CURRENT ECONOMIC CONDITIONS AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Vice Chairman Jim Saxton

Data as of February 27, 2004

Joint Economic Committee
1537 Longworth 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**

The economy has displayed a remarkable degree of resilience in recent years. During the rapid growth "boom times" of the late 1990s, the expansion was bolstered by substantial advances in both equity values and investment that in hindsight proved unsustainable. During these "boom times," expectations of continued growth dominated market psychology. Based on these expectations, debt and other commitments were taken on, increasing the economy's vulnerability to financial problems should asset prices fall and balance sheets deteriorate. Thus, the seeds for the subsequent slowdown were sown during this boom period.

The equity price bubble burst in early 2000, and stock prices fell sharply. As a consequence, an investment-led economic slowdown followed, which was evident in most economic data by mid 2000, well before the change in Administrations (in January 2001). Notably, most of the payroll employment weakness was concentrated in manufacturing. Revised data show that real GDP actually declined in the third quarter of 2000. [2]These declines evolved into a mild and short (8-month) recession in early 2001. Beset by the disruptions of 9/11, oil price increases, stock price declines, accounting scandals, and war preparations, the economy's resilience was evident as it emerged from this mild recession and advanced (on average) at more than a 2.6 percent annual rate for seven quarters. During this initial period of recovery, several sectors (e.g., consumption and housing) consistently contributed to the economy's forward momentum, while others (e.g., investment, manufacturing, and especially employment) remained sluggish. Faster growth, however, was registered for the second half of 2003: the third quarter of 2003 shot upward at a torrid 8.2 percent pace and was followed by a healthy 4.1 percent gain in the fourth quarter.

The current expansion has been importantly fueled by the Federal Reserve's maintaining low interest rates, timely tax relief, and a continued lack of new inflationary pressures.

- **The Historical Record: The Slowdown began in mid 2000**

The pattern of events surrounding the slowdown of mid 2000 and NBER-designated recession of 2001 serve as background for discussions of the current economy. In particular, Federal Reserve interest rate increases (from June 1999 to May 2000) and substantial energy price advances (from early 1999 through autumn 2000) impacted corporate profits, earnings, and an overvalued equity market and served as the catalyst to set in motion a substantial sharp stock price decline in early 2000. This, in turn, contributed to the economic slowdown beginning in mid-2000. Evidence that the economic slowdown began in mid-2000 is clearly evident in a host of economic data: i.e., in the data covering this period for GDP, consumption, investment, industrial production, the Institute for Supply Management (ISM) index, manufacturing employment, as well as in many other data series.

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

[2] Several economists contend that revised data indicate that the recession actually began well before March 2001. Press reports also suggest that the NBER dating committee may adjust the official dates of the beginning of the recession to late 2000. See for example, Nell Henderson, "Recession Could Have Begun Early: Research Group Ponders Setting Start Date in Late 2000," Washington Post, January 23, 2004.

- **The Current Economic Outlook**

Recent information suggests that the economy initially advanced during this expansion at better than 2.6 percent on average for seven quarters and economic growth continued at a better than 6.0 percent pace during the second half of 2003. The latest consensus forecasts indicate the economy will expand at better than 4.0 percent for the next several quarters. Currently, consumption continues to hold up, investment has began to recover, housing sales remain near record levels, real incomes continue to advance, the service sector continues to improve, inflation and interest rates remain low, and for the most part productivity gains remain robust. Further, the stock market has regained some lost ground. Overall, then, there are a number of reasons to be optimistic.

- **Causal Factors**

Several factors are contributing to the current economic expansion. The rebound is significantly related to the sharp interest rate reduction undertaken by the Federal Reserve. Current low interest rates are expected to remain in place for the near-term. This substantial rate reduction clearly was a most important factor in supporting interest-rate sensitive sectors (such as housing and autos). Well-timed tax relief also played an important role in bolstering the stock market and the economy as well as sustaining their forward momentum. The continued maintenance of price stability bolstered the expansion as well. In the near-term, these key policy pieces appear to be in place and are expected to contribute to further expansion.

- **Risks to the Outlook:** There remain downside risks to the economy that should not be ignored. Household debt burdens are sizeable, the threat of terrorism still weighs on the economy, State and local governments are in a fiscal crisis that may lead to tax increases, and questions remain about the sustainability of the current expansion should some of this stimulus be removed.

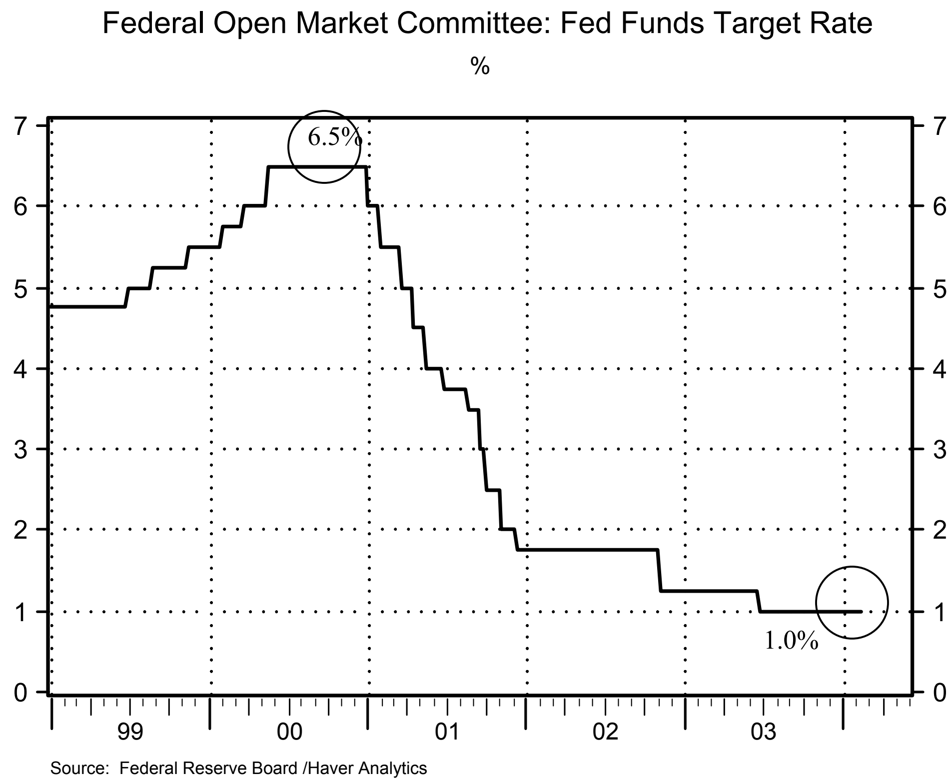
- **Prices and Inflation**

Broad measures of core inflation continue to indicate that inflation or expectations of inflation are not important problems at this time. Most forecasters are projecting a continuation of low rates of inflation. For the most part, forward-looking market price indicators are consistent with this view. Long-term interest rates continue to fluctuate not far from 40-year lows. Commodity prices are well off their lows and have regained most of the price decline which occurred during the 1997-2001 period. In short, commodity prices have experienced reflation in recent years. Further increases, should they occur, however, merit the close attention of policymakers. The dollar has depreciated, especially against major currencies. In short, when assessed over time and in conjunction with one another, forward-looking market price indicators continue to suggest that while some reflation is apparent, an imminent and important resurgence of rapid inflation is not likely in the near-term, but that deflationary pressures no longer pose a risk.

- **Policy Implications**

In sum, while risks face the economy, most analysts believe that monetary and fiscal stimulus is accommodative and employment gains will inevitably occur in the near-term as this stimulus continues to impact the economy. According to this view, no major new policy initiatives appear necessary at this time. However, 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 may be appropriate.

I. Federal Reserve Monetary Policy

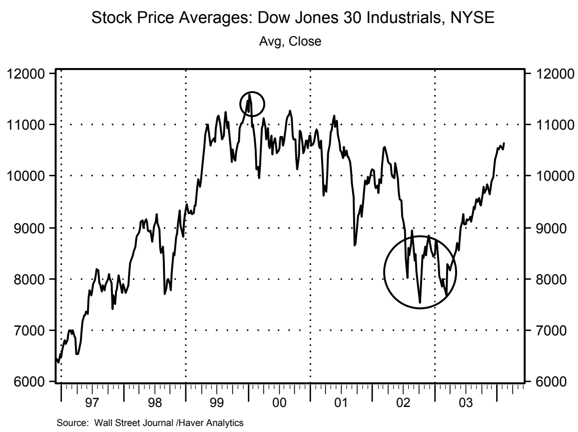


- Monetary policy has played a significant role in affecting the performance of the economy in recent years. The Federal Reserve **lowered** short-term interest rates 550 basis points beginning in January 2001, putting the Fed funds rate at 1.00 percent and a 40-year low by June 2003. **<u>This easing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

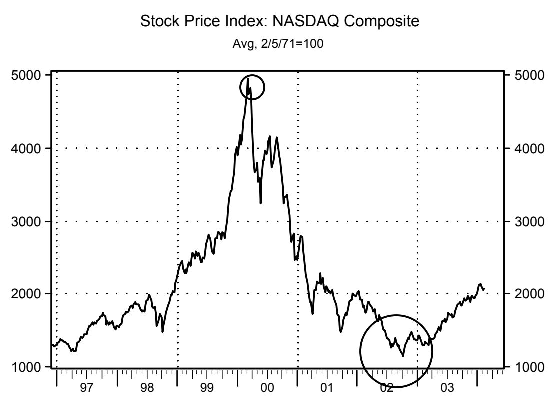
- Contrary to some popular opinion, the Fed still has the ability to pursue an easier monetary policy stance despite low levels of interest rates.

- Recently, the Fed has attempted to manage expectations of future Fed monetary policy. Markets and most analysts currently expect <u>no</u> Fed interest rate moves until late summer at the earliest.

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. It has gained ground since then. In fact, the Dow has recouped a good deal of what it lost.



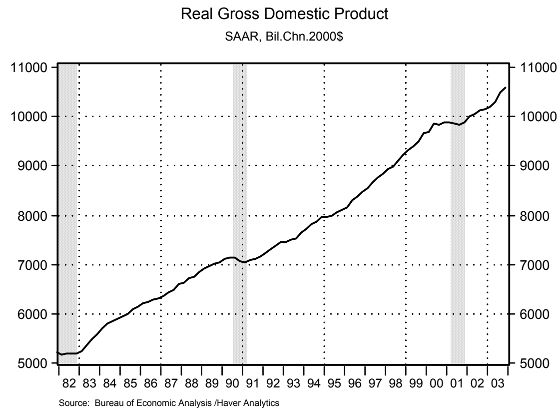
- The NASDAQ peaked in March 2000 and lost a great deal of value (and market capitalization) until October 2002. Notably, most of the NASDAQ's large decline took place prior to January 2001, and consequently, had nothing to do with Bush economic policy. The NASDAQ has gained ground in recent months, 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.

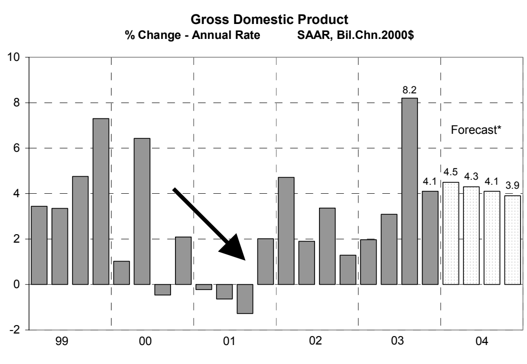
- Some of the recent stock market gains can be attributed to various forms of tax cuts made in recent years. These tax cuts helped the stock market, which in turn helped the economy.

III. Output Measures
Gross Domestic Product

Long-Term GDP



Recent Quarterly GDP Change



- 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. Regardless, events of late should be considered against a backdrop of the lengthy economic growth of the last two decades during which recessions were relatively infrequent (see chart.)

- Recently, revised data, however, suggest that the 2001 recession may have started earlier than previously believed.

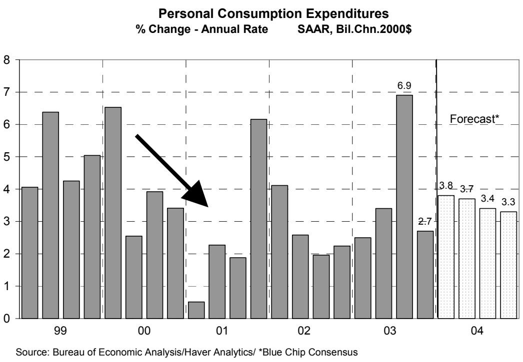
- Beginning in mid-2000, quarterly real GDP growth began to slow significantly from growth rates previously recorded.

- 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 torrid 8.2 percent growth rate registered in the third quarter of 2003 was followed by a healthy 4.1 percent growth in the fourth quarter. **Consensus forecasts are for 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.

Consumption

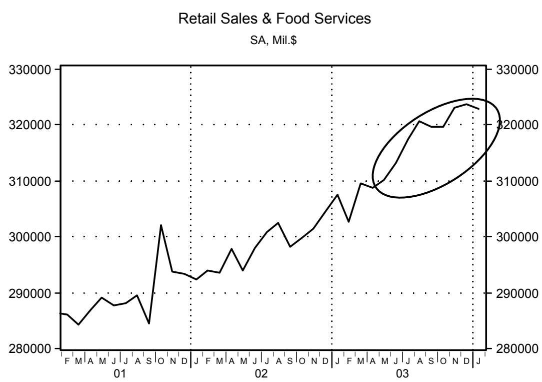
Consumption Growth



- 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.

- About mid-2000, real consumption growth slowed along with, but not as much as, GDP. Consumption growth never became negative as the slowdown continued. Despite this slowdown, consumption growth held up better than some had expected.

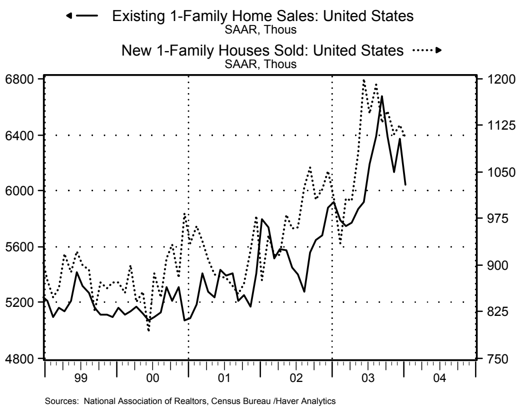
- Consumption growth increased sharply in the fourth quarter of 2001 and was a major factor boosting real GDP for that and subsequent quarters. According to consensus forecasts, <u>**consumption is expected to continue to contribute to GDP growth in the near-term**</u> (see chart.)



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

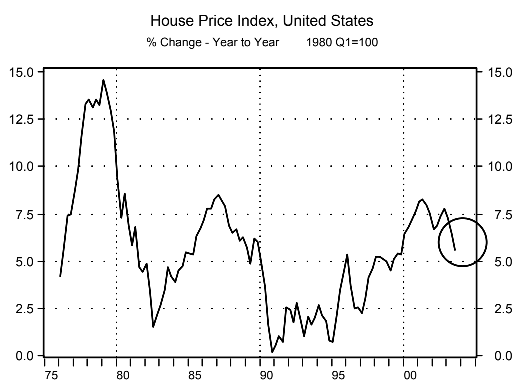
Housing Activity

Housing Sales



- Housing is another sector consistently supporting the economy in recent years. Low interest rates are a factor contributing to housings' persistent strength.
- **Housing sales – both new home sales and existing home sales – have held up in recent years (including during the recession.) Despite some recent cooling, both of these categories of sales are not far from record levels** (see chart.)

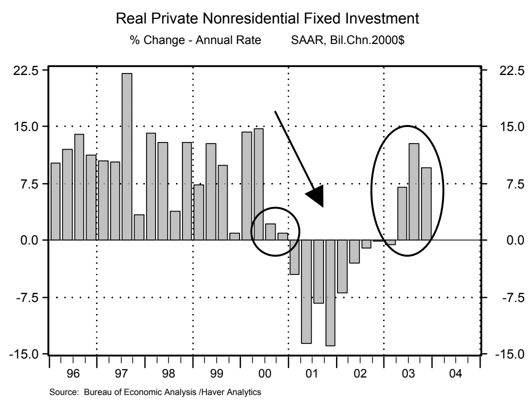
House Prices



- House prices have increased in recent years, but such price advances have cooled of late. Currently, the home price index is up at about a 6 percent rate (year over year.)
- There is little evidence of a housing asset price "bubble" behaving like stock prices in recent years.

Investment

Fixed Private Non–Residential
Investment Growth

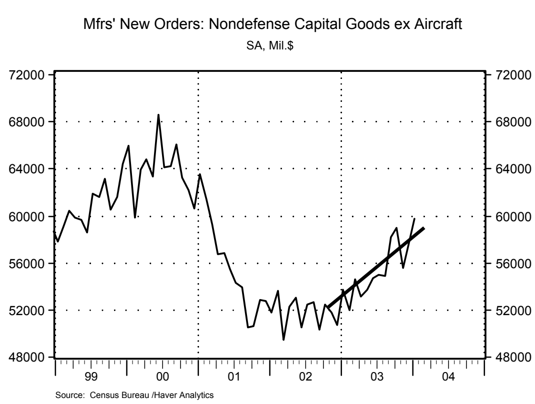


- The business investment component of real GDP was both a leading sector in the earlier extended expansion and a leading sector in the more recent contraction: it has grown at rates exceeding GDP both on the upside and the downside.

- Investment growth slowed dramatically in mid-2000. And it subsequently declined for nine consecutive quarters. Currently, however, investment has turned around. **Investment** has **expanded for three quarters in a row.**

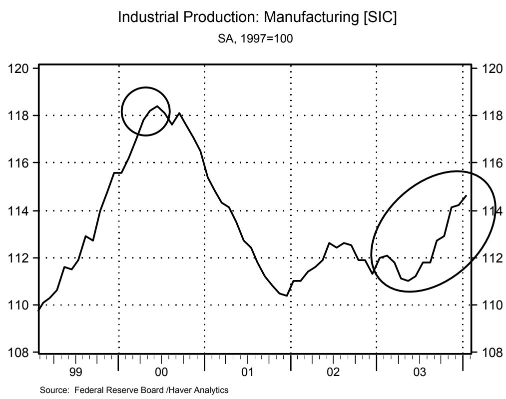
- **Some components of investment have shown more positive growth (e.g. equipment and software)** whereas others have remained relatively sluggish (e.g. structures). These components are not displayed.

New Orders for Capital Goods

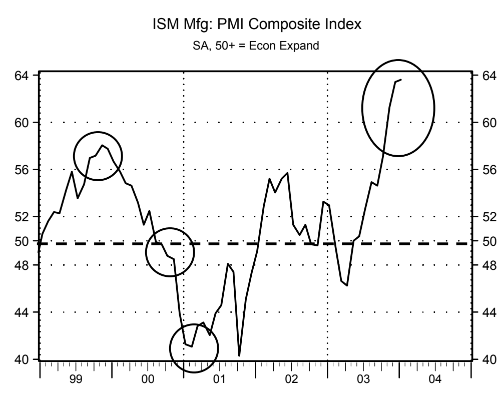


- More timely information from monthly indicators that correlate with investment also provide useful insights. Manufacturers' **new orders for non-defense capital goods** (ex-aircraft), for example, **have stabilized and trended up** after falling sharply in 2000 and 2001. This is believed to be a leading indicator for investment spending.

The Manufacturing Sector



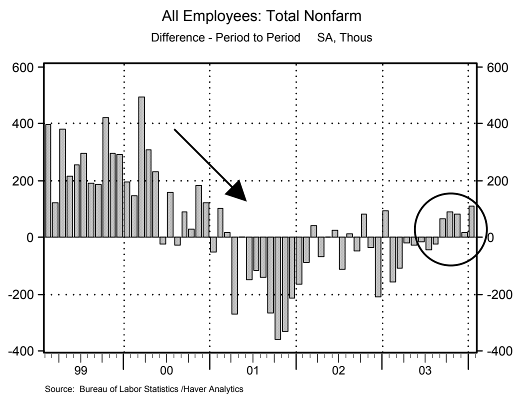
- Although the manufacturing sector was weak after mid-2000, it has advanced in recent months. The industrial production manufacturing index, for example, peaked in June 2000 but has trended up since the spring of 2003.



- **The Institute for Supply Management's manufacturing diffusion index shows dramatic improvement in manufacturing activity. According to this index, manufacturing activity has been improving for several months** (figures above 50 denote expansion.)

- Note that this index began falling in late 1999 and fell especially sharply in the last several months of 2000. The index shows that manufacturing activity actually began contracting in August 2000 (when the index fell below 50) and this contraction became especially widespread well before the Bush Administration or its policies were in place.

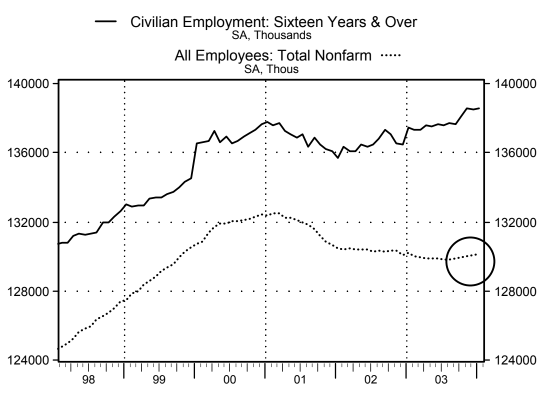
IV. The Labor Market



- This chart shows the monthly gains in total employment on nonfarm payrolls in recent years.

- Employment gains were relatively strong in the period <u>before</u> mid-year 2000. After mid-2000, however, employment gains on average slowed dramatically to a fraction of those reported earlier. In fact, most monthly changes in 2001 were declines.

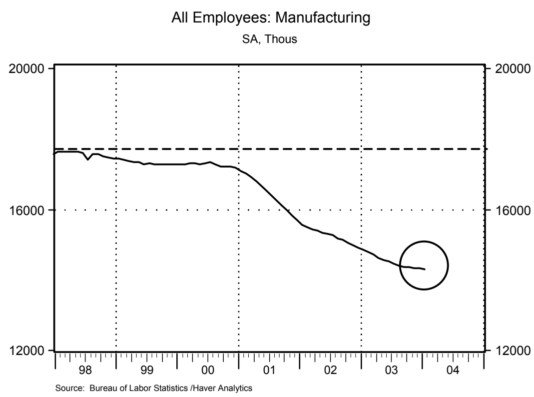
- From early 2002 to mid 2003, employment fluctuated in a "sawtooth" pattern. **For the past five months however, payroll employment has registered continuous gains.**



- 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.

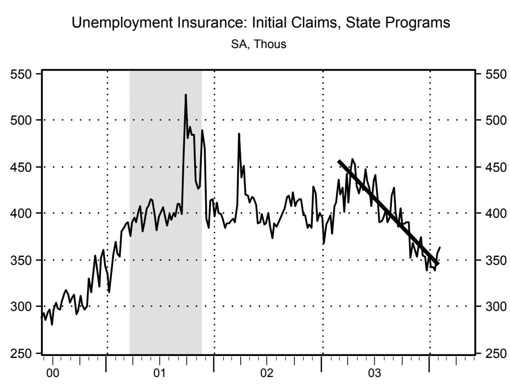
- In recent months, however, the two surveys have diverged from one another. The household survey has shown persistent gains in total employment while the payroll survey has shown losses until recently.

Manufacturing Employment



- The chart to the left shows manufacturing payroll employment in recent years. Manufacturing employment has been weak for an extended period, but this weakness became more pronounced after mid-year 2000. **Most of the recent employment weakness is concentrated in manufacturing.** In fact, more than 3 million manufacturing jobs have been lost since March 1998.

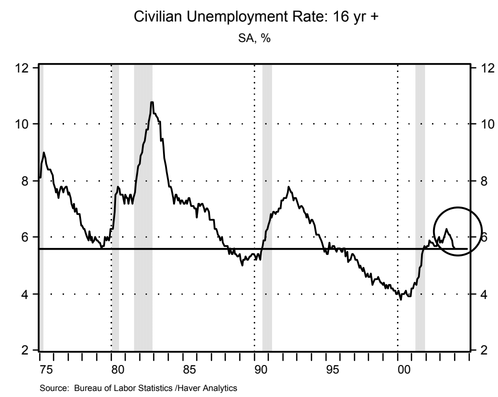
- As of January, manufacturing employment has declined for 42 months in a row, starting in August 2000. The most recent losses, however, have moderated; they are less than earlier losses.



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

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

Unemployment

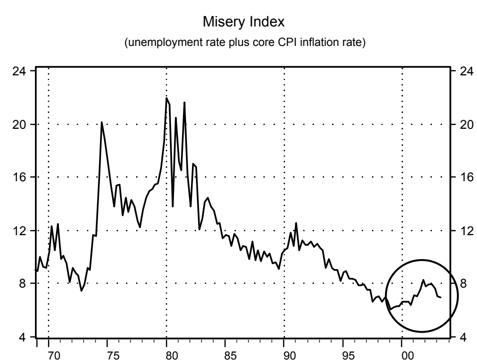


- The top chart shows the unemployment rate over a long period of time. The chart suggests that the current unemployment rate is relatively low when compared to rates at equivalent stages of earlier business cycles.

- After falling during the 1990s expansion, the unemployment rate trended up after late 2000.

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

- **Consensus forecasts predict that the unemployment rate will gradually drift down from current levels.** 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." The misery index 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.

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

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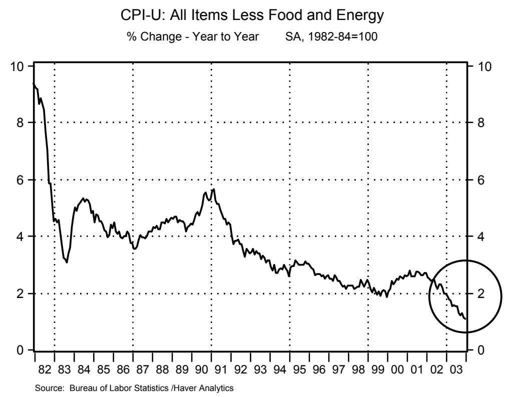
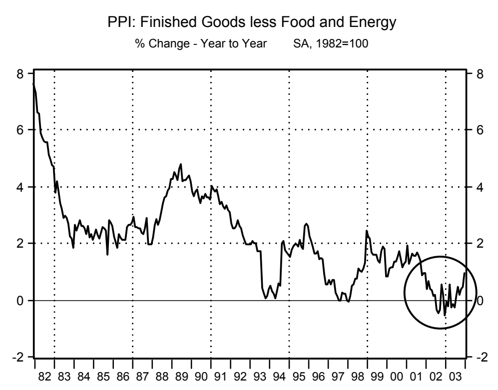
V. Inflation Measures



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

- This measure shows inflation trending down over the past two decades. In fact, **the most recent economic data shows inflation is well below two percent, the lowest rate since the mid-1960s.**

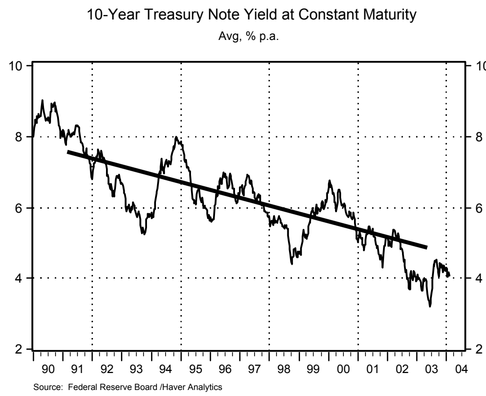


- The chart on the left shows core (ex food and energy) finished good producer price inflation over the last 20 years (on a year-to-year basis).

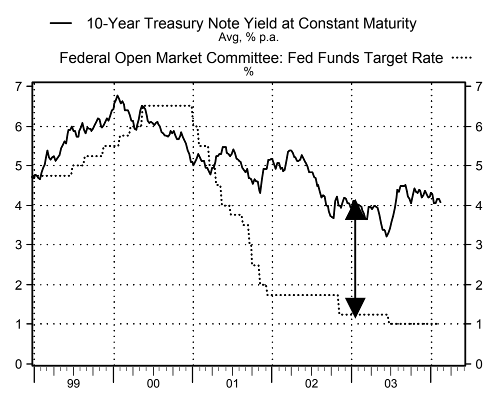
- This measure shows inflation trending down over most of this period. In fact, **the latest data suggest that PPI inflation is also well below 2.0 percent and among the lowest readings during this entire period.**

- **According to these data, inflation is not a serious problem at this time.**

VI. Forward-Looking Market Price Indicators

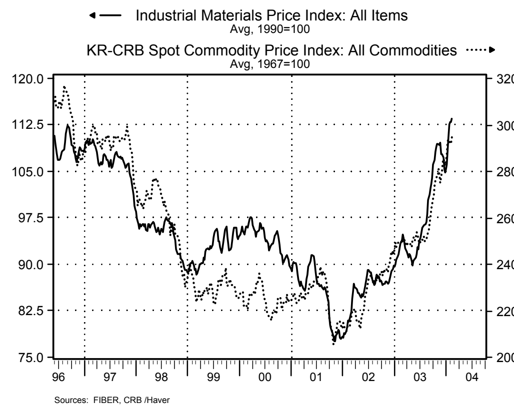


- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.
- Long-term interest rates generally have trended down for most of the past decade as inflation has diminished, and remain near 40-year lows.
- **Recently, long-term rates have actually declined 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.**



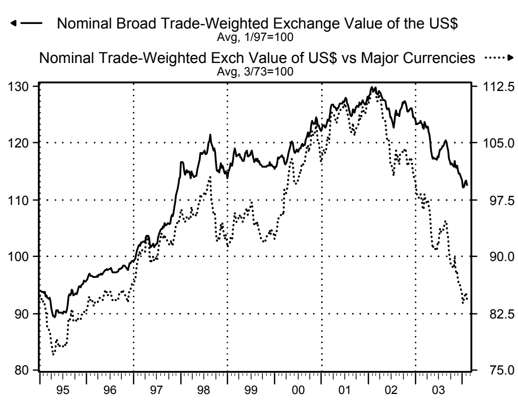
- The lower chart shows both the short-term federal funds rate and the long-term treasury rate in recent years. The difference between these rates is referred to as the "yield spread."
- During 1999-2000, the Federal Reserve increased the Federal funds rate until it exceeded the long-bond rate; the Federal Reserve inverted the yield spread (or produced a negative yield spread). An inverted yield spread is associated with restrictive (or "tight") monetary policy.
- During 2001-2003, **the Federal Reserve lowered the fed funds rate 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 is 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. These price indices, however, should be closely monitored since further significant increases could signal 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, however, the dollar has depreciated.
- This recent dollar depreciation has occurred largely against major currencies such as the euro and yen. To date, this depreciation has been relatively measured.
- Such 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.