JOINT ECONOMIC COMMITTEE
ROBERT F. BENNETT, VICE CHAIRMAN

RECENT ECONOMIC DEVELOPMENTS
JUNE 13, 2006

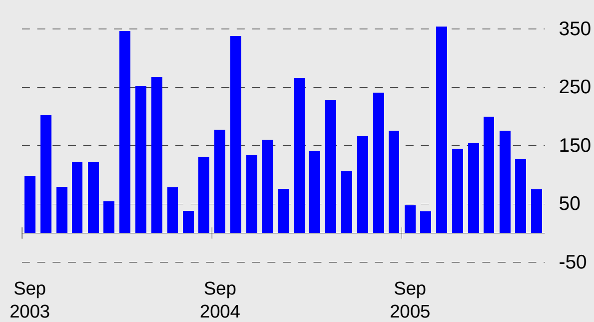
Moderating Toward Sustainable Growth

Incoming data are consistent with a moderation of economic activity following the rapid 5.3% annualized rate of growth in the inflation-adjusted (real) gross domestic product (GDP) in the 1st quarter. Employment growth slowed in the last two months to an average gain of just over 100,000 new payroll jobs per month, down from an average monthly gain of 176,000 in the first three months of this year. Housing markets also continue to show signs of slowing. The Federal Reserve (Fed) has made clear that inflation measures are running at the high end of its comfort level. Recent remarks by Fed officials have raised the odds that financial markets assign to further increases in interest rates as the Fed responds to concern about inflation acceleration. A portion of recent downturns in stock market prices likely reflects higher odds of increases in interest rates. Despite inflation concerns, which largely reflect higher energy prices, forecasters see a moderation in economic growth from last quarter's rapid pace toward more trend-like growth of around 3.0%, on average, through 2007.

Highlights

- Payroll employment gains moderated to an unexpectedly low 75,000 net new jobs in May (Fig. 1).
- The unemployment rate edged down to 4.6% in May, well below the recent peak of 6.3% in June 2003.
- Real GDP growth was revised up to an annualized 5.3% rate in the 1st quarter, from an earlier estimate of 4.7% (Fig. 2, next page).
- Housing markets continue to show signs of moderation, but levels of activity remain high by historical standards (Fig. 3, next page).

Job Growth in the Past 33 Months Fig. 1
(Change in employment, in thousands)



Source: Bureau of Labor Statistics

Over 5.3 Million New Jobs in 33 Consecutive Months of Job Gains

The economy added 75,000 new *payroll jobs* in May, the 33rd consecutive month with job gains (Fig. 1). Over 5.3 million net new jobs have been added to payrolls in that period, and 1.9 million new jobs have been created in the last year alone. The *unemployment rate* edged down to 4.6% in May. The unemployment rate remains below the averages of the 1960s (4.8%), 1970s (6.2%), 1980s (7.3%), and 1990s (5.8%) and is well below the near-term peak in the unemployment rate of 6.3% in June 2003.

Rapid 5.3% Annualized GDP Growth in the 1st Quarter; Moderation Expected in 2nd Quarter

GDP growth was a rapid 5.3% in the 1st quarter, a sharp rebound from the lull to 1.7% growth in the 4th quarter of last year. GDP growth has averaged a robust 4.0% since the tax relief measures were enacted in 2003, faster than the averages of the 1970s (3.4%), 1980s (3.1%), and 1990s (3.3%). The *Blue Chip* forecast—a monthly consensus of private forecasters—is for trend-like real GDP growth of around 3.0%, on average, through 2007 (Fig. 2, next page). The consensus forecast for the 2nd quarter is for moderation from the rapid 5.3% growth of the 1st quarter to 2.9% growth. The expected slowdown in growth partly reflects indications that consumer spending, which accounts for around 70% of GDP, has slowed in recent months. In turn, slower consumer spending partly reflects high energy prices.

Inflation at Upper End of Fed's Comfort Zone

Inflation in the *consumer price index* excluding energy and food prices ("core" CPI inflation) was an annualized 3.2% over the past three months and 2.8% over the past six months. Annual inflation in the core *personal consumption expenditures price index*, the Fed's preferred measure of consumer prices, was 3.0% in the past three months and 2.3% in the past six months. Fed Chairman Ben Bernanke remarked last week that these inflation increases "are unwelcome developments."

Stock Markets React to Fed's Inflation Scare

Partly reflecting the prospect of higher future interest rates (a possible Fed reaction to discomfort over signs of higher inflation), *stock prices* retreated in recent weeks. For example, on June 12 the Dow Jones Industrial Average closed 7.3% below its value on May 10. Over the same period, the NASDAQ was down 9.9% and the Standard and Poor's 500 index was down 6.6%.

Federal Reserve is Expected to Raise Rates Again

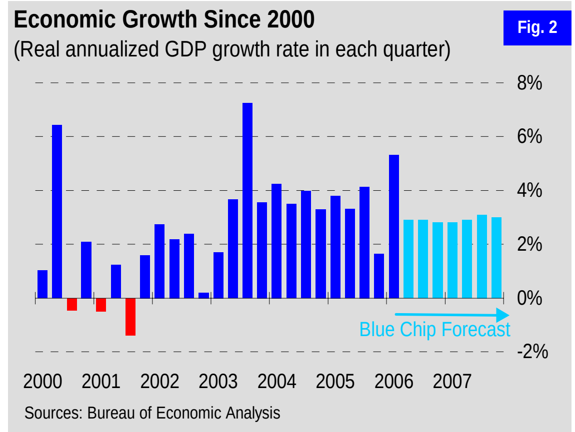
The *Federal Reserve* has raised its target for overnight interest rates from 1.00% to the current 5.00% in a sequence of quarter-point increases that began in June 2004. Market guesses about yet another quarter-point increase in the target overnight interest rate at the Fed's policymaking meeting on June 28 and 29 have been variable and "data dependent." Following comments by Fed officials last week expressing concern over inflation, markets have raised the odds they assign to another quarter point increase from below 50% to around 70%.

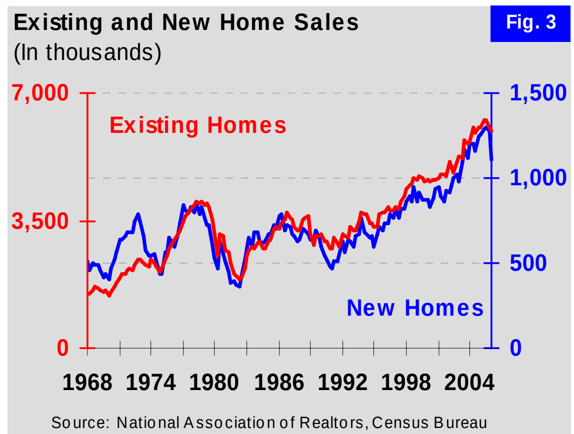
Housing Market is Cooling

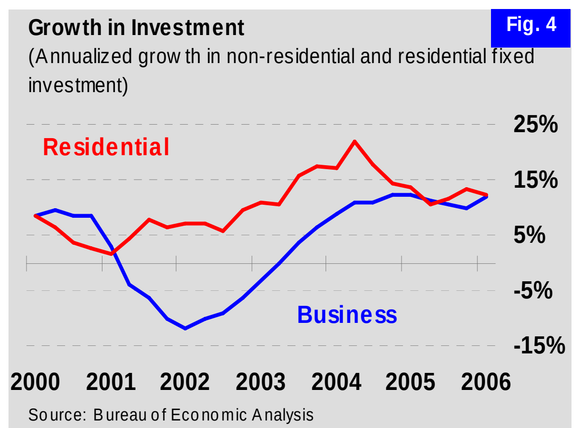
Both *new and existing home sales* have fallen, on net, from their peak highs of last summer and early autumn (Fig. 3). *Inventories of unsold homes* have also increased significantly. However, levels of home sales remain high by historical standards. *House prices*, which have accelerated rapidly in the past several years, are growing at slower rates. The median sales price of existing homes, for example, grew 4.2% on a year-over-year basis in April, down from a peak of 15.7% in August 2005. Slowing of the real estate market may restrain future consumer spending, as the pace of increase in the value of homeowner equity slows.

Business Investment Helpful as Housing Moderates

While consumer spending is showing signs of moderation, *business investment spending* appears to have been very robust, on net, this year. Business investment recovered and has remained strong since enactment of tax relief in May 2003. Continued gains in business investment spending can help absorb resources released by a slowing housing sector (Fig. 4).







Upcoming Indicators

Inflation – The Consumer Price Index for May is scheduled to be released on *June 14*.

GDP – The final look at GDP growth for the 1st quarter is scheduled for release on *June 29.*

Federal Reserve – The Fed's next monetary policy meeting is scheduled for *June 28 and 29.*

Employment – The Bureau of Labor Statistics reports June's employment situation on *July 7.*