# CURRENT ECONOMIC CONDITIONS AND OUTLOOK

## JOINT ECONOMIC COMMITTEE

**Prepared for Chairman Jim Saxton**

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# CONTENTS

**Introduction -- Economic Performance and Outlook**
Summary and Overview

**I. Federal Reserve Monetary Policy**
Federal Funds Rate

**II. Energy Prices**

**III. Stock Prices**

**IV. Output Measures**
GDP
Consumption
Investment
The Manufacturing Sector

**V. The Labor Market**
Payroll Employment
Unemployment Rate

**VI. Inflation Measures**
GDP Implicit Price Deflator
CPI-U
PPI

**VII. Forward-Looking Market Price Indicators**
Bond Yields
Commodity Prices
Foreign Exchange Rate

**VIII. Factors Promoting Economic Growth without Inflation**

# ***Economic Performance and Outlook***[1]

- **Summary and Overview**

According to the National Bureau of Economic Research (NBER), the recent economic expansion officially peaked in March 2001. Economic performance, however, began deteriorating earlier than March; most broad measures of economic activity were slowing significantly by mid-year 2000. Investment and manufacturing were particularly weak. There were several key explanations for this earlier slowdown including a (June 1999 – May 2000) tightening of monetary policy, substantial energy price increases (during 1999 – 2000), a related weakening of equity prices, and an increasing tax burden. Many of these factors, however, moderated, stabilized, or unwound and reversed themselves during much of 2001. Nevertheless, the effects of the terrorist attacks of September 11, 2001 pushed the economy into recession.

Prospects for economic recovery appear promising because of substantially lower interest rates, lower energy prices, stock market stability, and the implementation of tax cuts last spring. Recent, albeit preliminary, signs of an economic bottoming have emerged. Nonetheless, the persistence of several key downside risks suggests that an additional economic insurance stimulus package would be appropriate.

- **The mid-2000 Slowdown**

While the expansion officially peaked in March 2001, economic growth slowed much earlier from the robust growth rates experienced in the mid-to-late 1990s. Real GDP growth, for example, slowed dramatically beginning mid-year 2000 from the rapid growth rates registered in the late 1990s. The growth of key GDP components also fell significantly with investment growth slowing especially sharply. Growth in fixed nonresidential business investment slowed in mid-2000 and has fallen significantly in recent quarters. The growth of consumption has registered more modest declines. These declines were reinforced by a weakening manufacturing sector; industrial production and capacity utilization of industry fell sharply.

The labor market was not immune to this mid-2000 slowdown. Employment gains slowed significantly with average monthly payroll advances registering significantly lower gains after mid-year 2000 than before that time. Manufacturing employment fell sharply after July 2000 and the unemployment rate began to increase in the fall of that year.

- **Causal Factors**

There are several obvious explanations for the rapid slowdown that most economists would identify as contributing to the slowdown: (1) an earlier tightening of monetary policy, (2) a sharp increase in energy prices in 1999-2000, and (3) a concomitant sharp decline in (somewhat overvalued) equity prices.

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

First, the Federal Reserve raised interest rates six times and 175 basis points from June 1999 to May 2000 putting the Federal funds rate at 6.5 percent, the highest level since 1991. For the most part, these moves were taken without convincing evidence that a resurgence of core inflation was imminent. This restrictive monetary policy affected financial (including equity) markets, and some, though not all, interest sensitive sectors of the economy, as well as several categories of investment.

Second, substantial energy price increases in 1999-2000 also adversely impacted the economy. Consumers, spending more on higher-priced energy products, had less to spend on discretionary items. Analogously, such energy price increases had a negative impact on economic activity since purchasing power was transferred to oil-producing countries from oil-consuming countries. Such energy price increases also impacted the supply-side of the economy; they raised costs, reduced aggregate supply, and led to output reductions. As part of the process, higher costs of energy inputs squeezed businesses' earnings and profits, thereby adversely impacting the non-energy sectors of the stock market.

Third, these factors taken together worked in concert with other forces to weaken a somewhat overvalued stock market, which, in turn, operated to reverse that market's "wealth effect" boost to consumption. The associated higher cost of capital also contributed to a slowdown in investment activity. Thus, stock market weakness in and of itself (and the decline in net worth that such weakness sometimes entails) also adversely impacted the economy.

For the most part, these factors were influencing the economy by mid-2000; thus, the seeds of the slowdown were sown prior to mid-2000. But because of long and variable lags, these factors continued to influence the economy for a time. As the economy remained sluggish or continued to weaken, however, many of these causal factors moderated, stabilized, or unwound and reversed themselves during much of 2001. The Federal Reserve lowered interest rates, energy prices retreated and stabilized at prices well below their peaks, and the stock market stopped falling and began to stabilize. As a consequence, by late summer many economists were expecting a near-term economic rebound.

- **<u>The Terrorist Attacks</u>**

The economic impact of the terrorist attacks of September 11, however, changed this outlook in several important ways. In the <u>short-term</u>, the attack increased uncertainty and apprehension in financial markets and affected consumption and investment as confidence waned. The attack had a direct impact on certain industries, most notably airlines, aerospace, travel, insurance, hotels, and related areas.

There are <u>long-term</u> effects of the terrorist attacks as well. The economic costs of a permanently increased terrorist threat will likely bring major changes to our way of life. This will, for example, entail an increased cost of security. Such additional costs will take the form of travel delays, additional security checks, longer cross-border transfers, higher insurance costs, additional identification requirements, and other added inconveniences.

They will involve spending money on more security guards and buying metal detectors, which do nothing to increase the quantity or quality of goods or services provided. These factors will raise the cost of doing business, stifle gains from free exchange, add inefficiencies, and hence constitute a negative supply-side shock or added "tax" on the economy. Consequently, it will adversely impact both productivity growth and the economy's long-term potential growth rate.

Similarly, while the attacks will spawn near-term investment and defense spending to repair and replace buildings and shore-up our security, intelligence, and defenses, the total private capital stock will be less than it would otherwise have been. The so-called "peace dividend" – a dividend that freed up resources for growth – is lessened. Monies for a necessary military/security buildup to some extent crowd out private investment. Thus, the attacks will adversely affect aggregate supply and the longer-term potential growth rate of the economy.

- **Current Prospects**

As a consequence of the effects of September 11, the economy officially tilted into recession, as certified by the NBER. Despite lingering effects of the terrorist attacks, the prospects for an economic rebound this year look promising; current recessionary conditions look to be short and mild. A number of indicators, albeit preliminary in nature, suggest that the economy already may be bottoming. And there are a number of key reasons to expect the economy to rebound. In particular, with an inventory correction near completion, a retreat of energy prices, a substantial easing of monetary policy in the pipeline, tax cuts in place, a rebounding stock market, and inflation pressures largely absent, consensus projections of a rebound next year appear quite plausible.

- **Macroeconomic Policy Response**

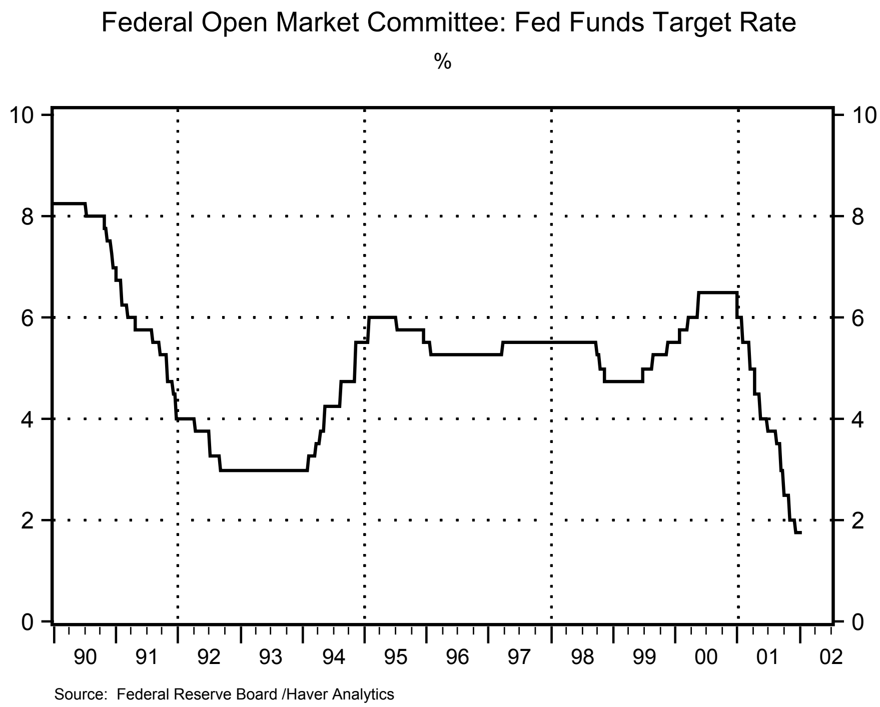
Several of these reasons to expect a rebound relate to recent macroeconomic policy action. The Federal Reserve, for example, has lowered short-term interest rates eleven times since January 2001, reducing the federal funds rate 475 basis points to 1.75 percent, a forty year low. Several of these moves came after September 11. Further, a degree of fiscal policy easing has also occurred in 2001 to support the economy. Some additional fiscal action (in the form of tax cuts and spending increases) may yet occur. Nevertheless, this policy response will foster a shorter period of economic weakness than would otherwise have been the case.

- **Uncertainties and Risks**

Despite consensus forecasts of a near-term economic rebound, and scattered, preliminary evidence of a possible bottoming of the economy, it is still premature to contend that the downturn is over. Further, a number of significant uncertainties and mostly downside risks persist, suggesting a robust rebound is by no means assured. The effects of additional security costs, for example, will weigh on the economy for some time. Debt burdens are sizeable and will take time to work off. The international economy appears quite weak and vulnerable with no obvious source of strength. The risks of further terrorist attacks remain. All of this suggests that substantial downside risks exist and pose substantial challenges to economic policymakers.

The preponderance of these downside risks suggests that a further stimulus “insurance” package would be prudent. Such a package should address the weakness in investment that has led the economic slowdown and aim to offset the adverse effects of additional security costs described above. Accordingly, accelerated depreciation allowances, liberalized expensing provisions, and front-loading scheduled tax rate cuts would be especially appropriate elements of such a package.

# I. Federal Reserve Monetary Policy



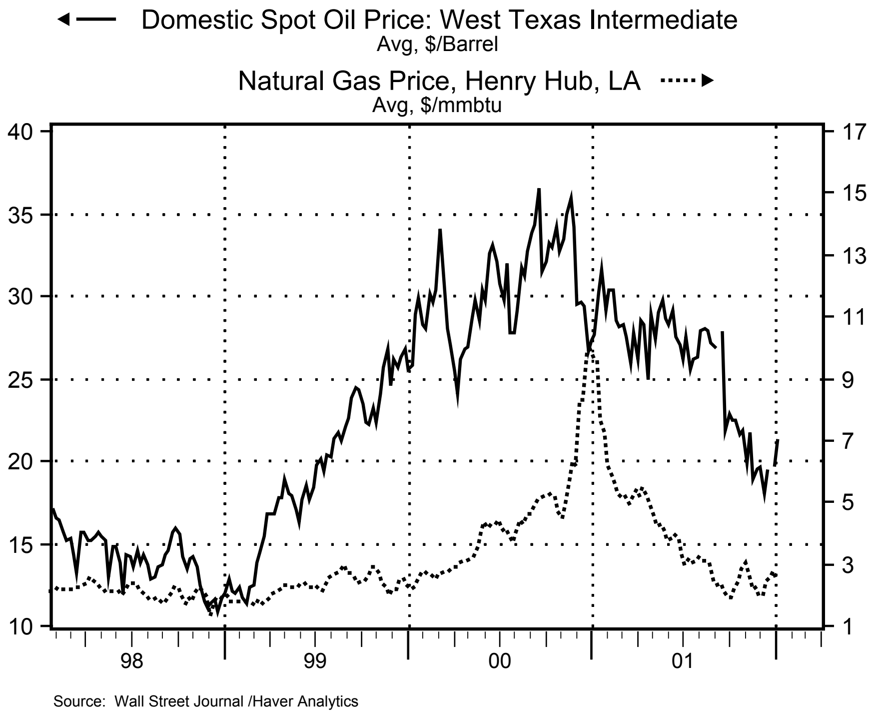

- Monetary policy has played a significant role in affecting the performance of the economy in recent years. This period has witnessed a notable reversal in the movements of short-term interest rates.

- The Federal Reserve raised interest rates six times and 175 basis points from June 1999 to May 2000, putting the Fed funds rate at 6.5 percent, the highest rate since 1991.

- Changes in monetary policy affect the economy with an uncertain lag, so it is difficult to predict their impact's exact timing or magnitude. Nonetheless, this restrictive monetary policy affected financial markets and some interest-sensitive sectors of the economy such as certain categories of durable consumption and investment.

- Recognizing these effects, the Federal Reserve subsequently lowered short-term interest rates eleven times and 475 basis points beginning in January 2001, putting the fed funds rate at 1.75 percent and a forty year low. The most recent cuts were in response to events surrounding the terrorist attack of September 11. Because of lags, the economic effects of recent rate cuts will not be fully felt for months. But this easing of monetary policy is a key reason that most economists expect an economic rebound in the near future.

# II. Energy Prices

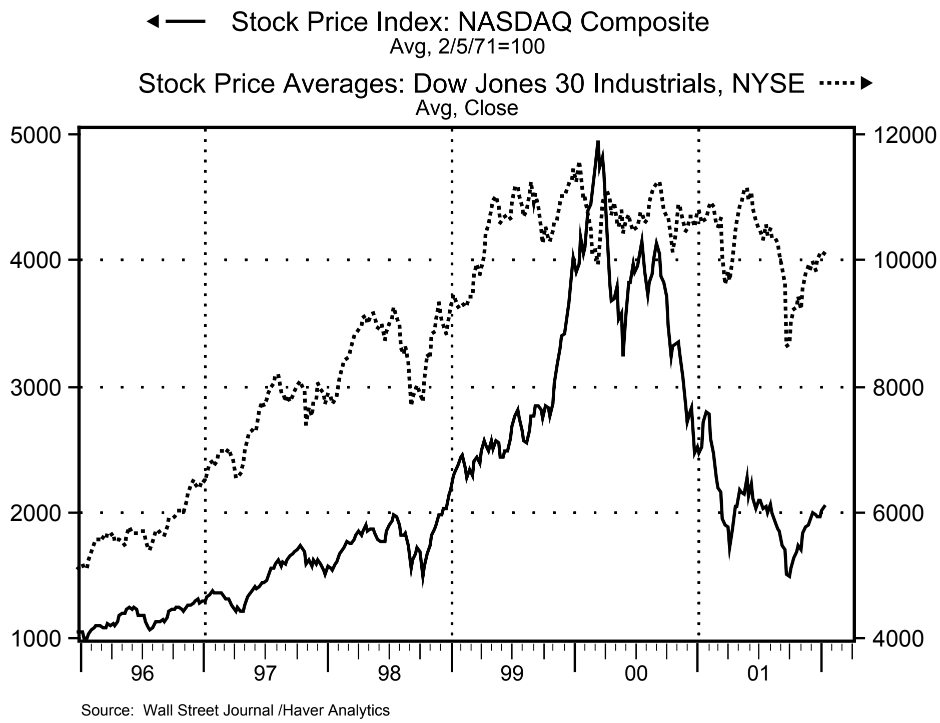



- Recent years have also witnessed significant movements in energy prices. Energy prices, for example, sharply increased in 1999 and through most of 2000. This sharp increase contributed to the economic slowdown beginning in mid 2000.

- 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 (and especially natural gas) prices, however, have retreated (or reversed themselves) since late 2000. This moderation of energy prices is another key reason most economists expect an economic rebound in the near future. This should work eventually to reverse the adverse effects mentioned above and thus to support economic growth, all other things equal. This moderation of energy prices is another key reason most economists expect an economic rebound in the near future.

# III. Stock Prices




- Stock price movements are affected by economic factors and, in turn, influence economic activity. Earlier Federal Reserve tightening and sharp energy price increases, along with other factors, for example, impacted corporate profits, earnings, and an overvalued equity market by mid-year 2000.

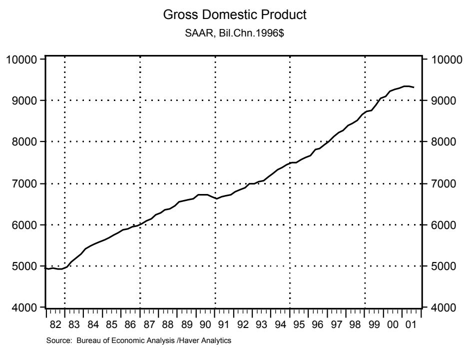
- This chart shows two well-known stock indices: the Dow Jones Industrial and the NASDAQ composite indices. The Dow Jones average peaked in early 2000. The NASDAQ peaked in March 2000 and lost a good deal of value (and market capitalization) after that time.

- Many analysts argue that stock market weakness may have important economic repercussions. It raises the cost of capital, adversely impacting future investment. And the equity market's "wealth effect" that boosted consumption in recent years could weaken significantly, or even reverse itself, adversely impacting consumption. Further, many consumers took on debt when equity values were high and now, with equity values diminished, face significant debt burdens and weakened balance sheets. These burdens could weaken consumption for a longer-than-expected period of time.

- Recently, however, the stock market – looking ahead to economic improvement and better earnings – has reversed a portion of its earlier losses.

# IV. Output Measures
## Gross Domestic Product

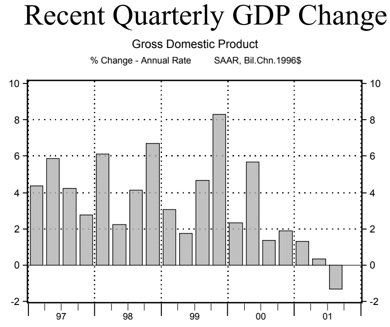
Long-Term GDP




- Using monthly indicators and data, the National Bureau of Economic Research (NBER) recently determined that the recent economic expansion peaked in March 2001. Quarterly GDP growth has slowed since mid-year 2000. But recent events should be considered against a backdrop of the lengthy economic growth of the last two decades.

- In particular, the economic expansion of recent years 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




- Recent quarterly GDP growth, however, shows a significant slowdown in economic activity.

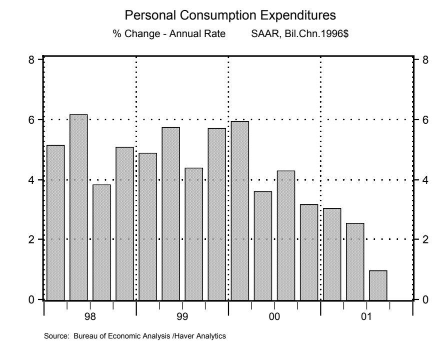
- The data indicate that this slowdown began in the second half of 2000.

- After expanding at a healthy pace for several years, GDP growth slowed abruptly in mid-2000 and over the past year has averaged only a slightly positive annual rate.

- Growth turned negative in the third quarter. This third quarter growth was the weakest since 1991.

# Consumption

Recent Consumption Growth

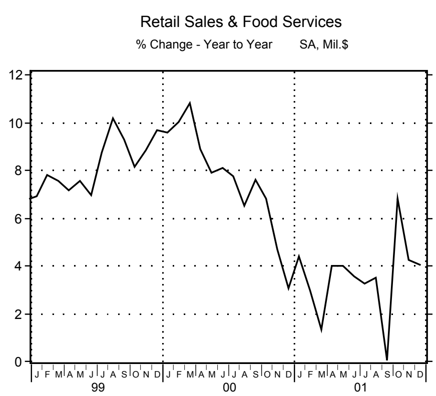



- Quarterly real consumption growth has been a sector bolstering the economy throughout the recent expansion; its growth has generally exceeded that of GDP.

- Since about mid-2000, however, real consumption growth has slowed along with, but not as much as, GDP. Consumption growth has held up better than some had expected. Auto sales and purchases related to the housing market have helped keep consumption up and the overall economy in positive territory until recently.

- Consumer confidence (not shown) has been weak. But recent readings suggest improvement in both consumer confidence and sentiment.

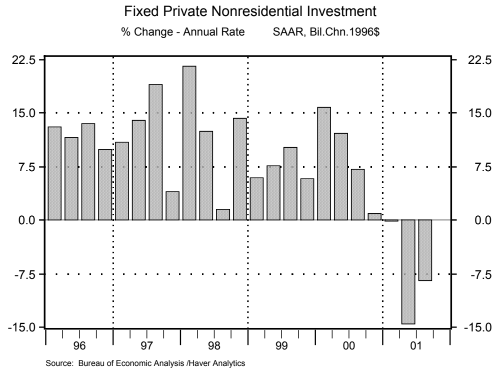
Recent Retail Sales




- Consumer activity can also be observed in more timely monthly retail sales data. Recently, total retail sales growth has picked up in the fourth quarter. This increase is largely related to strong auto sales during that period. The chart shows year-over-year data.

# Investment

Fixed Private Non –Residential Investment Growth



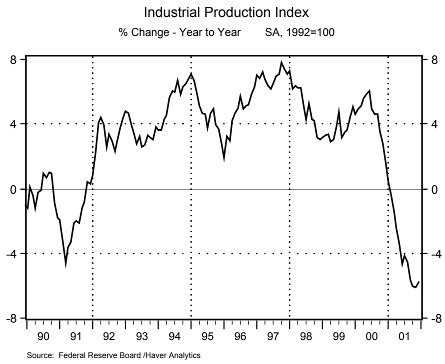

- The business investment component of real GDP has been both a leading sector in the expansion and a leading sector in the contraction; it has grown at rates exceeding GDP both on the upside and the downside.

- Recently, investment growth has slowed dramatically since mid-2000. Investment now is one of the weakest sectors of the economy. For example, private non-residential fixed investment growth fell sharply from low growth rates registered after mid-2000 (see chart). The equipment and software component has been especially weak.

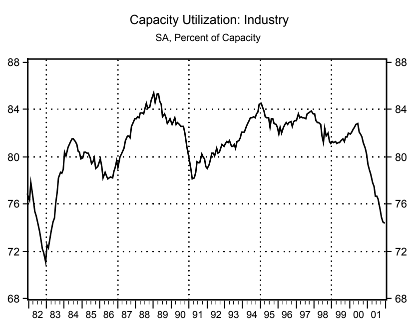
New Orders for Capital Goods


- More timely information from indicators that correlate with investment also portend investment weakness. Manufacturers' new orders for non-defense capital goods, for example, depict a sluggish investment outlook. Very recent figures, however, improved a bit. The figures in the chart are year-over-year figures.

# The Manufacturing Sector

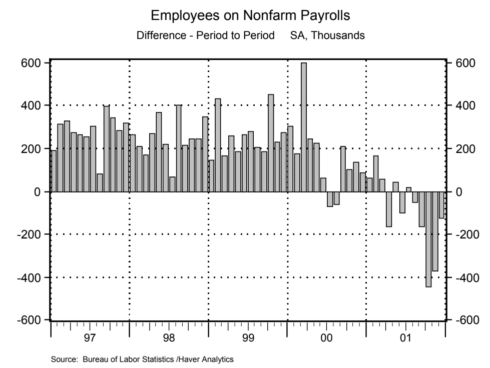



- The manufacturing sector has been weak for an extended period of time. The industrial production index, for example, peaked in June 2000.
- The year-over-year change in industrial production has slowed dramatically since mid-2000 (see chart). Recent year-over-year figures are weaker than those registered during the recession in the early 1990s.
- The purchasing managers' index (not shown) weakened through most of 2000. It has improved somewhat in recent months.




- Capacity utilization of industry has fallen since mid-2000 and remains near its lowest levels since the early 1980s (see chart). This means there is plenty of idle capacity in industry.
- Manufacturing employment also has decreased for an extended period and the manufacturing workweek has trended down to lower levels.

# V. The Labor Market

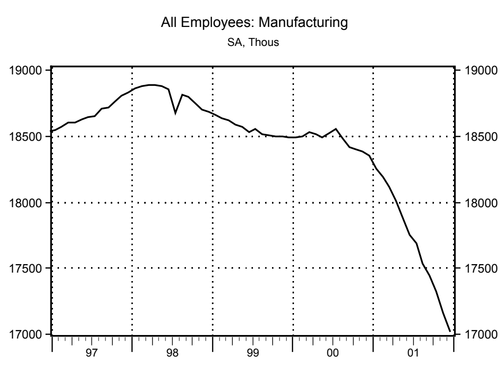



- This chart shows the monthly gains in total employment on non-farm payrolls in recent years.

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

- Gains in total non-farm payrolls, for example, averaged about 255,000 per month for the 2½ years prior to mid-2000 and on average have actually fallen 38,000 per month after mid-year 2000.

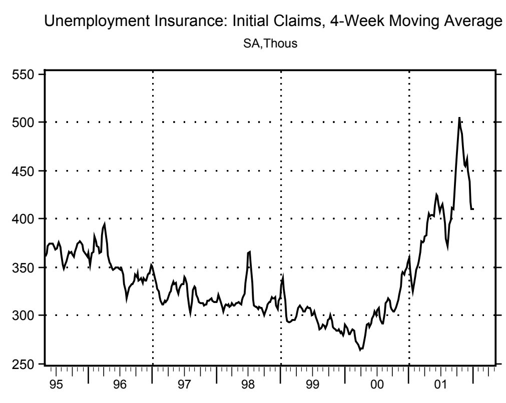
Manufacturing Employment




- The lower chart shows manufacturing employment in recent years. Manufacturing employment has been weak for an extended period, but this weakness became more pronounced after mid-year 2000. In fact, 1.5 million manufacturing jobs have been lost since July 2000.

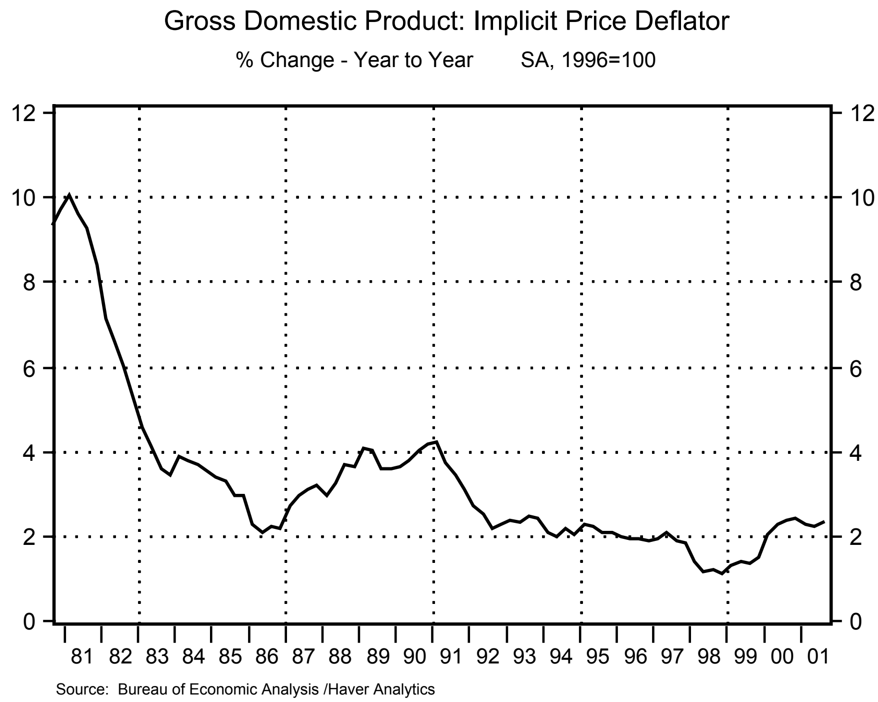
# Unemployment


- After trending down during the expansion, the unemployment rate increased in the fall of 2000.
- The December 2001 unemployment rate was 5.8 percent.
- Unemployment is a lagging economic indicator. With a cooling labor market, the unemployment rate is expected to increase in the near term.



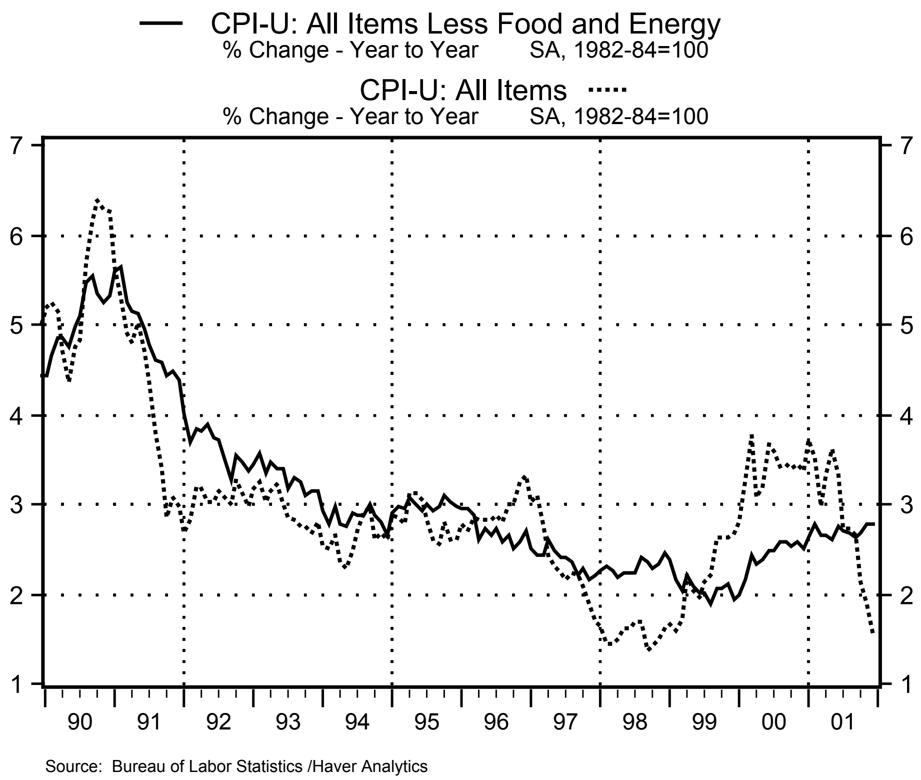

- Initial claims for unemployment are a leading indicator for the unemployment rate. These claims trended down for much of the expansion.
- These claims began increasing in the spring of 2000 – leading the unemployment rate – and have trended upwards since that time.
- The recent decline in unemployment claims, however, is a positive sign that conditions may improve and job losses may begin to abate.

# VI. Inflation Measures




- This chart shows the broad GDP price deflator, on a year-over-year basis, over a long time frame. It shows that inflation is relatively contained and not a serious problem.

- According to this measure, inflation remains relatively subdued despite a recent increase (related in part to energy price movements). Furthermore, inflation is generally forecasted to moderate. Nonetheless, despite being contained, it appears that currently, this measure of inflation is no longer falling.

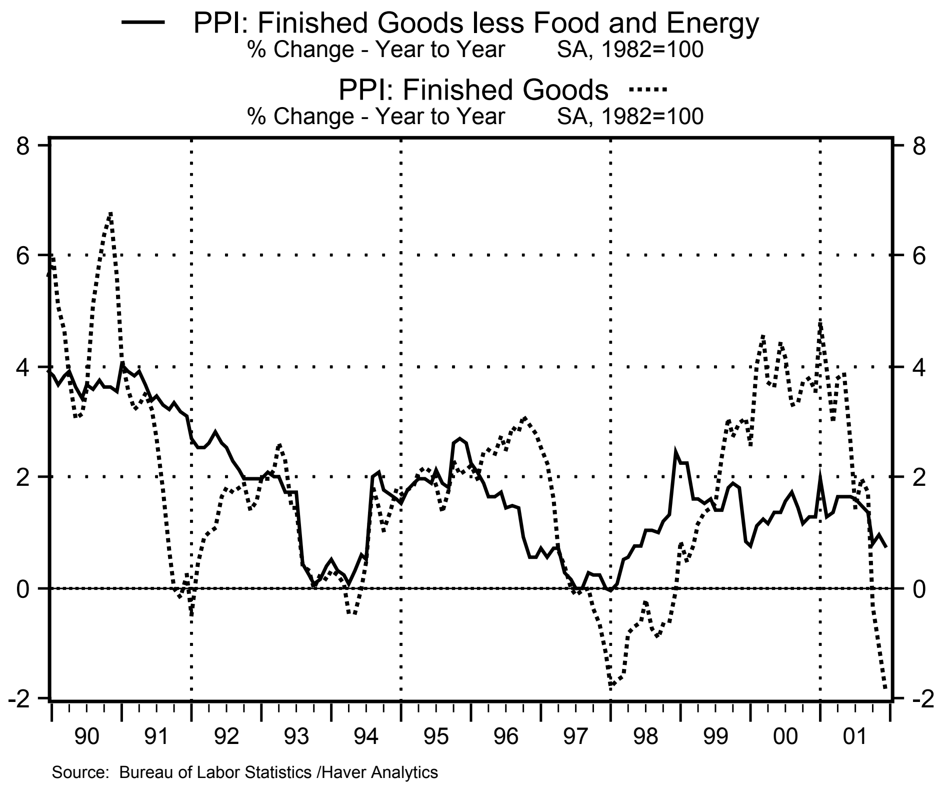



- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last ten years on a year-over-year basis.

- Changes in energy prices have caused similar movements in the total CPI in recent years. Energy price increases elicited upward movements in the total CPI in the 1999-2000 period, for example. But recently, as energy prices have retreated, total CPI gains have fallen dramatically.

- If special factors are removed, however, core CPI inflation gains are less volatile. Core consumer price inflation, for the most part, has continued to post modest gains on a year-over-year basis but recent figures indicate that core inflation is no longer falling.

- Figures for December indicate core CPI advanced at a 2.8 percent year-over-year rate.

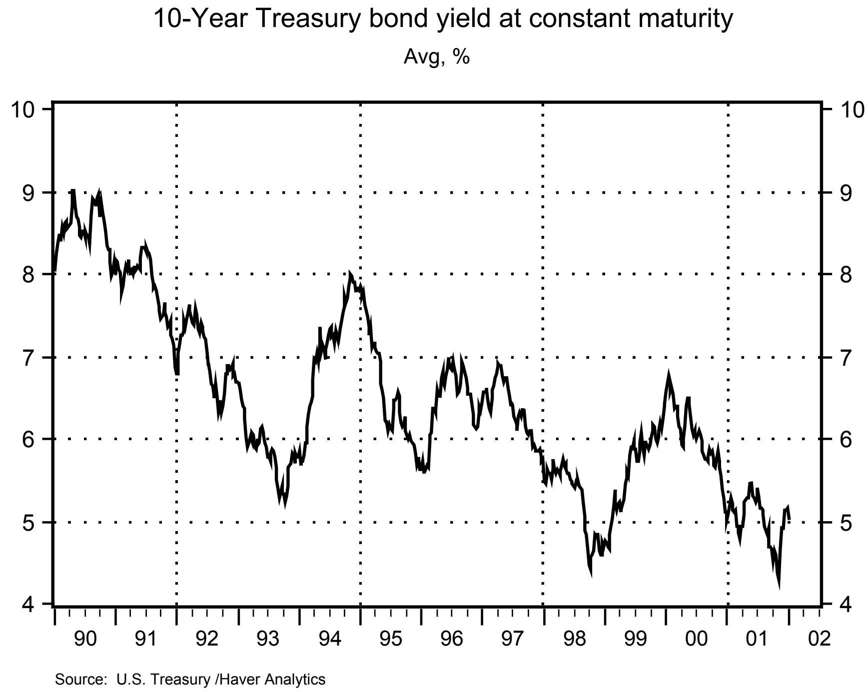



- This graph shows finished good producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- Energy price increases boosted the total PPI figure in 1999 and 2000. Last year, however, energy prices retreated, bringing down this total (year-over-year) PPI figure to almost minus 2 percent by December. If the volatile food and energy price components are removed, the resulting "core" inflation rate has fallen to about 0.75 percent. In fact, the "core" rate has trended down since early 1999 on a year-over-year basis.

- The producer price index also has intermediate and crude stage of processing categories. Core intermediate goods prices and core crude goods prices indicate that there is no inflation in the stage-of-processing "pipeline."

# VII. Forward-Looking Market Price Indicators



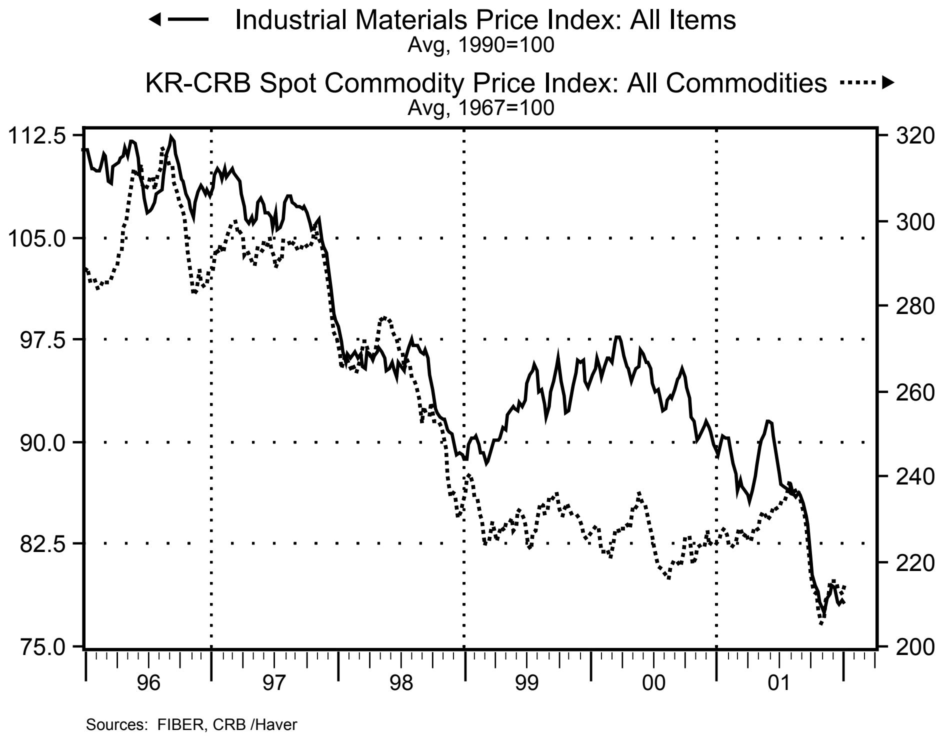

- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.

- Long-term interest rates have trended down for most of the past decade as inflation has diminished and remain near 35 year lows.

- Since early 2000, these rates have generally moderated and come down because of a lessened concern about future inflation and changes in expectations from concerns about Fed tightening, to anticipation of, and reaction to, easing. Treasury rates also may have fallen during this period partly because of less issuance. Notably, despite recent significant reductions in the Fed funds rate, long-term Treasuries remain relatively contained (although they have fallen), producing a positively sloped "yield spread."

- Recent gains largely reflect anticipations of an economic expansion.

# Commodity Prices

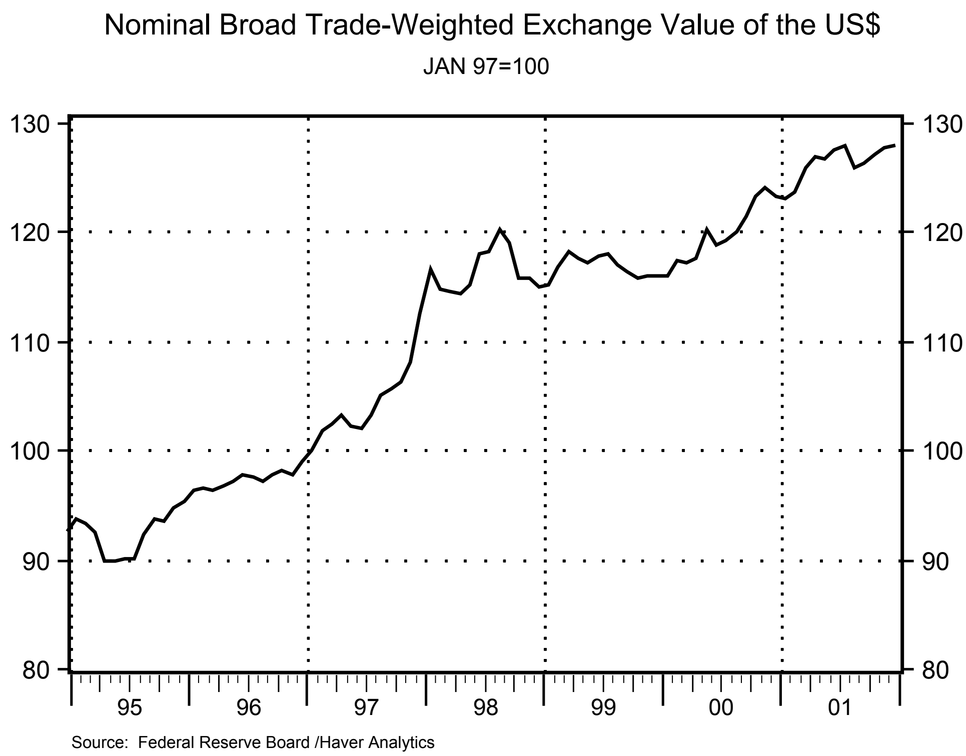



- This chart shows two commonly used broad commodity price indices – the Knight-Ridder-Commodity Research Bureau spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.

- The industrial materials index contains industrial commodity prices <u>including energy prices</u>. It has fallen for several years but increased in 1999 (related to energy price hikes) and fell again in 2000 and 2001. It remains below levels of a few years ago.

- The CRB spot index <u>does not include energy prices</u>. It remains below levels of a few years ago. Food-related commodities account for recent modest increases in the CRB-Spot Index.

- These commodity price indices show little sign of future increases in inflation or inflationary expectations and suggest inflation is not an important problem.




- This chart shows a broad, trade-weighted value of the dollar. Specifically, it shows the trade-weighted value of the dollar against 26 currencies of the U.S.' major trading partners.

- The foreign exchange value of the dollar has generally strengthened during much of the 1995-2000 period, and remains at a firm level.

- The dollar also remains relatively firm against both the Euro and the Japanese Yen.

- Taken together and assessed in conjunction with one another, these forward-looking market price indicators – commodity prices, long-term interest rates, and the foreign exchange rate value of the dollar – continue to suggest that a resurgence of inflation is not imminent, and that Federal Reserve Monetary policy is not as easy as some contend. These indicators also suggest there is room for further Federal Reserve interest rate reductions.

# VIII. Factors Promoting Economic Growth Without Inflation

- **Price - Stabilizing Monetary Policy.** A Federal Reserve policy of gradually pursuing price stability can foster growth in a number of ways. Such a policy:
    - Lowers interest rates.
    - Reduces unnecessary uncertainty and volatility in financial markets.
    - Enables the price system to work better.
    - Acts like a tax cut (especially for those portions of the tax code that are not indexed for inflation).

- **Low Marginal Tax Rates.** Lower marginal tax rates promote incentives to work, save, invest, and innovate. Entrepreneurial activity is fostered and individuals are encouraged to enter market activity. All of this promotes growth without inflation.

- **Government Spending Restraint.** Keeping government spending shrinking as a share of GDP enables more economic resources to be allocated and utilized more efficiently and productively in the private sector. This allows more growth to occur without upward pressure on prices.

- **Investment and Technological Innovations.** Promoting investment and technological innovation can add to productive capacity, thereby allowing for sustained expansion without inflation. Such investment can help to improve productivity growth, providing for wage increases without inflationary consequences and therefore higher living standards. Price-stabilizing monetary policy and removal of the tax bias against saving and investment can help on this score.

- **Globalization and Open Markets.** Reducing tariff barriers and promoting open markets increase the size of the international sector, which helps economic growth while fostering lower prices. Increased international integration enables the economy to take advantage of larger markets and to become more specialized and more efficient, productive, and competitive. This allows the economy to produce more goods with the same or even less input; to grow faster without inflation.