226-3234
Fax: 202-226-3950

Internet Address:
http://www.house.gov/jec

Prepared by Dr. Robert Keleher, JEC Staff

CONTENTS

Economic Performance and Outlook[1]

- **Summary and Overview**

Recent macroeconomic performance has been strong. Annualized quarterly growth rates of real GDP averaged 5.4 percent since the third quarter of 2003. Real GDP growth is expected to average better than 4.0 percent for the remainder of 2004. For the most part, inflation and interest rates remain relatively low, although they are no longer falling. Productivity gains remain robust. Real GDP growth has been not only rapid, but also broad-based and widespread across all sectors of the economy.

- **Sectors**

Consumption growth, for example, continues to expand at a healthy pace, averaging 4.6 percent over the past three quarters. Consumption growth is expected to continue through 2004 at a healthy pace. Retail (and auto) sales have held up as have key determinants of consumption such as trends in real disposable income. Measures of consumer confidence and sentiment continue to trend upward. **Housing sector activity** remains strong with housing starts and (new and existing) home sales displaying persistent strength while remaining at or near record levels.

Recent **investment** gains also have been solid and have contributed significantly to total GDP growth. Nonresidential fixed investment, for example, rebounded sharply during the last four quarters with quarterly growth averaging 9.0 percent. The equipment and software component has expanded for eight quarters in a row and growth has averaged 12.4 percent over the last four quarters. With capital good orders trending up and profits expanding, investment is expected to continue to expand at a healthy clip. With inventory/sales ratios near historic lows, inventory investment should also increase and bolster real GDP growth in the near term.

Manufacturing activity has also rebounded. For example, industrial production (which is largely manufacturing activity) on average has advanced 7.0 percent since July 2003. Industrial production is expected to advance at a 5.7 percent pace for the remainder of 2004. The ISM (Institute for Supply Management) manufacturing activity diffusion index also has increased to levels well above 50, suggesting that the expansion of manufacturing activity is more widespread among manufacturing firms. The ISM index has been above 50 (and expanding) for 12 months in a row. Upward trends in durable good orders and shipments suggest that further manufacturing gains are likely.

Along with these manufacturing sector gains, **service sector** activity continues to increase. The ISM service activity index, for example, has been above 60 in nine of the last 12 months, suggesting that service sector gains are widespread among service sector firms.

---

[1] The source for all graphs in this publication is Haver Analytics.

The labor market has also participated in this expansion. Gains this year in **payroll employment**, for example, have reached 1.3 million jobs, averaging +211,000 per month. In general, these gains have been widespread among industries, including the manufacturing sector in recent months. Increases in leading indicators for employment, like advances in temporary help, suggest more employment gains are on tap. The unemployment rate, at 5.6 percent, is at a rate lower than the average unemployment rate of the 1970s, 1980s, and 1990s. This rate is expected to be about 5.4 percent in the fourth quarter.

- **Inflation**

Core inflation measures are still relatively contained from a long-term, historical perspective. On a year-over-year basis, for example, the latest readings show increases in the core CPI of 1.8 percent, the core PPI of 1.4 percent, and the core PCE of 1.6 percent. These core inflation measures, however, have all stopped falling and begun to tick up (especially on monthly basis). Any additional increases should alert the Federal Reserve into more prompt additional tightening moves.

- **Market Price Indicators**

Market price indicators, on the whole, suggest that inflation and inflationary expectations are no longer falling but, rather, are beginning to increase. Increases in commodity prices and long-bond rates, together with a persistent depreciation of the dollar in foreign exchange markets, for example, are consistent with such an interpretation. Indeed, since these markets undoubtedly have some Fed tightening already built into their prices, the inflation risk without Fed action is more serious than market prices currently suggest. Movements of some key asset prices, however, are mixed; the stock market has treaded water since early this year, while housing prices continue to advance, albeit at single digit rates. The oil price increases that we have recently witnessed largely reflect rapid growth in the demand of an expanding world economy and, therefore, may not be as disruptive to the U.S. economy as supply disruption.[2]

- **Causal Factors**

Several factors are contributing to the ongoing economic expansion. Monetary policy remains accommodative and should remain so for a time. The continued, credible maintenance of price stability will help to keep financial markets stable and interest rates low. Tax cuts are in place and should promote economic gains. The economic outlook for some other countries, like Japan, has improved. In short, a number of economic policies are in place that should foster continued economic advance.

[2] The International Energy Agency argues that the "global economic expansion is fueling the biggest increase in world oil demand in 24 years." "Global expansion fuels rapid gains in demand for oil," Wall Street Journal, Friday June 11, 2004, p.b2 (emphasis added.)

- **Risks to the Outlook**

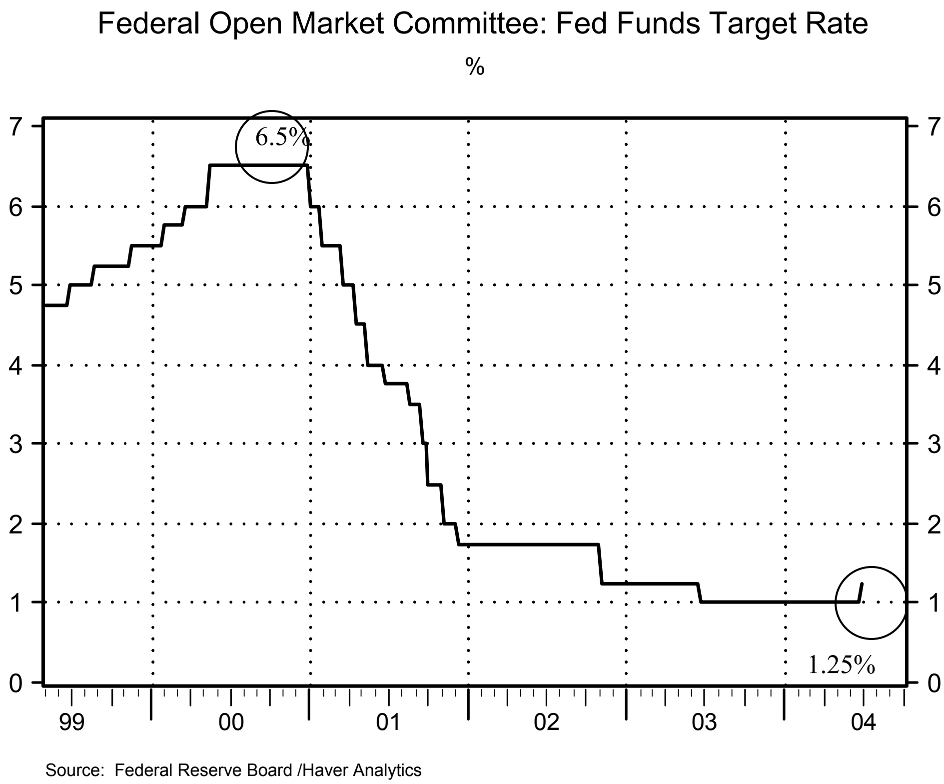
There remain downside risks to the economic outlook that should not be ignored. These risks, should they materialize, are unlikely to derail the expansion but could possibly slow it down over time. Household debt burdens are sizable and the threat of terrorism still weighs on the economy. Furthermore, energy prices are up sharply and could remain near elevated levels. A consensus of economists concludes that if oil prices remain at $40/b ($50/b) through 2004, the consensus forecast of year-over-year real GDP growth in 2005, which is now 3.7 percent, would fall to 3.4 percent (2.7 percent).[3]

- **Policy Implications**

In sum, the U.S. economy is robust and most analysts believe that monetary and fiscal policy are fostering continued growth. As expected, the Federal Reserve increased the federal funds rate by 25 basis points at its June FOMC meeting. Differing opinions prevail, however, as to how rapidly the Federal Reserve will raise rates in the future. Fed officials suggest they will "do what is necessary" to preserve price stability. As to the language of the public policy statement, the Fed suggested that the upside and downside risks to inflation were roughly equal. Given the desirability of healthy and sustained economic and employment growth, earlier tax cuts should be made permanent and further measures to reduce the burden of taxes and government regulation on the economy would be appropriate.

[3] See Blue Chip Economic Indicators for June, 2004, pp. 1, 14.

I. Federal Reserve Monetary Policy

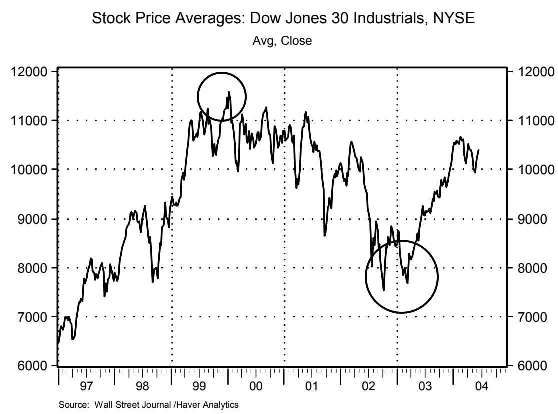


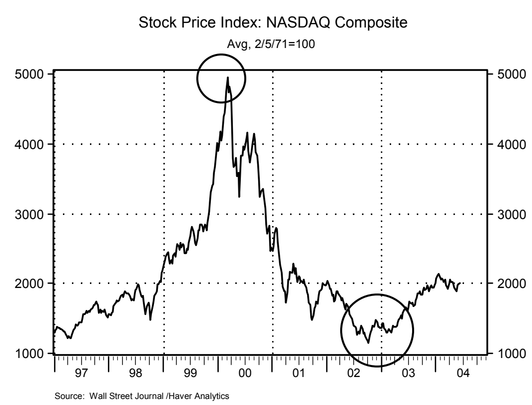
- Monetary policy has played a significant role in affecting the performance of the economy in recent years. The Federal Reserve **lowered** short-term interest rates 550 basis points beginning in January 2001, putting the Fed funds rate at 1.00 percent and a 40-year low by June 2003. **This easing and accommodation of monetary policy is a key reason for the economic turnaround and expansion we are currently witnessing**.

- This accommodative posture gave business, households, and financial institutions the opportunity to strengthen their balance sheets from the equity bubble recession.

- Currently, the markets and many analysts expect the fed funds rate to be increased by about 100 basis points by year end. The first increase of 25 basis points occurred, as expected, at the June FOMC meeting. The policy statement released at that meeting contained language indicating the upside and downside risks of future inflation were roughly balanced.

II. Stock Prices





- This page shows two well-known stock price indices: the Dow Jones Industrials index (in the upper panel) and the NASDAQ Composite index (in the lower panel.) The Dow Jones index peaked in January 2000 and trended down until spring of 2003. Overall, it has gained ground since then. In fact, the Dow has recouped a good deal of what it lost.

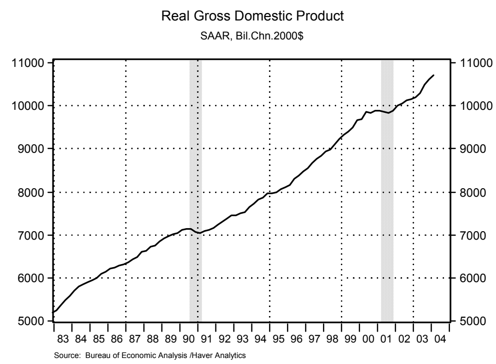
- The NASDAQ peaked in March 2000 and lost a great deal of value (and market capitalization) until October 2002. Notably, most of the NASDAQ's large decline took place prior to January 2001, and consequently, had nothing to do with Bush economic policy. The NASDAQ has gained ground in recent months, but has not recouped proportionately as much ground as the Dow.

- Many analysts argue that stock market moves have important economic repercussions. Such market moves, for example, alter the cost of capital and thereby impact future investment. And the equity markets' "wealth effect" can importantly impact consumption.

- Some of the recent stock market gains can be attributed to various forms of tax cuts made in recent years. These tax cuts helped the stock market, which in turn helped the economy.

III. Output Measures
Gross Domestic Product

Long-Term GDP



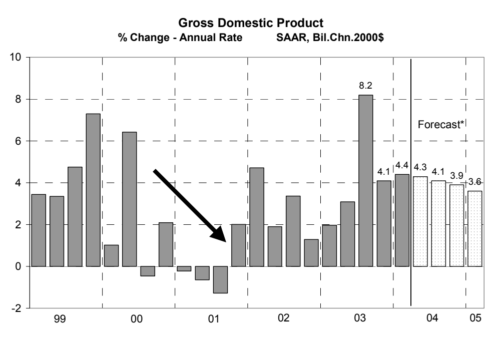
- Using monthly indicators and data, the National Bureau of Economic Research (NBER) determined that the previous decade-long economic expansion peaked in March 2001. The slowdown, of course, began months earlier, in mid-year 2000. The recession ended in November 2001, making it a relatively short 8 months long. Recent events should be viewed in context of the lengthy economic growth of the last two decades during which recessions were relatively infrequent (see shaded areas of chart.)

- Beginning in mid-2000, quarterly real GDP growth began to slow significantly from growth rates previously recorded.

- GDP growth turned negative in the third quarter of 2000, as well as in the first, second, and third quarters of 2001. The recession of 2001 was short and one of the mildest on record.

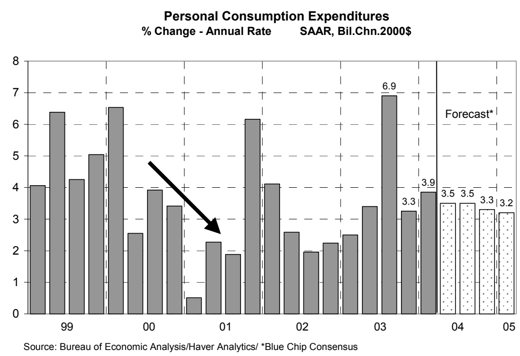
- But real GDP growth turned positive again in the fourth quarter of 2001. Growth averaged better than 2.6 percent for seven quarters. After this, the economy has strengthened considerably, annualized quarterly growth rates of GDP averaged 5.4 percent since the third quarter of 2003. **Consensus forecasts project robust growth over the next several quarters, with growth averaging higher than 4.0 percent.** Many analysts attribute at least part of this improvement to tax relief.

Recent Quarterly GDP Change



Consumption

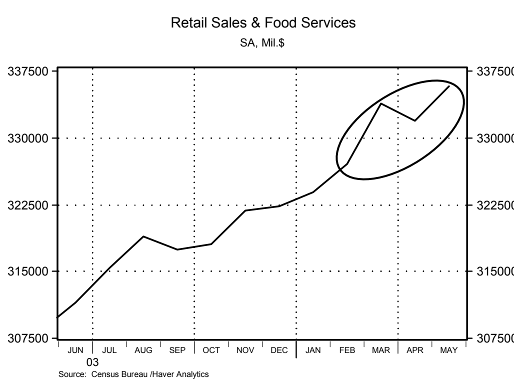
Consumption Growth



- Consumption has been a sector consistently contributing to the strength of the economy in recent years. This is depicted in the accompanying quarterly real consumption growth chart.

- Consumption growth increased sharply in the fourth quarter of 2001 and was a major factor boosting real GDP for that and subsequent quarters. According to consensus forecasts, **<u>consumption is expected to continue to contribute to GDP growth in the near-term</u>** (see chart.)

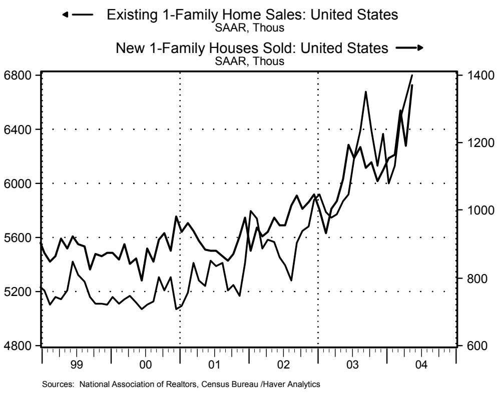
- Key determinants of consumption, such as trends in real disposable income and net worth, have advanced and supported consumption. Measures of consumer confidence also continue to trend upward.



- Monthly Retail Sales figures corroborate the quarterly consumption data: i.e., consumer momentum remains intact as retail sales continue to advance.

Housing Activity

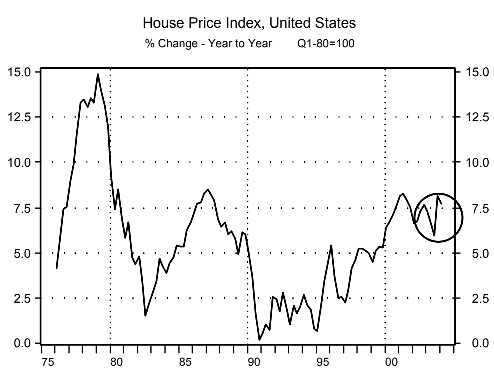
Housing Sales



- Housing is another sector consistently supporting the economy in recent years. Low interest rates are a factor contributing to housing's persistent strength.

- **Housing sales – both new home sales and existing home sales – have held up in recent years (including during the recession.) These categories of sales are at or near record levels** (see chart.)

House Prices

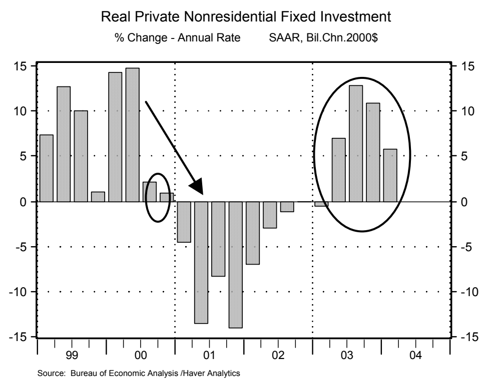


- House prices have increased in recent years. Currently, the home price index is up at about a 7.5 percent rate (year over year.) This rate has persisted for several years.

- There is little evidence of a housing asset price "bubble" behaving like stock prices in recent years.

Investment

Fixed Private Non–Residential Investment Growth

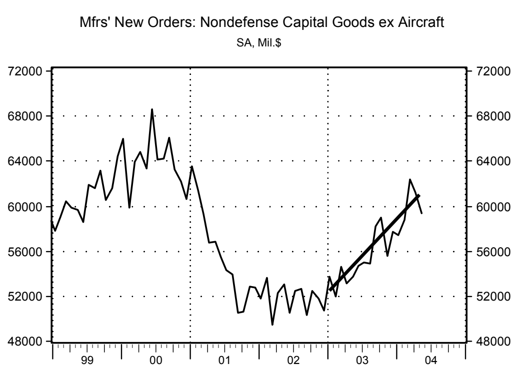


- The business investment component of real GDP has been a leading sector in the economy: it has grown at rates exceeding GDP both on the upside and the downside.

- Investment growth slowed dramatically in mid-2000 in response to the bursting of the stock market bubble. It subsequently declined for nine consecutive quarters. Recently, however, investment has turned around. **<u>Investment has expanded sharply for four quarters in a row at an average growth rate of 9.0 percent.</u>**

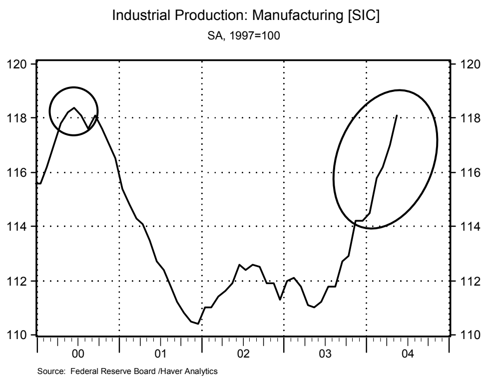
- **<u>Some components of investment have shown more positive growth (such as equipment and software.)</u>** The equipment and software component has expanded for eight quarters in a row and growth has averaged 12.4 percent over the last four quarters. This component is not displayed.

New Orders for Capital Goods

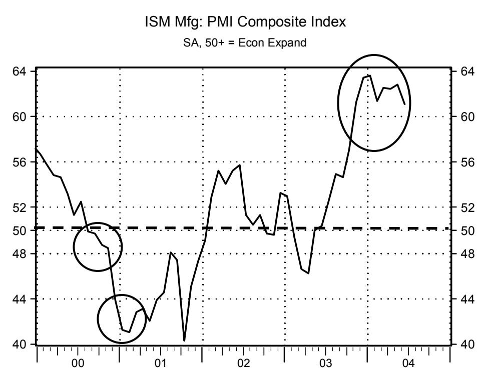


- More timely information from monthly indicators that correlate with investment also provide useful insights. Manufacturers' **<u>new orders for non-defense capital goods</u>** (ex-aircraft), for example, **<u>are trending up.</u>** This is believed to be a leading indicator for investment spending.

The Manufacturing Sector



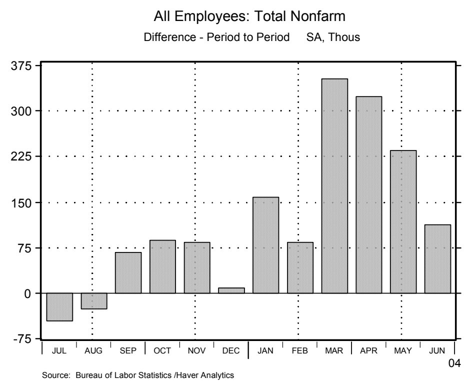
- Although the manufacturing sector experienced weakness after mid-2000, it has advanced sharply in recent months. The industrial production manufacturing index, for example, on average has advanced 7.7 percent annually since September 2003. It has nearly surpassed its previous peak. Industrial production, which is mostly manufacturing activity, is expected to advance at a 5.7 percent pace for the remainder of 2004.



- **The Institute for Supply Management's manufacturing diffusion index also shows dramatic improvement in manufacturing activity. According to this index, manufacturing activity has been improving since mid-2003.** (Figures above 50 denote expansion.) Specifically, the index has been above 50 (and expanding) for 13 months in a row.

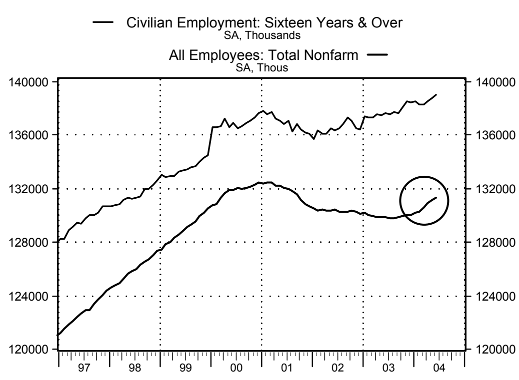
IV. The Labor Market

Payroll Employment



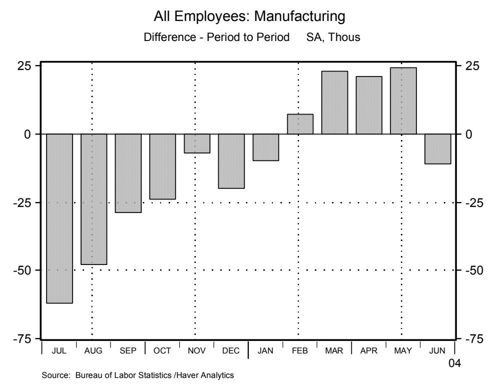
- This chart shows the monthly gains in total employment on nonfarm payrolls in recent months.
- Gains this year in payroll employment have reached 1.3 million jobs, averaging +211,000 per month. Payroll employment has been up 10 months in a row. These gains have been widespread across industries, including in recent months, the manufacturing sector.

Payroll vs. Household Employment

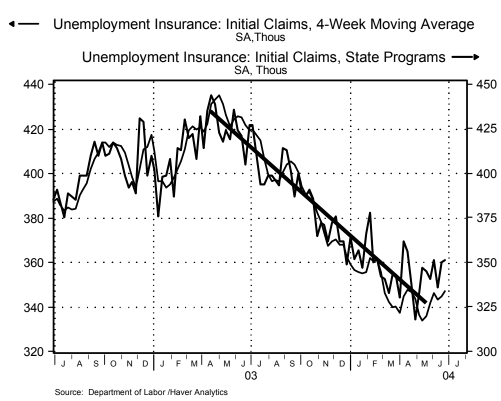


- The lower chart shows the levels of both household employment (from the household survey) and payroll employment (from the payroll survey). While there are many differences between the two employment surveys, normally over time the two surveys track one another.
- Until recently, however, the two surveys had diverged from one another. The household survey showed persistent gains in total employment while the payroll survey was, until recently, a bit more sluggish. The most recent figures, however, show some narrowing of this gap.

Manufacturing Employment



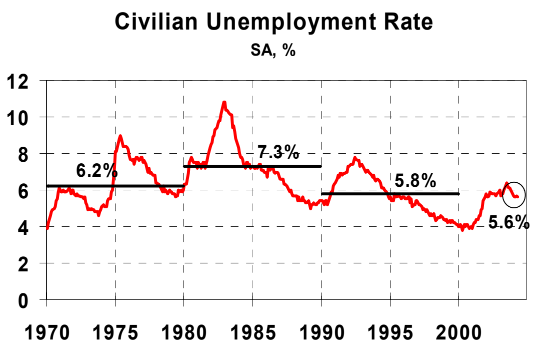
- The chart to the left shows manufacturing payroll employment in recent months. Manufacturing employment has been weak for an extended period, but its weakness has dissipated in recent months. In fact, manufacturing employment has gained in four of the last five months.



- The lower chart shows recent movement in initial unemployment claims. Initial unemployment claims are a leading indicator for employment.

- As the graph shows, initial unemployment claims have trended downward since the spring of 2003. This suggests that conditions in the labor market should continue to improve in the near-term and augers well for future employment gains.

Unemployment

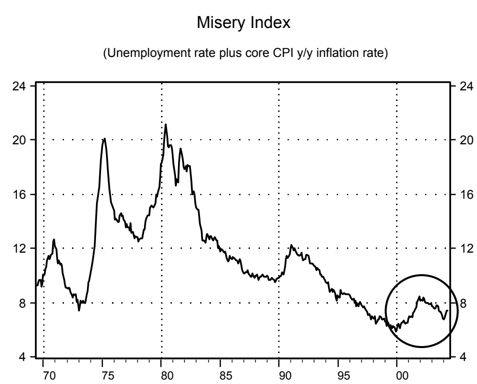


- The top chart shows the unemployment rate over three decades. The data suggest that the current unemployment rate is relatively low when compared to rates at equivalent stages of earlier business cycles.

- Recently, the unemployment rate has fallen from 6.3 percent (in June 2003) to 5.6 percent (in June 2004.)

- The unemployment rate, at 5.6 percent, is at a rate lower than the average of the 1970s, 1980s, and 1990s (See chart.)

- **<u>Consensus forecasts predict that the unemployment rate will gradually drift down from current levels.</u>** Even at around 5.5-6.0 percent, the unemployment rate is at levels that several years ago would have been regarded as consistent with full employment.

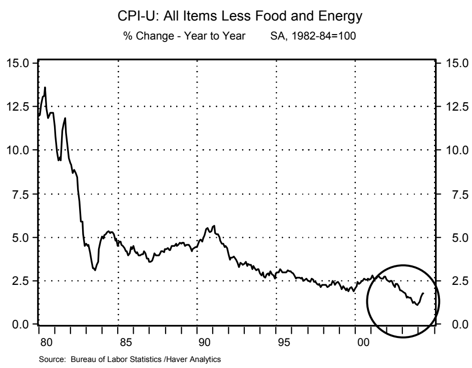


- The chart on the left presents the so-called "Misery Index," which measures the sum of the unemployment rate and the core CPI inflation rate. It is premised on the notion that both a higher rate of unemployment and a worsening of inflation create economic costs for a country. The index is used unofficially to assess a nation's economic health.

- **<u>Currently, the misery index is relatively low. It is lower than it has been for most of the last 35 years.</u>**

.

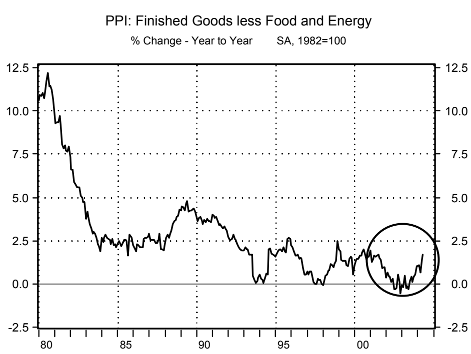
V. Inflation Measures



- This chart shows the less volatile core (ex food and energy) measure of the consumer price index (CPI), over the last 20 years on a year-over-year basis.

- This measure shows inflation trending down over the past two decades. In fact, **the most recent year-over-year data shows inflation is well below 2.5 percent, and relatively low from a historical perspective.**

- However, the latest data do show some uptick in inflation. The Fed should be closely monitoring these inflation measures.



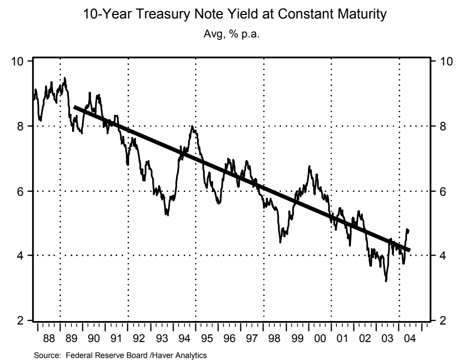
- The chart on the left shows core (ex-food and energy) finished good **producer price** inflation over the last 20 years (on a year-to-year basis).

- This measure shows inflation trending down over most of this period. In fact, **the latest data suggest that PPI inflation is also well below 2.5 percent and low from a historical perspective.**

- **According to these data, inflation is not a serious problem at this time.** However, the year-over-year PPI measure does show some uptick in inflation during 2003. The Fed should be closely monitoring these price movements.

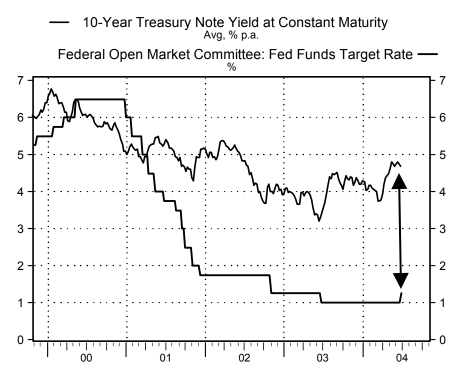
VI. <u>Forward-Looking Market Price Indicators</u>

Long-term Interest Rates



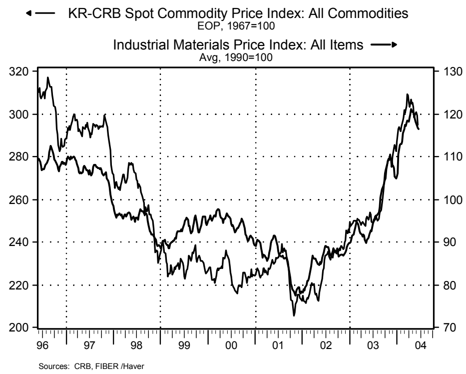
- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.
- Long-term interest rates generally have trended down for most of the past decade as inflation has diminished. Currently, long-term rates remain near 40-year lows.
- **Recently, long-term rates have remained low in the face of projections of larger federal budget deficits, suggesting that such deficits have only a minor role in determining long-term interest rates.**

Yield Spread



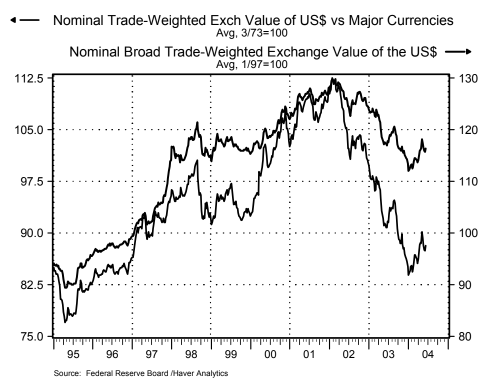
- The lower chart shows both the short-term federal funds rate and the long-term treasury rate in recent years. The difference between these rates is referred to as the "yield spread."
- During 2001-2003, **the Federal Reserve lowered the fed funds rate (from an inverted position) until it was significantly below the long-bond yield; it brought about a wide and positive yield spread. Such a spread is normally associated with "easy" or accommodative monetary policy. Currently, the yield spread continues to be wide and positive.**

Commodity Prices



- This chart shows two commonly used broad commodity price indices: the Knight-Ridder-Commodity Research Bureau (CRB) spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.
- The industrial materials index contains industrial commodity prices including energy prices.
- The CRB spot index does not include energy prices
- Recent increases in commodity prices are movements off their lows. They have recouped the decline that they experienced in recent years. The increases suggest the threat of deflation has dissipated and given way to reflation and some inflation. These price indices should be closely monitored since further significant increases could signal a turn toward additional inflationary pressures.

The Dollar



- The bottom chart shows the trade-weighted value of the dollar measured against both a broad group of currencies of the U.S.' major trading partners and against an index of major currencies.
- The foreign exchange value of the dollar generally strengthened during much of the 1995-2001 period. During 2002-2003, the dollar has steadily depreciated. The dollar, however, has held its own in 2004.
- Recent dollar depreciation has occurred largely against major currencies such as the euro and yen. To date, this depreciation has been relatively measured.
- Such measured depreciation is not as worrisome as a sharp depreciation would be since it does not involve sharp financial capital flows associated with a movement out of the dollar.