CURRENT ECONOMIC CONDITIONS AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Vice Chairman Jim Saxton

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CONTENTS

Economic Performance and Outlook[1]

- **Summary and Overview**

In recent years, the economy has displayed a remarkable degree of resilience. 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 may have been excessive. During these "boom times," significant debt commitments were undertaken, increasing the economy's vulnerability to financial problems if asset prices fell and balance sheets deteriorated. The "seeds for the slowdown were sown" during this period. The bubble burst on equity values in early 2000, and stock prices fell sharply. As a consequence, a sharp investment-led economic slowdown followed, which was evident in most economic data by mid 2000, well before the change in Administrations (in January 2001). These declines evolved into a mild and short (8-month) recession inherited by the new Administration 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 2.7 percent annual rate for seven quarters. 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.

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

While continuing to expand, however, earlier periods of the recovery were halting and sluggish. For the most part, growth persisted below both the economy's potential and average growth experienced during earlier expansions. Nonetheless, consensus forecasts predict significantly more robust economic growth in the second half of 2003 and into 2004.

- **The Historical Record: Slower growth began in mid 2000**

The pattern of events surrounding the slowdown of mid 2000 and 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 helped set in motion a substantial sharp stock price decline in early 2000, which 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, payroll and manufacturing employment, as well as in many other data series.

- **The Current Economic Outlook**

Recent information suggests that while the economy expanded at better than 2.7 percent on average for seven quarters, economic growth is expected to increase at better than 3.5 percent during the second half of 2003 and into 2004. Consumption, for example, continues to hold up, housing sales remain at or 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. Overall, then, there are a number of reasons to be optimistic.

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

- **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 a considerable period of time. 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 economy and sustaining its expansion. An earlier energy price moderation also contributed to this outcome. The continued maintenance of price stability bolstered the expansion as well. In the near-term, therefore, key policy pieces appear to be in place and contributing to the robust outlook.

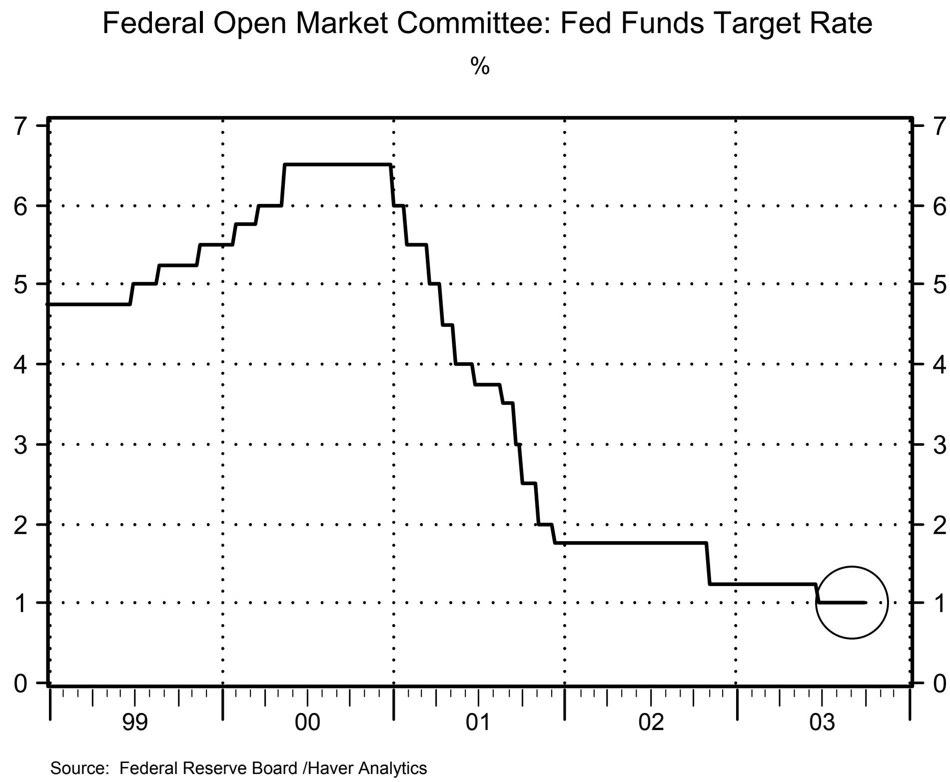
- **Prices and Inflation**

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 off their lows and reflating, but their levels are still below levels of several years ago. The dollar, however, 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, many analysts believe that sufficient monetary and fiscal stimulus is "in the pipeline" and employment gains will inevitably occur in the near-term as this stimulus impacts the economy with a lag. According to this view, no major policy action appears necessary at this time. However, given the desirability of healthy and sustained economic and employment growth, further measures to reduce the burden of taxes and government regulation on the economy may be appropriate.

I. Federal Reserve Monetary Policy

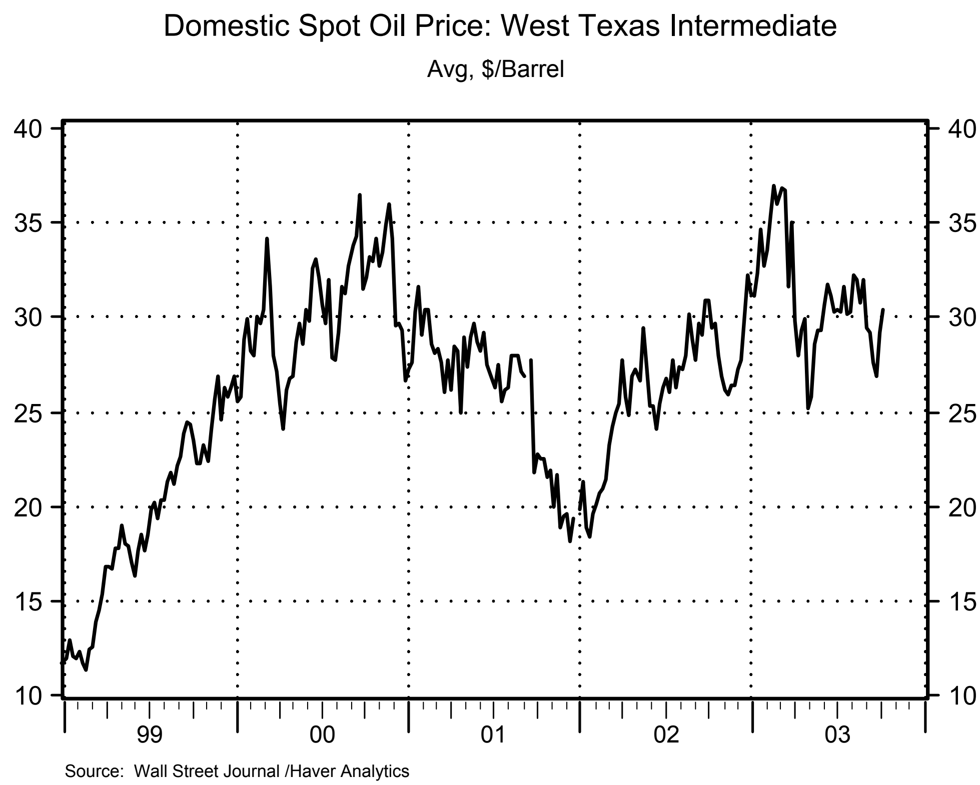


- Monetary policy has played a significant role in affecting the performance of the economy in recent years. This period has witnessed a notable reversal in the movements of short-term interest rates.

- The Federal Reserve raised interest rates 175 basis points from June 1999 to May 2000, putting the Fed funds rate at 6.5 percent. With a lag, this monetary policy affected financial markets and some interest-sensitive sectors of the economy such as certain categories of durable consumption and investment.

- The Federal Reserve subsequently 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 of monetary policy is a key reason for the economic turnaround and expansion we are currently witnessing**. Contrary to some popular opinion, the Fed still has the ability to pursue an easier monetary policy stance despite low levels of interest rates.

II. Energy Prices

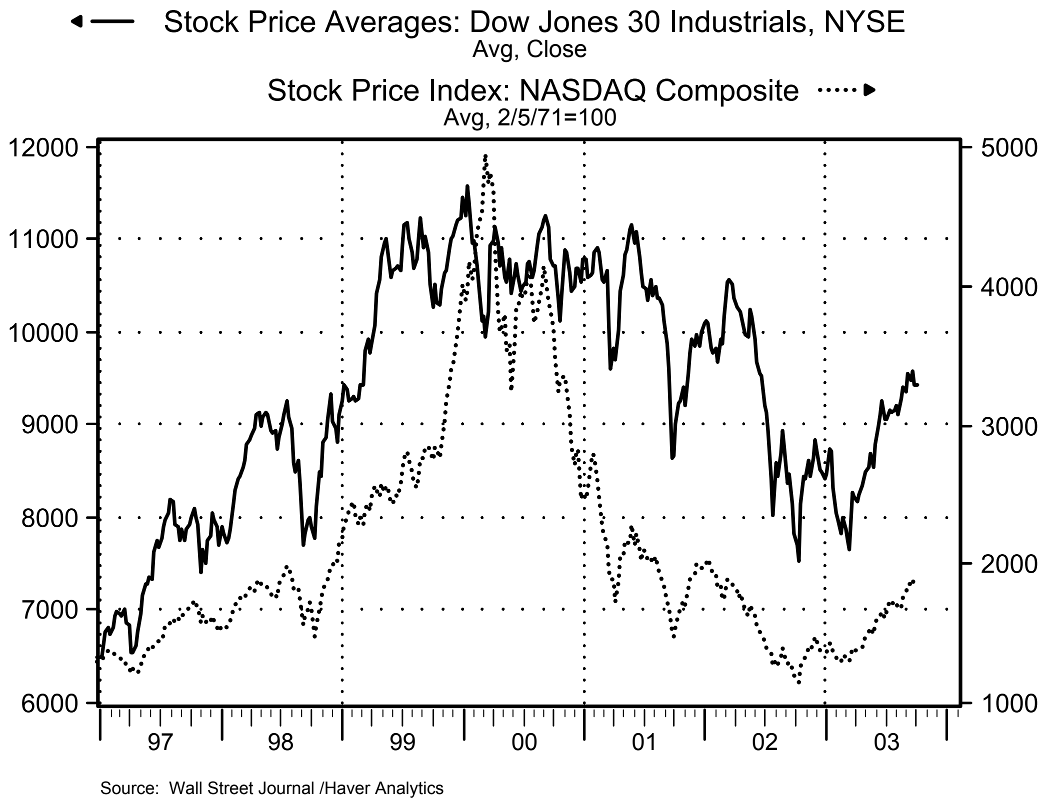


- Recent years have also witnessed significant movements in energy prices. Energy prices, for example, sharply increased in 1999 and through most of 2000. This sharp increase contributed to the economic slowdown, which began in mid-2000.

- Energy price increases, after all, raise costs, reduce aggregate supply, and lead to output reduction. Higher costs of energy inputs squeeze businesses' earnings and profits, thereby adversely impacting the stock market. Consumers, spending more on higher-priced energy products, have less to spend on other consumer products of a discretionary nature.

- Energy prices, however, retreated through 2001. This moderation of energy prices is another reason for the subsequent economic recovery. This moderation of energy prices worked to reverse the adverse effects mentioned above and thus to support economic growth, all other things equal. In 2002, however, energy prices increased again, before stabilizing at a range from $28/b to $32/b. The volatility partly reflects events in the Middle East. Higher oil prices continue to pose a serious risk to the near-term economic outlook.

III. Stock Prices



- This chart shows two well-known stock indices: the Dow Jones Industrial and the NASDAQ composite. The Dow Jones peaked in January 2000 and trended down until spring of this year. It has gained ground since then. 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. Both of these indices have increased in recent months.

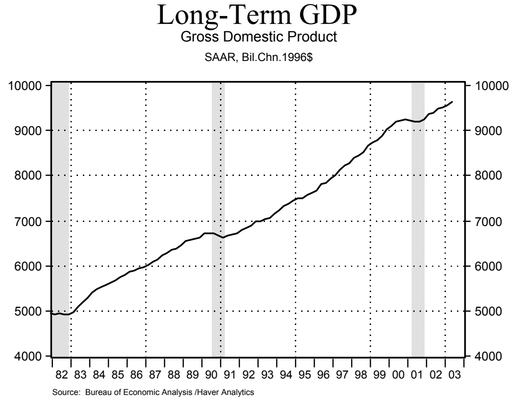
- Many analysts argue that stock market movements have important economic repercussions associated with asset price deflation or inflation. Stock market moves alter the cost of capital and thereby impact future investment. And the equity market's "wealth effect" can have impacts on consumption.

- Many consumers took on debt when equity values were high and now, with equity values diminished, face significant debt burdens and weakened balance sheets. All other things equal, these burdens could dampen consumption for a period of time.

IV. Output Measures

Gross Domestic Product

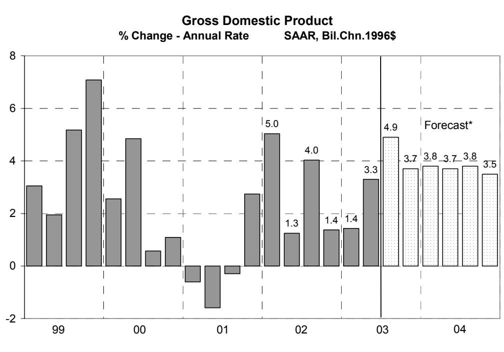
Long-Term GDP



- Using monthly indicators and data, the National Bureau of Economic Research (NBER) determined that the economic expansion of the past decade 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. Nevertheless, recent events of late should be considered against a backdrop of the lengthy economic growth of the last two decades.

- In particular, the economic expansion of the 1990s is the longest expansion on record. It followed the 1980s' expansion, the second longest peacetime expansion on record. In short, in the last two decades we have experienced back-to-back, two of the longest economic expansions in American history.

Recent Quarterly GDP Change



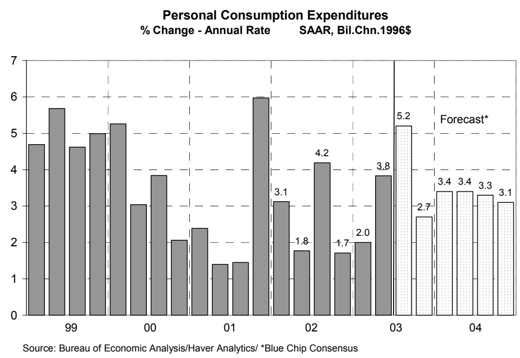
- Beginning in mid-2000, quarterly real GDP growth began to slow significantly from growth rates previously recorded.

- GDP growth turned negative in the first quarter of 2001. Second and third quarter growth were also negative. 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 2.7 percent for seven quarters. **<u>Consensus forecasts are for significant improvement over the next several quarters, with growth averaging higher than 3.5 percent</u>.** Many analysts attribute at least part of this improvement to tax relief.

Consumption

Consumption Growth

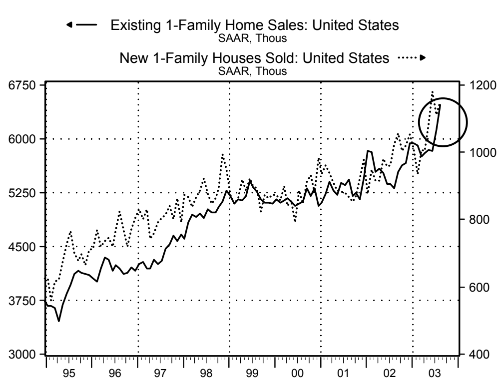


- Consumption has been a sector consistently supporting the economy in recent years. This is depicted in the accompanying quarterly real consumption growth chart.

- 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. **<u>Consumption is expected to continue to improve in the near-term</u>.**

Housing Activity

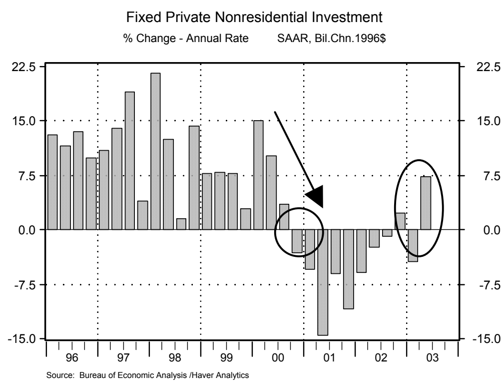


- Housing is another sector consistenly supporting the economy in recent years. Low interest rates are a factor contributing to housings' persistent strength.

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

Investment

Fixed Private Non–Residential Investment Growth

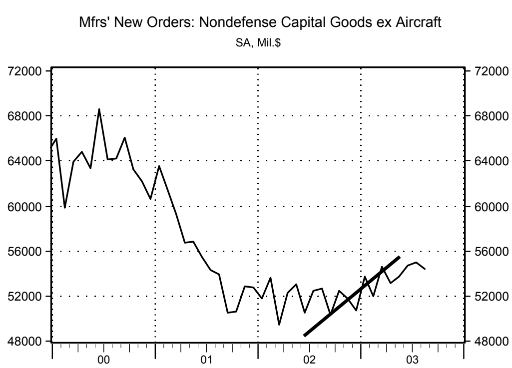


- The business investment component of real GDP was both a leading sector in the earlier extended expansion and a leading sector in the more recent contraction: it has grown at rates exceeding GDP both on the upside and the downside.

- Investment growth has slowed dramatically since mid-2000. Note that investment actually fell in the fourth quarter of 2000, before the new administration took office. **Investment** remains sluggish but has become less negative in recent periods and **actually expanded in two of the last three quarters.**

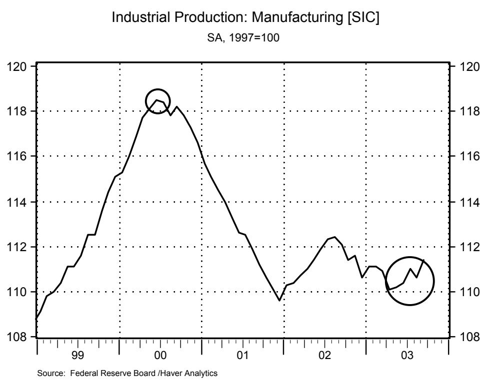
- **Some components of investment have expanded for several quarters (e.g. equipment and software)** whereas others have remained relatively sluggish (e.g. structures).

New Orders for Capital Goods



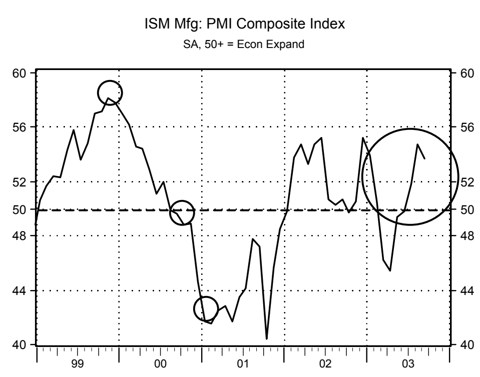
- More timely information from monthly indicators that correlate with investment also provide useful insights. Manufacturers' **new orders for non-defense capital goods** (ex-aircraft), for example, **have stabilized and begun to trend up in 2003** after falling sharply in 2000 and 2001.

The Manufacturing Sector



- The manufacturing sector has been weak in recent years. The industrial production manufacturing index, for example, peaked in June 2000 and has not regained that peak.

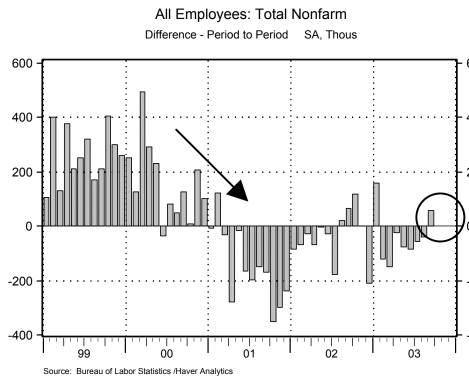
- Industrial production manufacturing generally fell from mid-2000 until late 2001 before increasing in the first half of 2002. After that, however, manufacturing production has generally been sluggish. Some improvement, however, is evident in very recent months.



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

- Note that this index began falling in late 1999 and fell especially sharply in the last months of the Clinton Administration. The index shows that manufacturing activity actually began contracting in August 2000 (when the index fell below 50) and this contraction became especially widespread in the last months of the Clinton Administration

V. The Labor Market



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

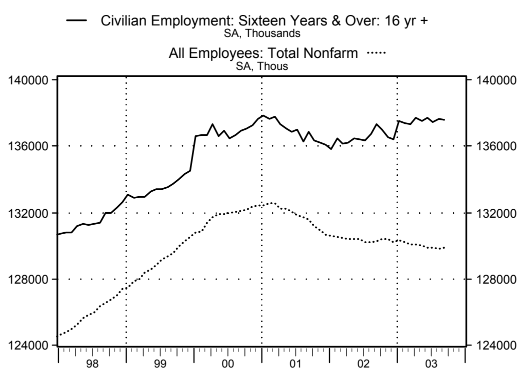
- Employment gains were relatively strong in the period before mid-year 2000. After mid-2000, however, employment gains on average slowed dramatically to a fraction of those reported earlier. In fact, most monthly changes in 2001 were declines.

- After advancing for most of the earlier months in 2002, recently employment has fluctuated in a "saw tooth" pattern. **The September figure, however, was up 57,000.**

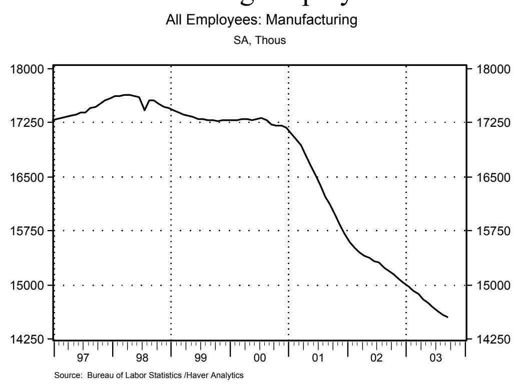
- The lower chart shows the levels of household employment (from the household survey) and payroll employment (from the payroll survey). While there are many differences between the two employment surveys, normally over time the two surveys track one another.

- 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 persistent losses.

- The BLS and many business economists believe the payroll survey is the more reliable survey partly because it is drawn from a much larger sample. Some economists, however, believe the household survey is superior at economic turning points

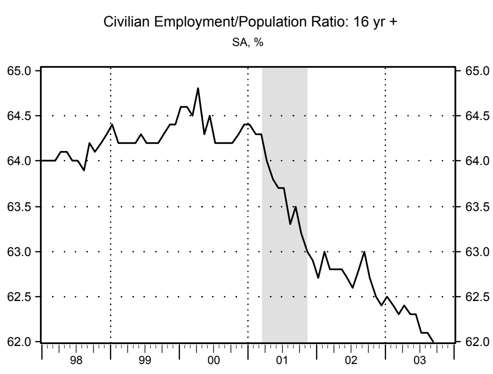


Manufacturing Employment



- 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 employment weakness is concentrated in manufacturing. In fact, more than 2.7 million manufacturing jobs have been lost since July 2000.

- As of September, manufacturing employment has declined for 38 months in a row.



- Another important indicator of the state of the labor market is the employment–to–population ratio from the household survey. This ratio indicates the percentage of the population with jobs. The ratio increased for much of the previous expansion.

- In April of 2000, the ratio peaked and thereafter began to trend downward.

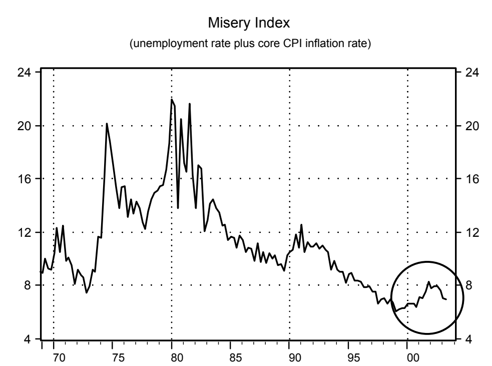
- This ratio is often inversely related to the unemployment rate.

Unemployment

- After falling during the previous expansion, the unemployment rate trended up after late 2002.

- Recently, the unemployment rate has stabilized in the neighborhood of 6.0 percent. The September 2003 unemployment rate was 6.1 percent.

- **<u>Consensus forecasts predict that the unemployment rate will gradually drift down below 6 percent.</u>** Even at around 6 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.

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

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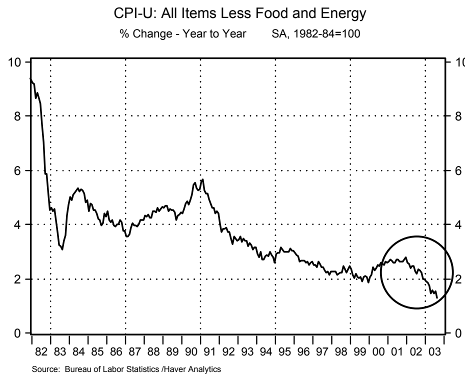
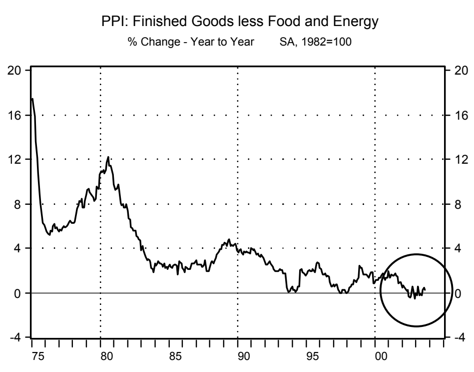
VI. <u>Inflation Measures</u>



- 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, **<u>the most recent economic data shows inflation is well below two percent, the lowest rate since the mid-1960s.</u>**

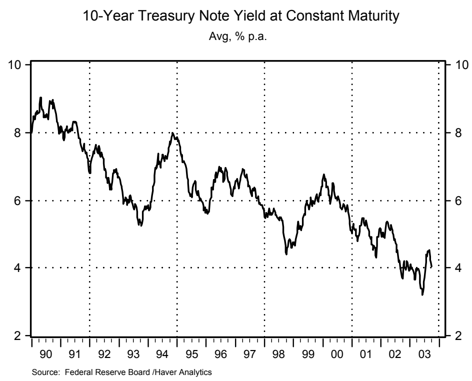


- This chart shows core (ex food and energy) finished good producer price inflation over the last 25 years (on a year-to-year basis).

- This measure shows inflation trending down over most of this period. In fact, **<u>the latest data suggests that PPI inflation has stabilized near zero percent, among the lowest readings during this entire period.</u>**

- **<u>According to this data, inflation is not a serious problem at this time.</u>**

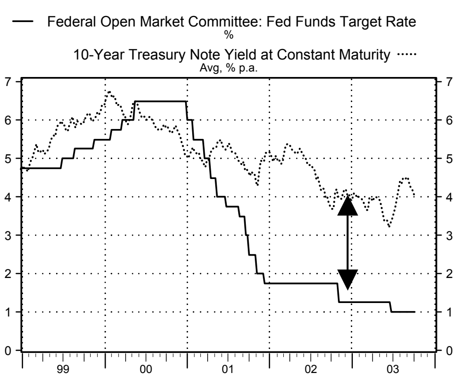
VII. Forward-Looking Market Price Indicators



- 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 influencing long-term interest rates.**

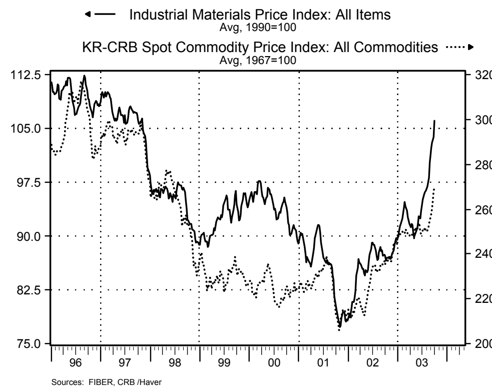


- The lower chart shows the short-term federal funds rate and the long-term treasury rate in recent years. The difference between these rates is referred to as the "yield spread."

- 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.

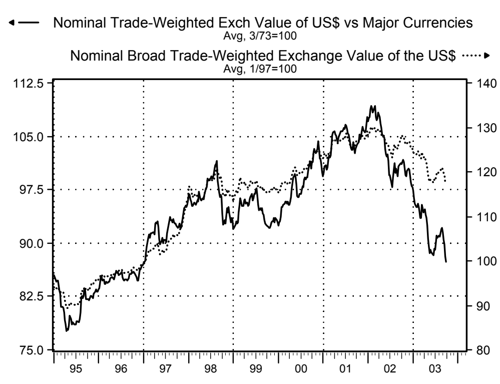
- During 2001-2003, **the Federal Reserve lowered the fed funds rate until it was significantly below the long-bond yield; it brought about a wide and positive yield spread. Such a spread is normally associated with "easy" or accommodative monetary policy. Currently, the yield spread is wide and positive.**

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 <u>including energy prices</u>.
- The CRB spot index <u>does not include energy prices</u>
- Recent increases in commodity prices are movements off their lows. They remain below levels of several years ago. The recent increases suggest the threat of deflation has dissipated and given way to some reflation. These indices, however, should be closely monitored. These price indices continue to suggest that while reflation is evident, rapid inflation is not an important problem at this time.

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 depreciated.
- This recent dollar depreciation has occurred largely against major currencies such as the euro and yen. To date, this depreciation has been gradual.
- Such gradual depreciation is not as worrisome as a sharp depreciation would be since does not involve sharp financial capital flows associated with a movement out of the dollar.