# CURRENT ECONOMIC CONDITIONS AND OUTLOOK

## JOINT ECONOMIC COMMITTEE

**Prepared for Chairman Jim Saxton**

## Data as of April 26, 2002


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

- **Summary and Overview**

Currently, economic activity and especially final demand are rebounding smartly from the slowdown and recession as well as the terrorist events surrounding September 11, 2001. The expansion leaves one of the mildest recessions on record in its wake. This rebound has emerged sooner, more forcefully, and with broader-based support than most economic forecasters predicted. Indeed, these prognosticators have often revised up their near-term forecasts as stronger than expected data became available. The expansion has been importantly driven by the Federal Reserve move to sharply lower interest rates in 2001 as well as by a moderation of energy prices, a stabilization/firming of asset prices, timely tax relief, and a continued lack of new inflationary pressure. While the expansion's near-term prospects are favorable, a number of risks and uncertainties loom on the horizon and pose questions about its long-run sustainability. Nonetheless, the economy's remarkable resilience appears to outweigh these risks at this time.

- **The Economic Turnaround**

A wide array of indicators is now pointing toward economic expansion, suggesting that the rebound is gradually becoming more broad-based and well-entrenched. Real GDP, for example, increased at a 5.8 percent annualized growth rate in the first quarter. Healthy consumption growth supported this figure and has continued, along with ancillary variables such as consumer confidence, retail sales, and personal income, to hold up better than expected in recent months. Consumption, however, does appear to be running ahead of investment activity in supplying momentum to the expansion. Nonetheless, while actual investment remains weak, some early hints of a possible investment revival together with inventory restocking have emerged suggesting that an investment revival may not be too far off. Housing, on the other hand, remains firm at elevated levels, but is not expected to contribute significantly to further economic expansion. Recent advances in manufacturing activity and industrial production provide signs of a turnaround in that sector.

- **Causal Factors**

Several factors contributed to bringing about this economic expansion. The rebound, of course, is significantly related to the eleven-time, 475 basis point interest rate reduction from 6.5 percent to 1.75 percent undertaken by the Federal Reserve during the course of 2001. This substantial rate reduction clearly was a most important, dominant factor in explaining the faster-than-expected turnaround. But a significant energy price moderation, which also occurred during 2001, contributed significantly to this outcome. A stabilization or firming of asset (equity and home) prices along with well-timed tax relief and the maintenance of price stability all contributed to the turnaround as well.

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

- **Current Prospects, Risks and Uncertainties**

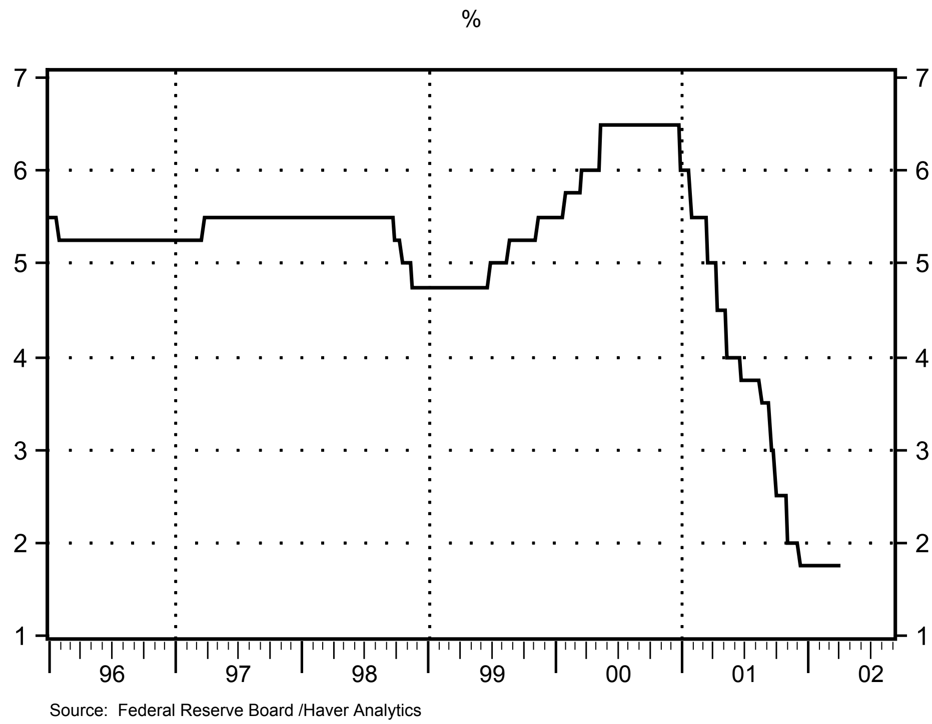
Prospects for a sustained expansion look promising, especially in the near-term (over the next several quarters) as inventory rebuilding takes place. While likely sustained, however, the expansion may not be as rapid as some expect. Specifically, the economy remains vulnerable to a number of potential headwinds, risks, and uncertainties that could weigh on the economy over time and adversely affect growth. Energy prices increases, for example, pose a genuine risk in the near-term. In fact, oil and gasoline prices have increased in recent days. But while risky in the near-term, energy prices increases are not expected to remain a long-term problem, with alternative suppliers on stream and the U.S. economy less vulnerable than was the case in the past. Household and business debt burdens as well as significant costs imposed on the economy by the terrorist threat also pose potential risks to the sustainability of the recovery. Further, lagging profits, weak equity markets, and sluggish capital goods orders could impact investment and bring about a weaker-than-expected expansion. And a re-emergence of inflationary pressures is also a risk that needs to be continually monitored. But currently, all these potential risks and uncertainties appear to be outweighed by the remarkable resilience of the U.S. economy.

- **Prices and Inflation**

Broad measures of inflation continue to indicate that inflation is not an important problem at this time. This is also true of core measures of inflation that remove the influence of special factors. Most forecasters are projecting a continuation of current low rates of inflation. Forward-looking market prices indicators corroborate this view. While long-term interest rates have increased in recent months, this has occurred in concert with a stronger-that-expected recovery and building expectations of future Federal Reserve interest rate increases. Commodity prices, less special factors, remain benign. And the dollar remains strong. In short, when assessed over time and in conjunction with one another, forward-looking market prices indicators continue to suggest that an imminent and important resurgence of inflation is not in prospect.

# I. Federal Reserve Monetary Policy

Federal Open Market Committee: Fed Funds Target Rate



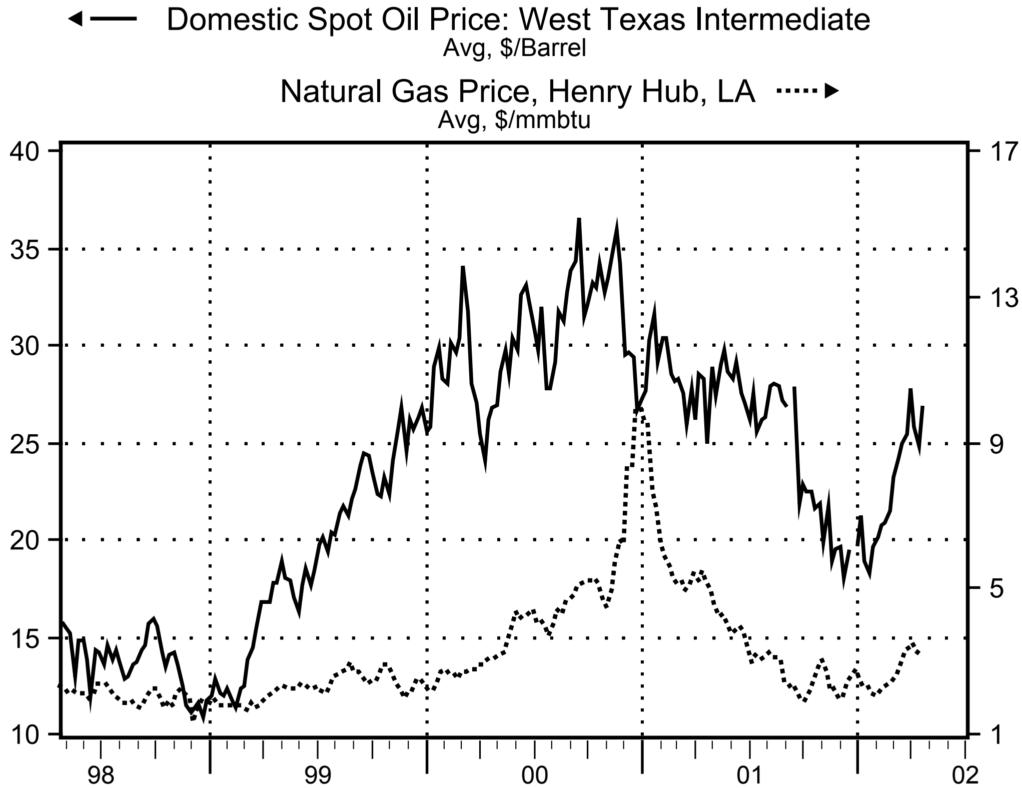

- Monetary policy has played a significant role in affecting the performance of the economy in recent years. This period has witnessed a notable reversal in the movements of short-term interest rates.

- 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. Cuts made after the fall were partly in response to events surrounding the terrorist attack of September 11. This easing of monetary policy is a key reason for the economic turnaround we are currently witnessing.

# II. Energy Prices



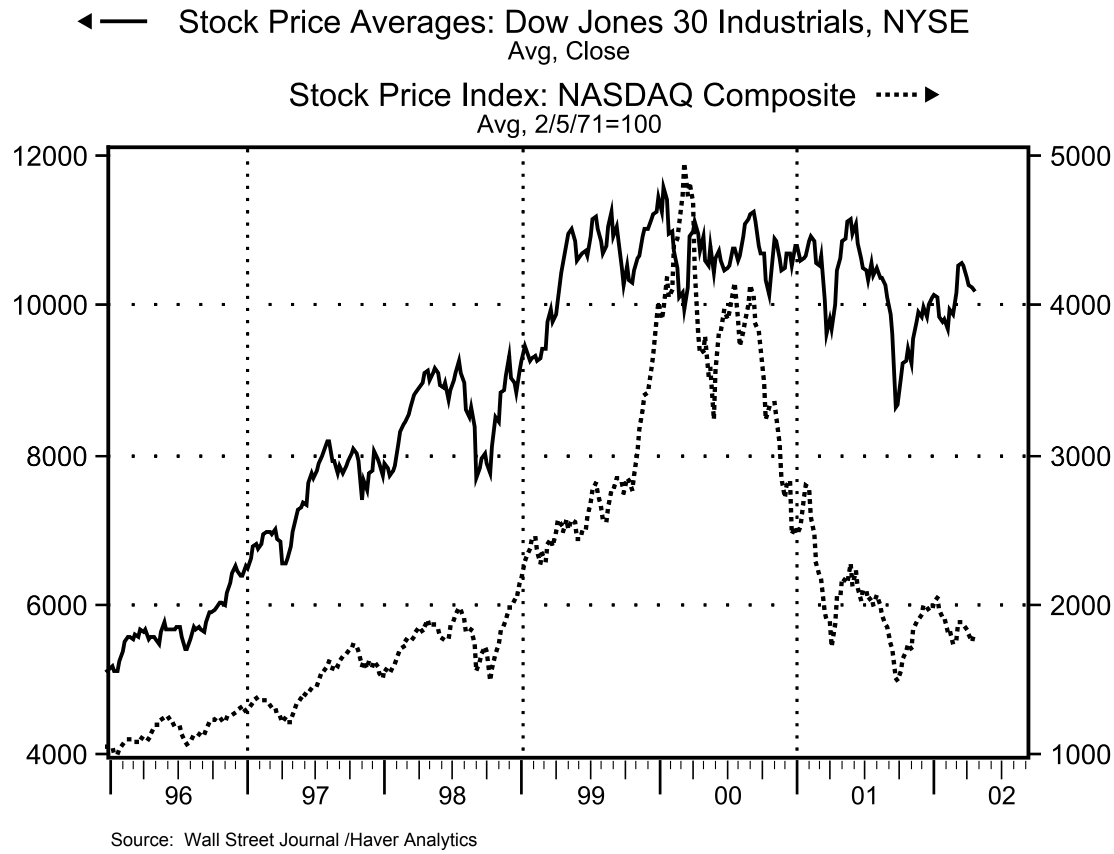

Source: Wall Street Journal /Haver Analytics

- 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 natural gas) prices, however, retreated through 2001. This moderation of energy prices is another reason for the current economic rebound. This moderation of energy prices worked to reverse the adverse effects mentioned above and thus to support economic growth, all other things equal. Recently, however, energy prices have increased. This poses a risk to the nascent recovery.

# 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, for example, impacted corporate profits, earnings, and an overvalued equity market by mid-year 2000.

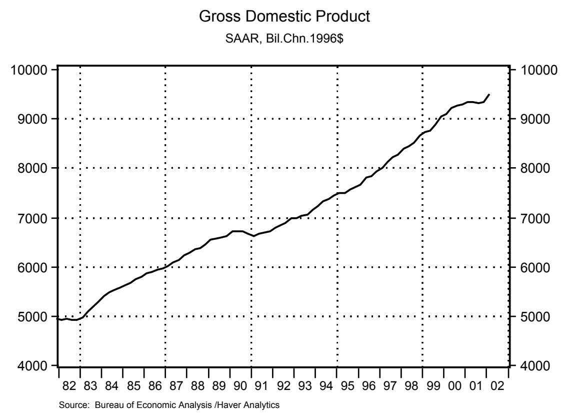
- This chart shows two well-known stock indices: the Dow Jones Industrial and the NASDAQ composite indices. The Dow Jones peaked in early 2000. The NASDAQ, peaked in March 2000 and lost a good deal of value (and market capitalization) after that time.

- Many analysts argue that the 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 dampen 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. This is particularly true of the Dow.

# IV. Output Measures
## Gross Domestic Product

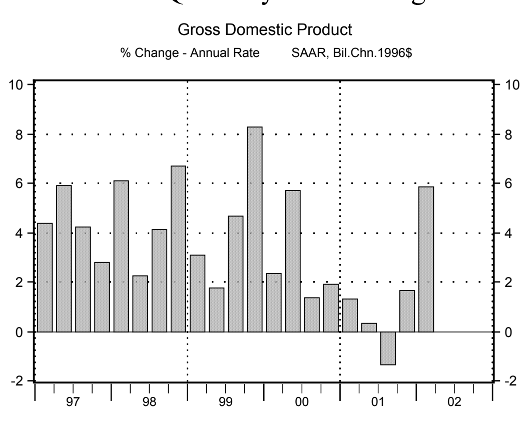
Long-Term GDP




- Using monthly indicators and data, the National Bureau of Economic Research (NBER) determined that the record economic expansion of the past decade peaked in March 2001. But 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 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



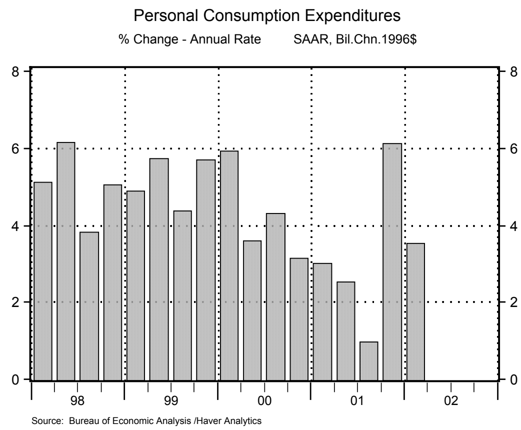

- Beginning in mid-2000, however, quarterly real GDP growth began to slow down significantly from growth rates previously recorded.

- Growth turned negative in the third quarter of 2001. This third quarter growth was the weakest since 1991 and related to the terrorist attack of September 11.

- But real GDP growth turned positive again in the fourth quarter of 2001 and in the first quarter of 2002, when it registered a robust 5.8 percent annualized growth rate. The recession of 2001 was one of the mildest on record.

# Consumption

Recent Consumption Growth



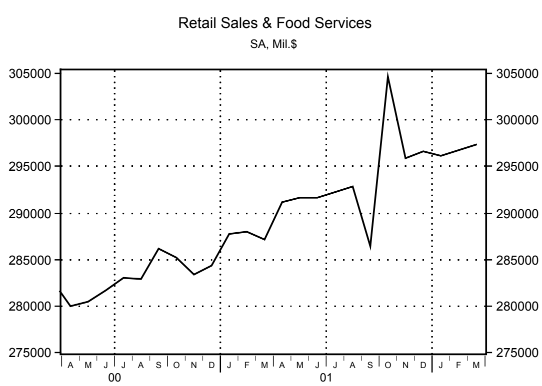

- Quarterly real consumption growth has been a sector bolstering the economy in recent years.

- About mid-2000, however, real consumption growth slowed along with, but not as much as, GDP. Nonetheless, consumption growth held up better than some had expected.

- Consumption increased sharply in the fourth quarter of 2001 and was a major factor boosting real GDP for that quarter. It continued advancing at a healthy rate in the first quarter of 2002.

- Consumer confidence and sentiment (not shown) have picked up since last fall.

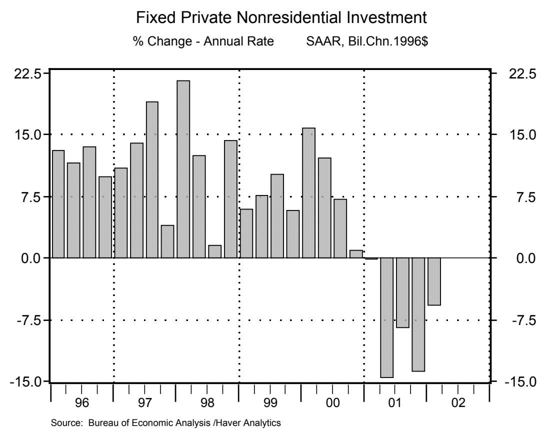
Recent Retail Sales




- Consumer activity can also be observed in more timely monthly retail sales data. After picking up in the fall, retail sales levels have held up better than some had expected. Although recent gains have been modest, the underlying trend in sales has been sound.

# Investment

Fixed Private Non–Residential Investment Growth



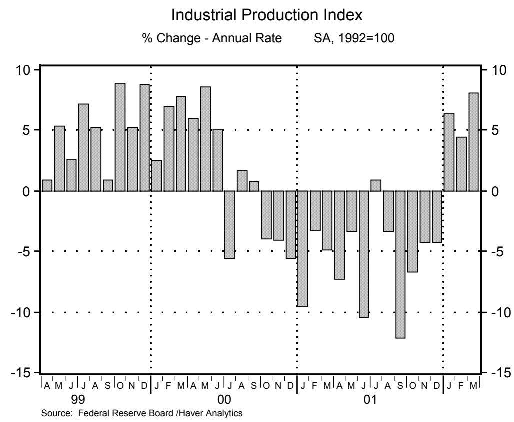

- The business investment component of real GDP has been both a leading sector in the earlier expansion and a leading sector in the recent contraction; it has grown at rates exceeding GDP both on the upside and the downside.

- 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 structures component was especially weak in recent quarters.

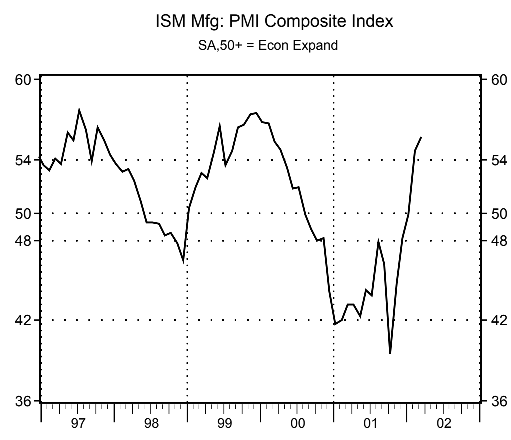
New Orders for Capital Goods


- More timely information from indicators that correlate with investment also provide useful insights. Manufacturers' new orders for non-defense capital goods, for example, have been weak, but picked up modestly since the autumn.

# The Manufacturing Sector

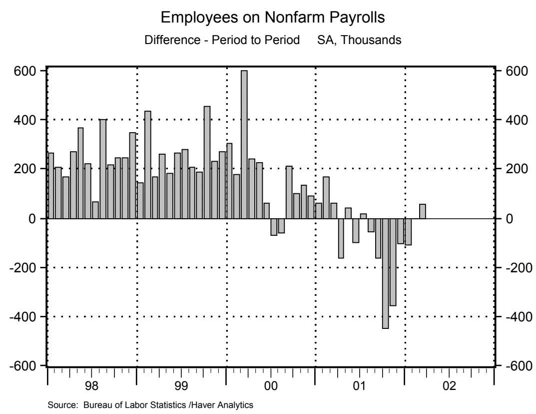



- The manufacturing sector has been weak for an extended period of time. The industrial production index, for example, peaked in June 2000.
- Changes in industrial production have generally fallen since mid-2000 (see chart).
- Recently, however, industrial production has shown signs of life, registering smaller declines in the fourth quarter and actual increases since January.



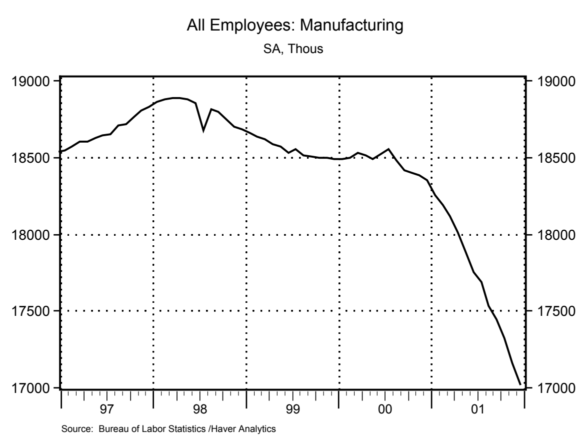

- The Institute for Supply Management's manufacturing diffusion index shows more dramatic improvement in manufacturing activity. According to this index, manufacturing activity has been improving for several months (figures above 50 denote expansion).
- Manufacturing hours worked and over-time recently have increased as well.

# 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. 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.
- In March, however, employment registered gains for the first time in several months.

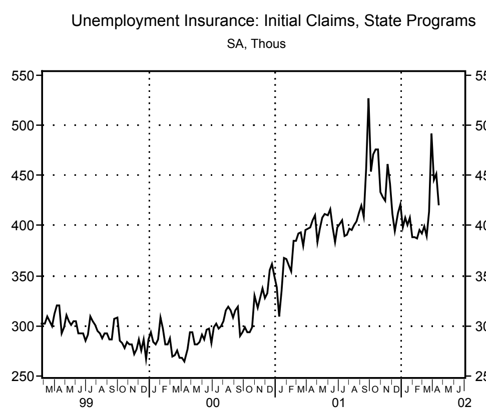
Manufacturing Employment




- 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, 1.7 million manufacturing jobs have been lost since July 2000.
- Recent losses, however, have been less severe than those registered earlier.

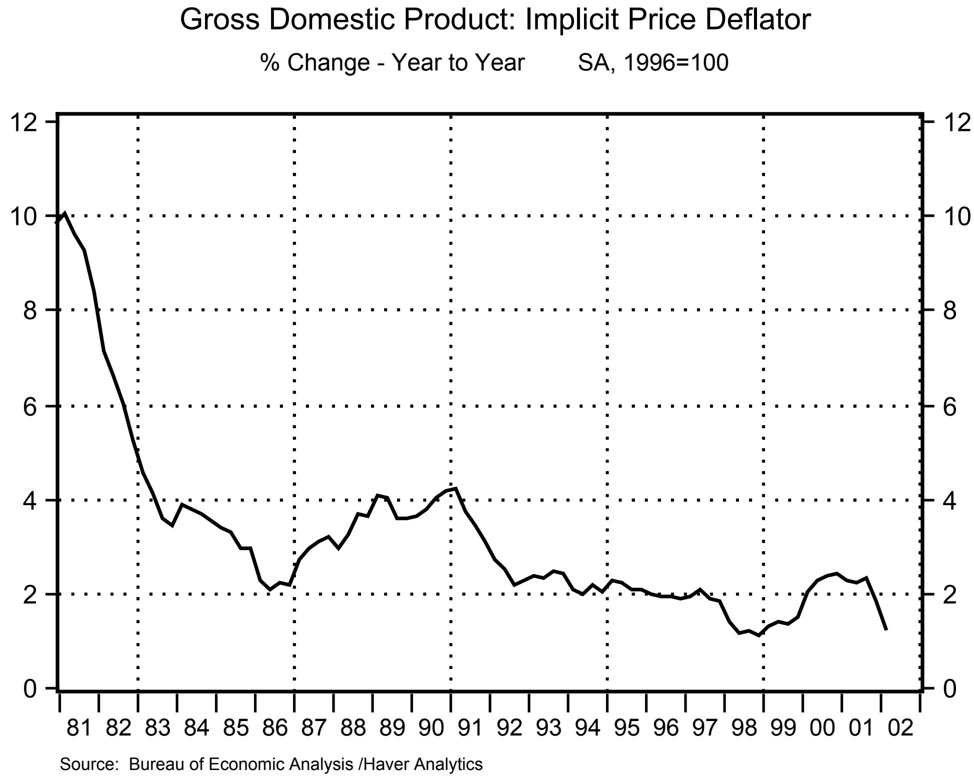
# Unemployment


- After trending down during the expansion, the unemployment rate turned up in the fall of 2000.
- The March 2002 unemployment rate was 5.7 percent.



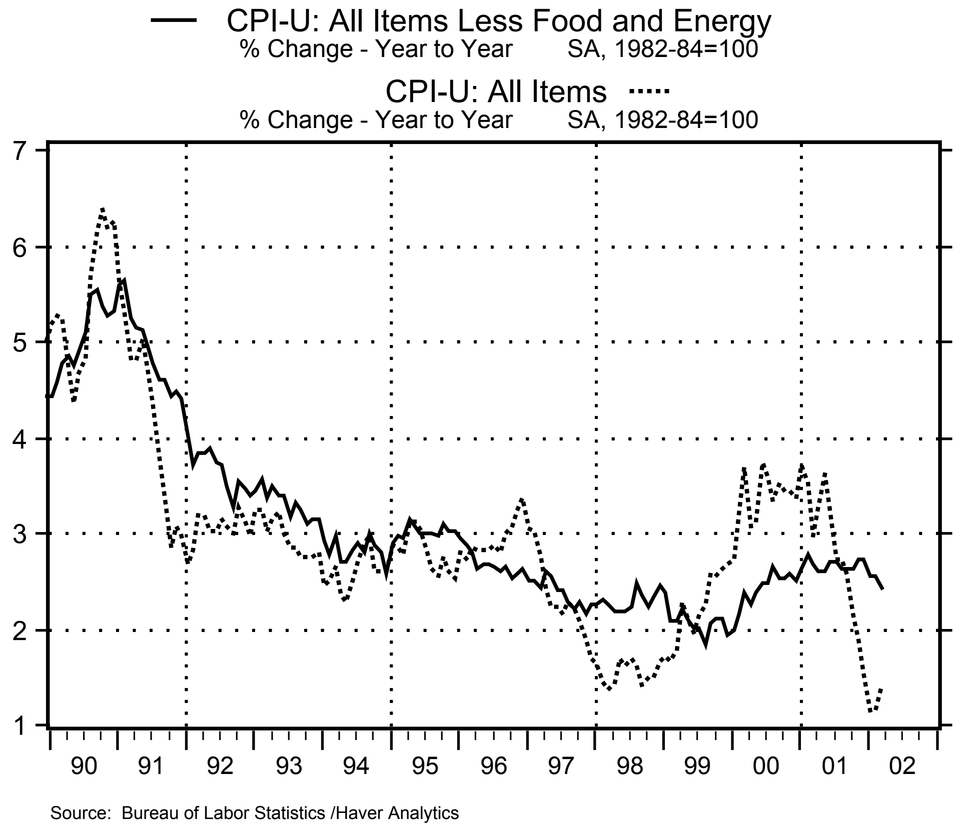

- Initial claims for unemployment are a leading indicator for the unemployment rate. These claims trended down for much of the earlier expansion.
- This indicator began increasing in the spring of 2000 – leading the unemployment rate – and trended upwards until last fall, when it reversed itself.
- This decline in unemployment claims has been temporarily disrupted by technical factors associated with the recent extension of unemployment compensation benefits.

# 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 in 2000 and a subsequent decline (related in part to recent energy price movements). Furthermore, inflation is generally forecasted to remain stable.

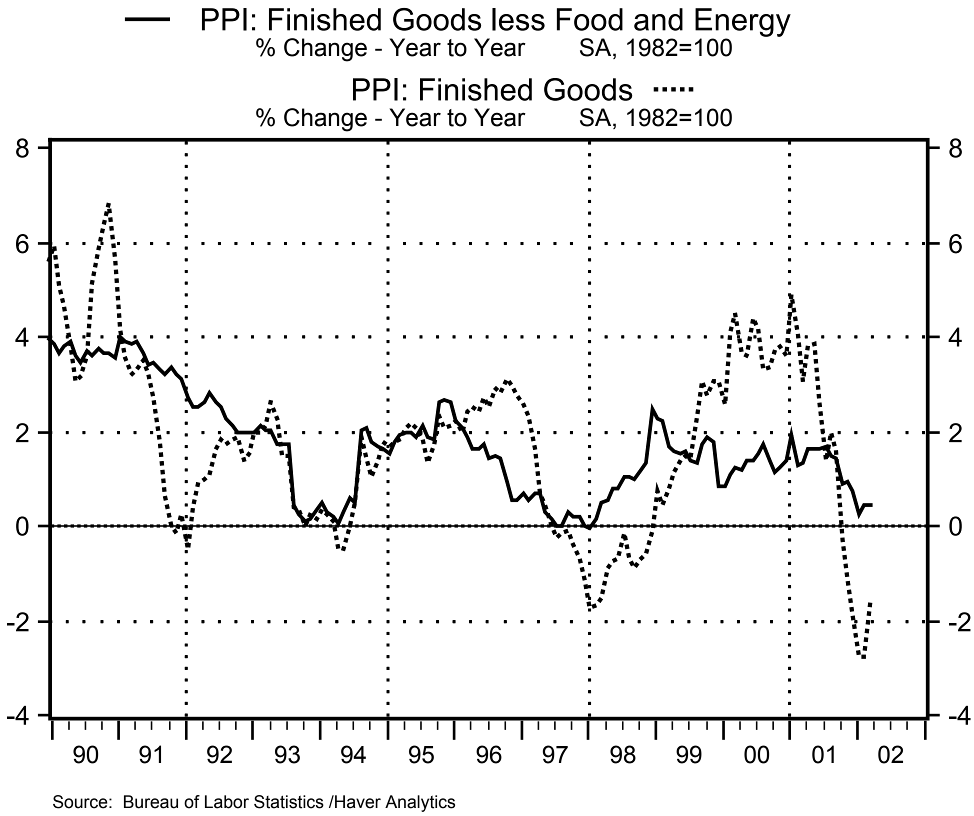



- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last ten years on a year-over-year basis.

- Changes in energy prices have caused parallel 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. As energy prices retreated in 2001, however, total CPI gains fell dramatically. Recent energy price increases could impact total CPI movements again.

- 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 March indicate core CPI advanced at a 2.4 percent year-over-year rate.

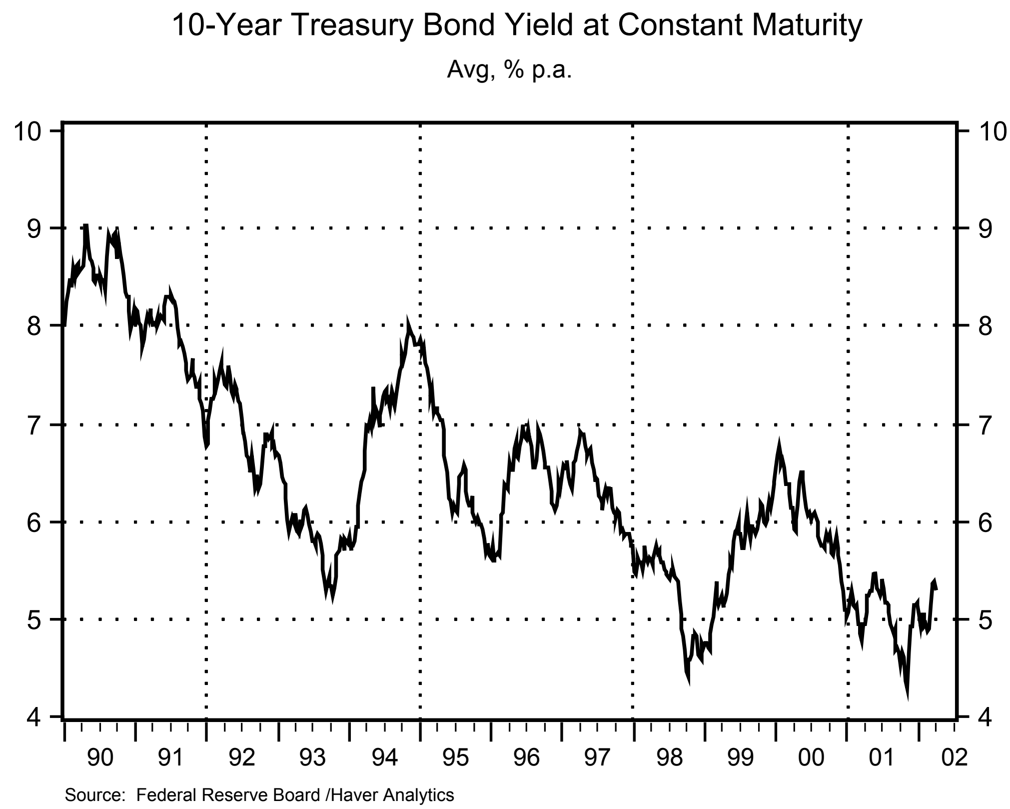



- This graph shows finished good producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown over the last 10 years on a year-over-year basis.

- 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. Recent energy price increases, however, may again influence the total figure in the near-term. If the volatile food and energy price components are removed, the resulting "core" rate has also fallen. 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 (not shown). 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



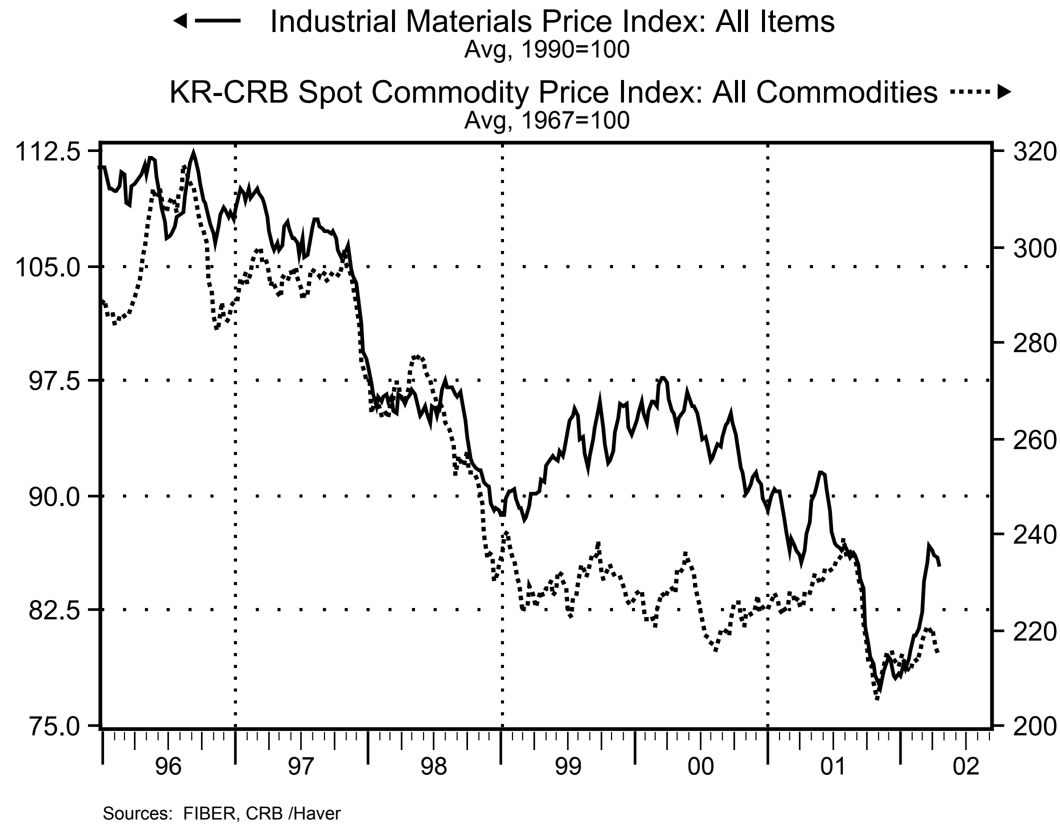

- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.

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

- From early 2000 through late 2001, 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. Notably, despite significant reductions in the Fed funds rate last year, long-term Treasuries remain relatively contained, producing a positively sloped "yield spread."

- Recent gains largely reflect anticipations of the economic expansion and concerns about Fed tightening.

# Commodity Prices

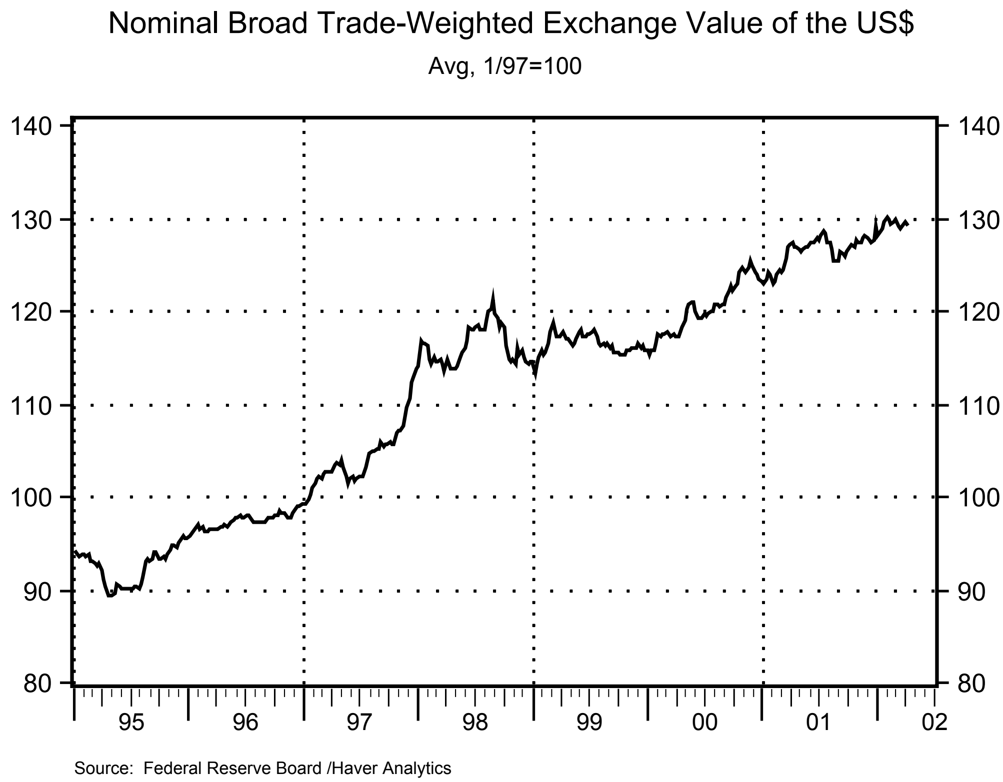



- This chart shows two commonly used broad commodity price indices -- the Knight-Ridder-Commodity Research Bureau (CRB) spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.

- The industrial materials index contains industrial commodity prices including energy prices. It fell for several years but increased in 1999 (related to energy price hikes) and fell again in 2000 and 2001. Most recently, this index has increased again due in part to energy price increases. Nonetheless, it remains below levels of a few years ago.

- The CRB spot index does not include energy prices. It remains well below levels of a few years ago.

- Recent increases in commodity prices are movements off their lows. They remain below levels of a few years ago. Removing the effects of energy prices, these commodity price indices show little sign of future increases in inflation or inflationary expectations and suggest inflation is not an important problem at this time.




- This chart shows a broad, trade-weighted value of the dollar. Specifically, it shows the trade-weighted value of the dollar against a broad group of 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 properly 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 major resurgence of inflation is not imminent.

# 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 less input; to grow faster without inflation.