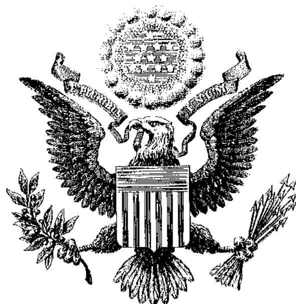
CURRENT ECONOMIC CONDITIONS AND OUTLOOK



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Prepared for Chairman Jim Saxton

Data as of September 28, 2001

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Economic Performance and Outlook[1]

Summary and Overview

- Prior to the Terrorist attack on September 11, the economy was experiencing a significant slowdown which began in mid-year 2000. In fact, the macroeconomy was quite weak. Real GDP growth in the second quarter was revised down to a low but positive rate. Investment growth had fallen. Manufacturing activity was especially weak with little sign of an imminent rebound. While consumption growth had slowed, it (along with housing strength) was sufficient to keep the economy out of outright recession. The labor market had softened as employment growth deteriorated and the unemployment rate increased. Broad measures of inflation as well as forward-looking inflation indicators suggested no resurgence of inflation was imminent.

  Despite this somber pre-attack picture, it was reasonable to expect that a near-term economic rebound was in the works. In particular, with an inventory correction near completion, a retreat of energy prices, a substantial Federal Reserve easing of monetary policy in the pipeline, a tax-cut program in place, and a perception that the stock market had stabilized, consensus projections of an imminent rebound in economic activity appeared quite plausible. These arguments were buttressed by data emerging in the period immediately preceding the acts of terrorism. Consumer spending, for example, moved higher in August and was maintained in early September. Auto sales were running close to August levels. Purchasing managers reported an improved orders picture in August and the profit decline was slowing. All of this suggested that a near-term economic turnaround as embodied in consensus forecasts was at hand.

- The Terrorist attack of September 11 changed all this in several important ways. In the short-term, for example, the attack increased uncertainty and apprehension in financial markets. Such increased uncertainty usually increases market volatility, thereby boosting risk premiums. It normally induces investors to move out of riskier assets (such as stocks) and into safer, more liquid, and shorter-term assets (such as short-term Treasuries, gold, and cash). This tends to adversely impact the stock market as well as commitments for long-term investments and purchases and boost demand for short-term liquidity.

  This increased uncertainty has negative impacts on consumption and investment as consumer and business confidence deteriorates. Discretionary consumer purchases (such as consumer durables) and long-term business commitments are often postponed or canceled as purchasers retrench. Additionally, related stock market declines adversely impact consumption (via negative wealth effects) and investment (via higher cost of capital).

  This terrorist attack, of course, had immediate impacts on certain industries, most notably airlines, aerospace, travel, insurance, hotels, and others. The negative effects on these industries, however, likely will spread to other industries as the negative effects on consumption and investment manifest themselves.

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

- There may be long-term effects of such terrorist attacks as well. The economic costs of a permanently increased terrorist threat will likely be associated with a change in our life style. This will, for example, entail an increased cost of security; in effect, an added "security tax." It will take the form of travel delays, additional security checks, longer cross-border transfers, higher insurance costs, additional identification requirements, immigration restrictions, and other added inconveniencies. Being a negative supply-side shock or added tax on the economy, it will adversely impact productivity growth and the economy's long-term potential growth rate.

  Similarly, while such a terrible disaster may spawn near-term investment and defense spending to repair and replace buildings and shore-up our security 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, such a disaster may adversely impact the longer-term potential growth rate of the economy.

- As a consequence of these effects of September 11, the prospects for the economic outlook have changed substantially. The expected near-term economic rebound, for example, is now in doubt. Real GDP growth is expected to contract in the near-term as a consequence of the events surrounding September 11. According to this scenario, as confidence wanes, unemployment increases, and a weak stock market adversely impacts wealth positions, consumption growth may slow as consumers postpone discretionary purchases, repair their weakened balance sheets, and increase their saving. With such uncertain prospects and the added "security tax" adversely affecting profits, investment growth could remain weak. The depth and duration of the retrenchment will depend in part on the extent of the damage to business, consumer, and investor confidence. But the near-term may be associated with recessionary conditions and a now weaker recovery may be pushed back into 2002.

- The full economic impact of recent events, however, will depend in part on the economic policy response. This response includes the following elements:

  - Monetary policy: The Federal Reserve lowered short-term interest rates by 50 basis points on September 17, and another 50 basis points on October 2. These were the Fed's eighth and ninth interest rate reductions this year, lowering the fed funds rate to 2.5 percent (from 6.5 percent in early January). In addition, the Fed has provided a substantial amount of liquidity to the markets to satisfy increased liquidity demands.

    Despite these moves, however, there is little economic evidence suggesting that monetary policy is "easy". Jointly assessed forward-looking market price indicators suggest inflation remains dormant and is not a significant problem. Commodity prices remain weak, the foreign exchange rate value of the dollar remains firm, and long-term interest rates recently have fallen. Evidence from key transmission paths or channels of monetary policy also indicate that the stance of policy is not easy. Bank lending has been weak and stock market values are off considerably. All of this suggests that current monetary policy may not be as "easy" as the recent lowered fed funds rate has led some to believe. An easier Federal Reserve policy stance may be in order.

- Fiscal policy: The Congress has already approved a $40 billion emergency spending package to aid in cleaning up, rebuilding, fighting terrorism, and increasing security. Additional government spending for these purposes is anticipated. Further fiscal stimulus measures to bolster the economy will be considered. Part of such proposals will likely include tax components designed to bolster the economy. These may include, for example, accelerated depreciation, liberalized expensing provisions, and front-loading scheduled tax rate cuts, among other proposals. Consideration of tax relief for mutual fund shareholders such as provided in H.R. 168 would be especially appropriate in this environment.[2]

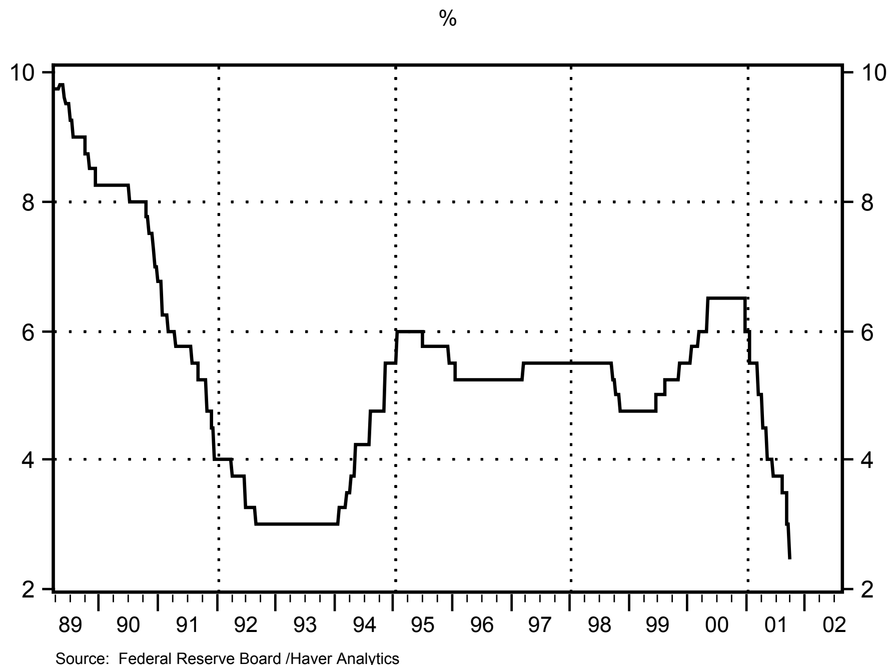
Aggressive monetary and fiscal policy responses, of course, would work to cushion but not offset the anticipated adverse consequences of September 11 outlined above. Such action would foster a shallower and shorter downturn as well as a stronger recovery than otherwise would be the case.

- In this new environment, inflation does not appear to be a problem. Key measures of broad price movements continue to indicate that trends in core inflation remain contained. Excluding special factors removes much of the measured price increases of recent years and most forecasters are projecting moderation in inflationary trends.

- Forward-looking indicators of inflation and expectations of inflation also suggest that inflationary pressures remain benign. Commodity price measures, for example, remain flat and below levels of a few years ago. The dollar remains firm, both on a trade-weighted basis and against most major currencies despite some moderation in recent weeks. Long-term bond yields have generally retreated. Overall, these indicators, jointly assessed, continue to suggest monetary policy is not easy and no resurgence of inflation is imminent. Their signals leave room for further interest rate reductions by the Federal Reserve.

[2] This bill provides partial exclusions for investors of capital gains distributions from mutual funds. For a thorough description of the bill, see, for example, Jason Fichtner, "Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains," JEC Study, June 2000; and Jason Fichtner, "The Taxation of Mutual Fund Investors: Performance, Saving and Investment," JEC Study, April 2001.

I. Federal Reserve Monetary Policy



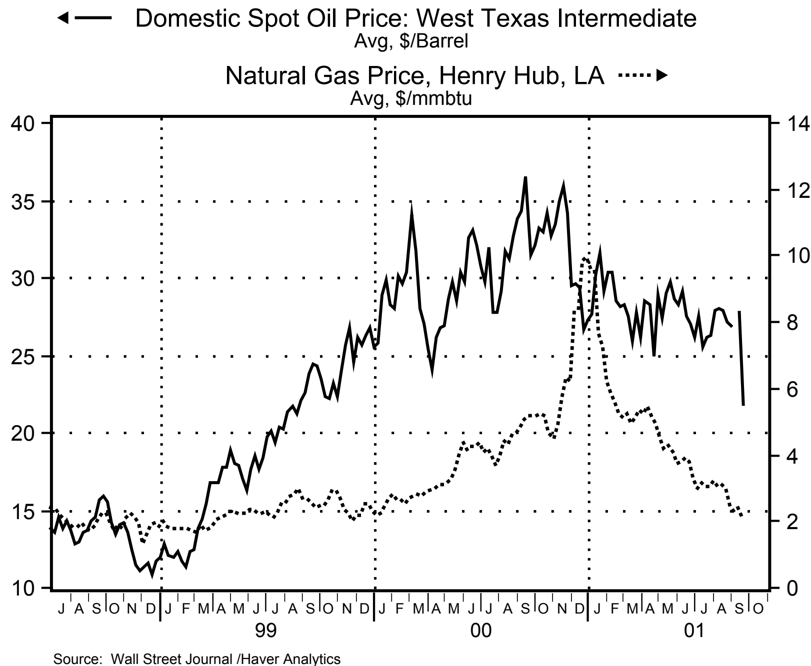
- The last two years have witnessed a notable reversal in the movements of short-term interest rates.

- 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. These tightening moves were undertaken when the Federal Reserves' loan officer survey indicated commercial banks were adopting more restructure credit/lending standards.

- 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 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 400 basis points beginning in January, putting the fed funds rate at 2.5 percent. 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 felt for months. The Fed continues to indicate that the economic risks remain on the downside, suggesting that further interest rate cuts are likely in the future.

II. Energy Prices



- Recent years have 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.

- Oil price increases also have a negative impact on economic growth, since they transfer purchasing power to oil-producing countries from oil-consuming countries. The ultimate impact of such price increases will depend in part on how oil producers use their increased oil revenue.

- Energy (and especially natural gas) prices, however, have moderated (or reversed themselves) in recent months. This should work eventually to support economic growth, all other things equal.

III. Stock Prices

- Federal Reserve tightening and sharp energy price increases -- along with other factors -- impacted corporate profits, earnings, and arguably an overvalued equity market.

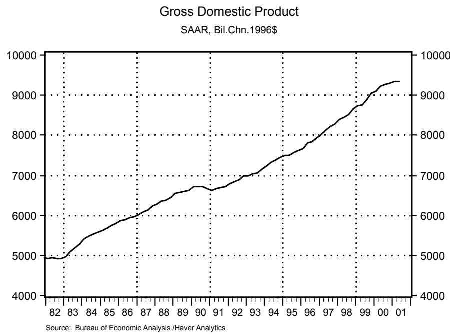
- This chart shows two well-known stock indices: the Dow Jones Industrial and the NASDAQ composite indices. The Dow Jones has been flat for well over a year, before its recent weakness. The NASDAQ, on the other hand, lost a good deal of value (and market capitalization) after March 2000.

- 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 weaken consumption for a longer-than-expected period of time.

IV. Output Measures

Gross Domestic Product

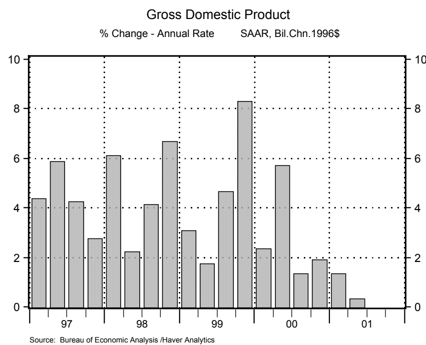
Long-Term GDP



- 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.

- The economic expansion of recent years is now well over 10 years old and the longest expansion on record. It followed the 1980s' expansion (the second longest peacetime expansion on record). In short, we have experienced back-to-back two of the longest economic expansions in American history.

Recent Quarterly GDP Change



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

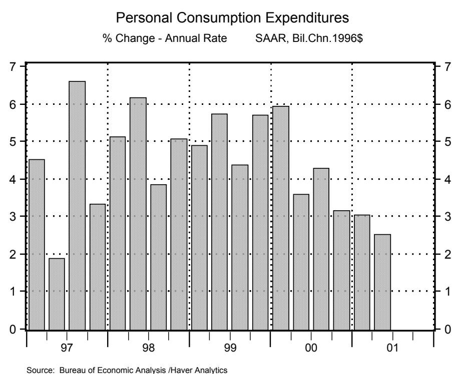
- The data indicate that this slowdown began in the second half of 2000.

- 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.

- The second quarter of GDP gain was the smallest gain in a number of years.

Consumption

Recent Consumption Growth



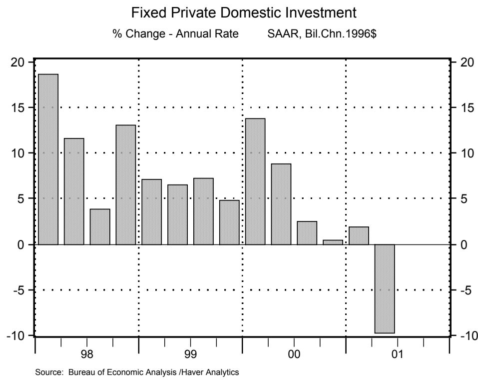
- Quarterly real consumption growth has been a leading sector throughout most of the expansion; its growth has generally exceeded that of GDP.
- Recently, however, real consumption growth has slowed along with GDP. But consumption growth has held up better than some had expected. Auto sales and purchases related to the housing market have helped keep consumption up and the overall economy in positive territory.
- But consumer confidence (not shown), which had stabilized somewhat in the summer, recently has deteriorated.

Recent Retail Sales

- Recent consumer activity can also be observed in more timely monthly retail sales data. The recent slowdown of retail sales growth underscores the reality of the slowdown. Recently, the slowdown in retail sales has moderated a bit. (The chart shows year-over-year data.)

Investment

Fixed Private Investment Growth



- The investment component of real GDP has also been a leading sector in this expansion; it often has grown at rates exceeding GDP growth during much of this expansion.

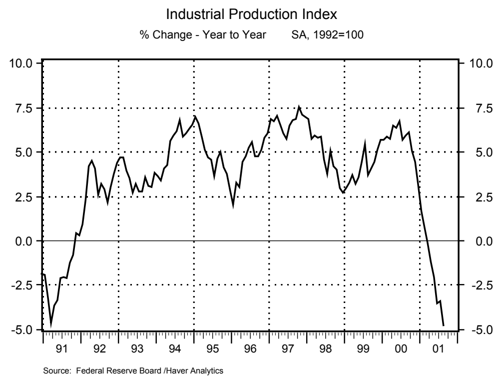
- Recently, however, investment growth has slowed dramatically since mid 2000. Investment now is one of the weakest sectors of the economy. For example, fixed private domestic investment growth in the second quarter fell sharply from low growth rates registered after mid 2000 (see chart). The equipment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

- A continued earnings slowdown, lower capacity utilization, and an increased cost of capital also portend continued investment weakness. Further, as the economy slows, there are increasing risks of additional diminished investment growth.

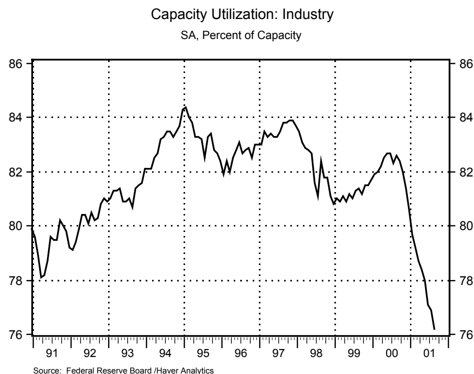
New Orders for Capital Goods

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

The Manufacturing Sector

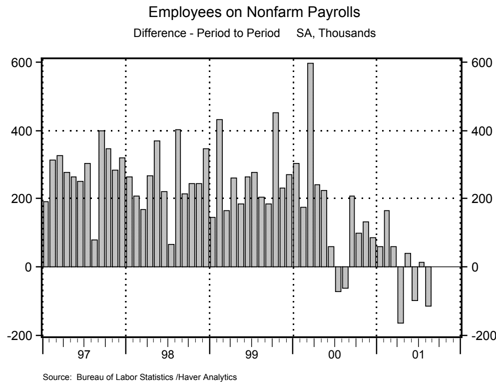


- The manufacturing sector has been weak for some time.
- The year-over-year change in industrial production has slowed dramatically in recent months (see chart). These year-over-year figures are the weakest since the recession in the early 1990s.
- The National Association of Purchasing Managers Index (not shown) weakened through most of 2000. It has improved somewhat since earlier in the year and especially in August.



- Capacity utilization of industry has fallen since mid 2000 and remains near its lowest levels since the early 1990s (see chart). This means there is plenty of idle capacity in industry.
- Manufacturing employment has actually decreased for an extended period and the manufacturing workweek has fallen to lower levels.

V. The Labor Market



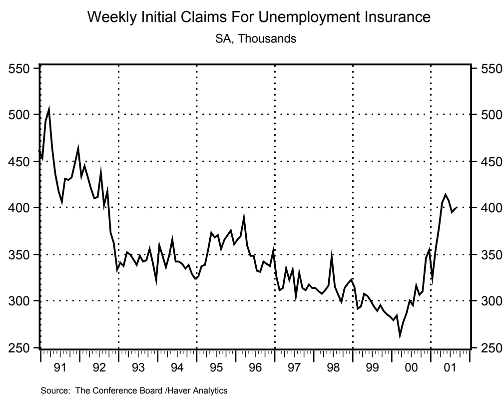
- This chart shows the monthly gains in total employment on non-farm payrolls in recent years.
- Employment gains were relatively strong in the period before mid-year 2000. More recent gains since mid 2000, however, have on average slowed dramatically to a fraction of those reported earlier.
- Gains in total non-farm payrolls, for example, averaged about 255,000 per month for the 2½ years prior to mid-2000 and only about 26,000 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.

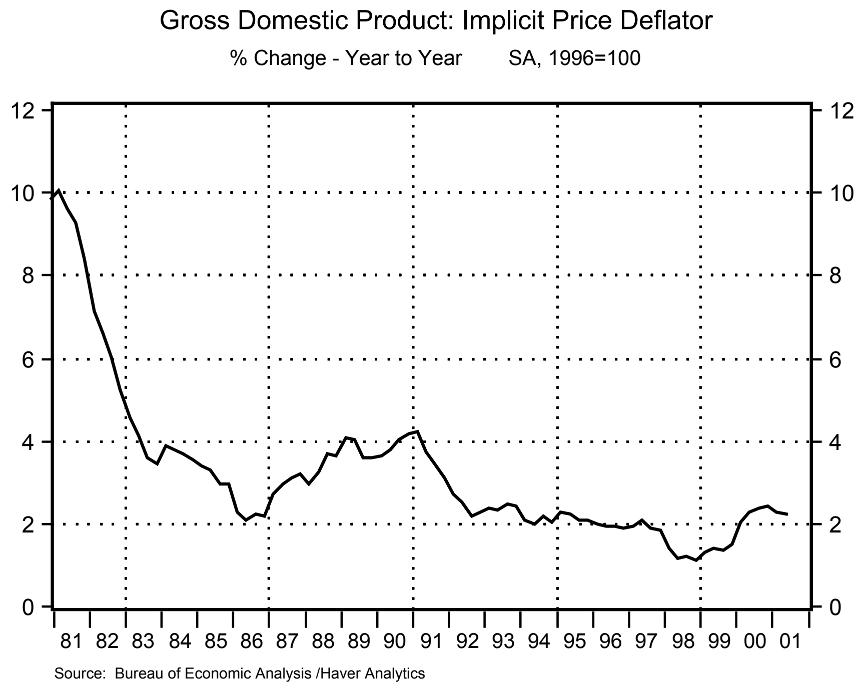
Unemployment

- The unemployment rate has trended down in recent years and despite increasing measurably in recent months, remains low historically.
- The August unemployment rate was 4.9 percent.
- Unemployment, however, is a lagging economic indicator. There are signs that the labor market is beginning to cool, portending an increase in the unemployment rate.



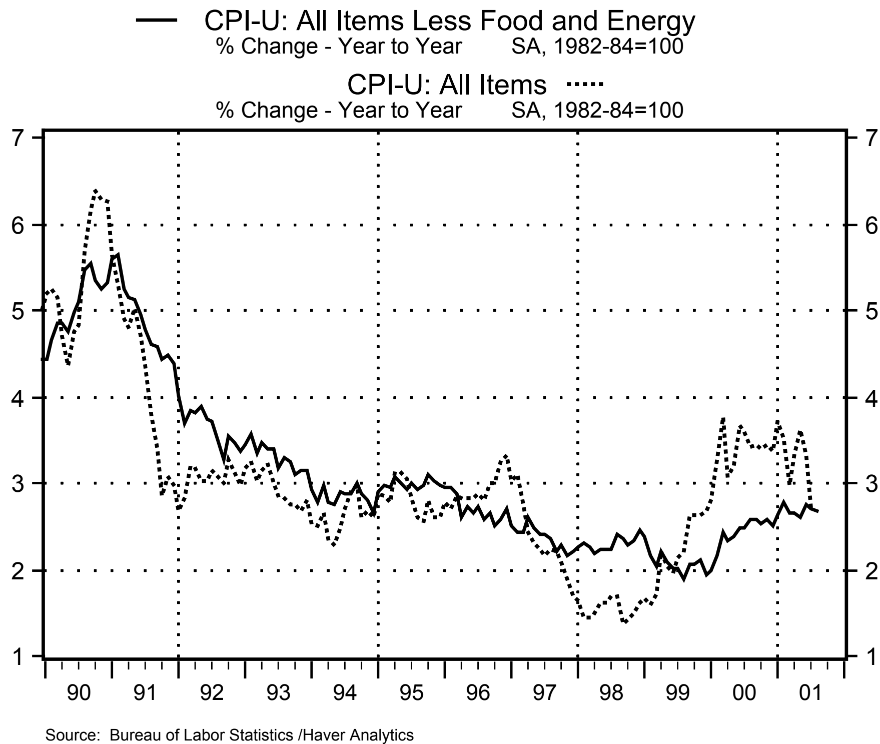
- In addition to slowing employment growth, initial claims for unemployment generally have increased in recent weeks, suggesting an increase in future unemployment.
- Additionally, the number of hours worked has fallen (not shown), and help-wanted advertising has fallen which often occurs before layoffs increase.
- Furthermore, anecdotal information about job layoffs suggests future boosts to the unemployment rate.

VI. Inflation Measures



- This chart shows the broad GDP deflator, on a year-over-year basis, over a long time frame.

- 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.

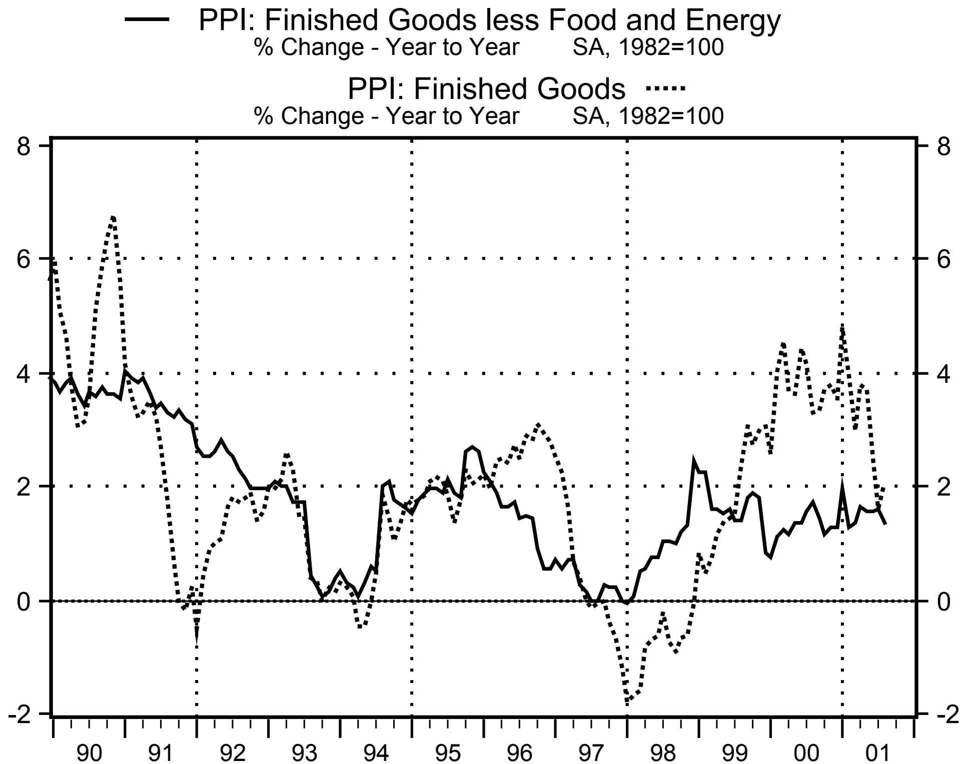


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last ten years on a year-over-year basis.

- Increases in energy prices caused the total CPI to increase in past months. But recently, as energy prices have retreated, total CPI gains have fallen.

- 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 August indicate core CPI advanced at a 2.7 percent year-over-year rate.

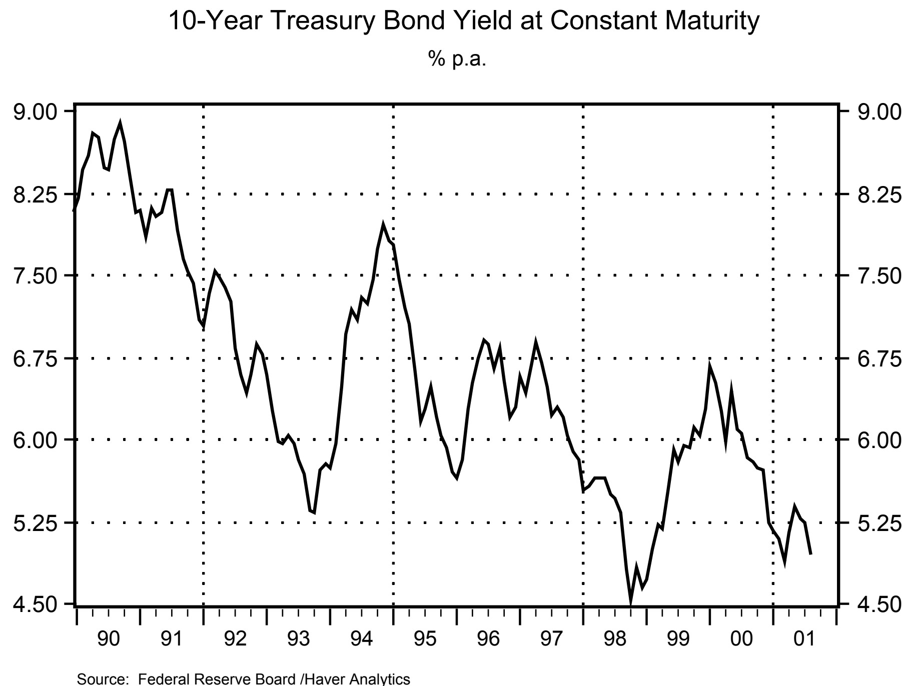


- This graph shows producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- Energy price increases boosted the total PPI figure in 1999 and 2000. Recently, energy prices have retreated, bringing down this total (year-over-year) PPI figure to about 2 percent. If the volatile food and energy price components are removed, the resulting "core" remains below 2 percent. In fact, the "core" rate has trended down since early 1999 on a year-over-year basis.

- August data indicated that the total inflation figure remained about 2 percent and the "core" number edged down to 1.35 percent on a year-over-year basis. Core intermediate goods prices and core crude goods prices indicate that there is no inflation in the stage-of-processing "pipeline."

VII. <u>Forward-Looking Market Price Indicators</u>

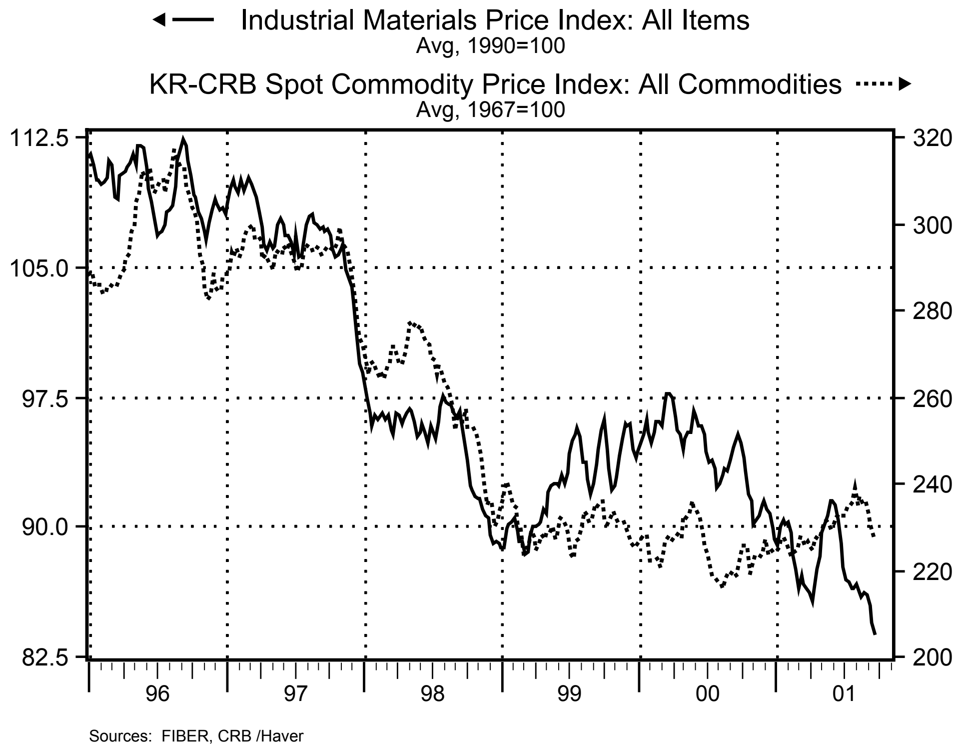


- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term Treasuries.

- Long-term interest rates have trended down for most of the past decade. In late 1998, however, long-term interest rates increased. This increase was partly related to market concerns about future Federal Reserve interest rate increases, but may also have been related to some increase in inflationary expectations.

- Since early 2000, however, 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 have fallen 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."

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 including energy prices. 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 does not include energy prices. 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.

- 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, despite falling some in recent weeks.

- 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 – suggest that a resurgence of inflation is not imminent, and suggest that Federal Reserve Monetary policy is not easy. These indicators leave 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 less input; to grow faster without inflation.