CURRENT ECONOMIC CONDITIONS AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Chairman Jim Saxton

Data as of September 13, 2002

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Economic Performance and Outlook[1]

· **Summary and Overview**

For the most part, macroeconomic activity continues to expand, albeit at a reduced, modest-to-moderate pace, slower than the typical post World War II recovery. Despite recent data revisions, the general pattern of key economic events during the period remains unchanged. In particular, the current economic advance follows the sharp mid-2000 slowdown, a mild recession beginning early in 2001, as well as the infamous terrorist events of September 2001. Several sectors (e.g., consumption and housing) consistently contribute to the economy's forward momentum, while other data (e.g., investment and employment) remain sluggish.

The current expansion has been importantly driven by the Federal Reserve's move to sharply lower interest rates during 2001, a moderation of energy prices during the same period, timely tax relief, and a continued lack of new inflationary pressures. While the expansion's near-term prospects remain favorable, a number of downside risks and uncertainties loom on the horizon and pose questions as to its long-run sustainability. Notably, equity markets continue to be extraordinarily weak and skittish, household and business debt loads remain burdensome, terrorist costs and risks remain, and uncertainties related to conflict in the Middle East and related oil price increases persist.

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

Recent GDP data revisions were significant. They altered the perceived character of the recent recession, but they did not change the fundamental pattern or interpretation of events surrounding the slowdown of mid-2000 or the recession of 2001. 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 set in motion a substantial economic slowdown beginning in mid-2000. Evidence that this economic slowdown definitely 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 other data series.

· **The Economic Expansion**

Currently, a number of economic indicators point toward economic expansion, suggesting the economic rebound is gradually taking root. While real GDP expanded at uneven rates of 5.0 and 1.1 percent in the first and second quarters, respectively, quarterly growth averaged about 3.0 percent at an annual rate for the first half as a whole. The consensus among economists has real GDP expanding at 2.7 and 2.9 percent in the third and fourth quarters, respectively. Consumption growth has consistently contributed to this expansion and has continued to hold up, along with retail and especially auto sales. The residential housing sector has also been a consistent contributor to the expansion. Recent evidence of some re-emerging strength in

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

manufacturing activity has also occurred. Specifically, advances in industrial production, capacity utilization, durable goods orders, and manufacturing activity as measured by ISM's purchasing manager's index all point to forward momentum.

On the other hand, continued weakness in investment and sluggishness in the labor market remind us that the economy is not yet "out of the woods". Further, persistent stock market weakness and associated declines in household wealth (or net worth) suggest that the expansion may not be as robust as other recoveries in the post World War II era.

- **<u>Causal Factors</u>**

Several factors contributed to bringing about the current economic expansion. The rebound is significantly related to the sharp 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 factor in supporting interest-rate sensitive sectors (such as housing and autos). But a significant energy price moderation, which also occurred during 2001, contributed to this outcome. Well-timed tax relief and the continued maintenance of price stability contributed to the expansion as well.

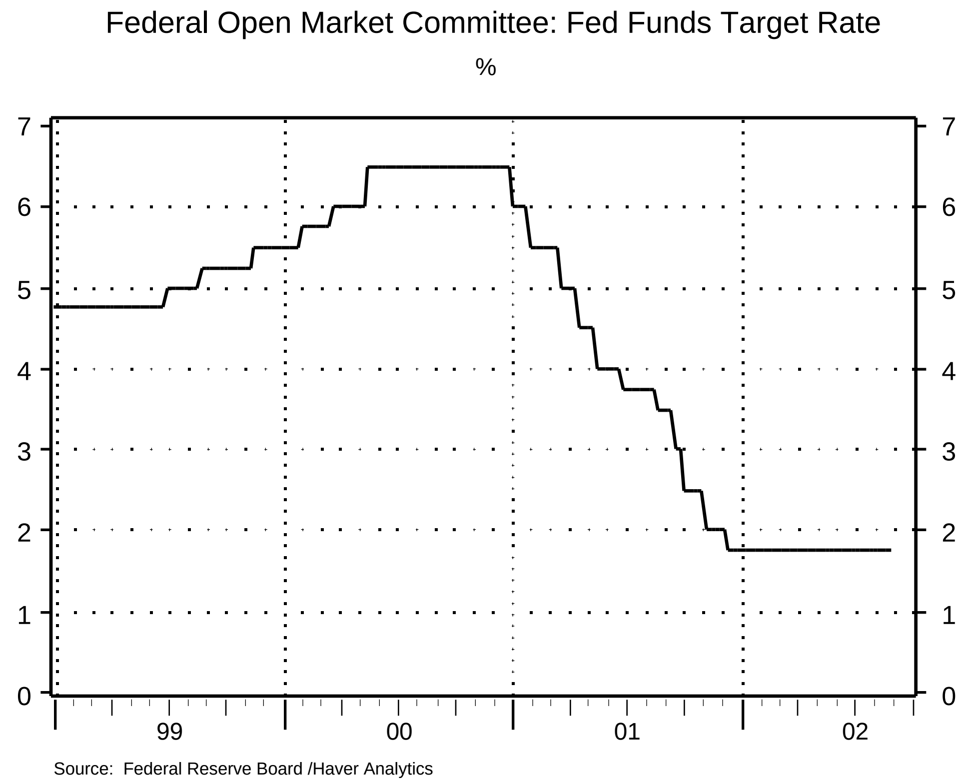
- **<u>Prospects, Risks, and Uncertainties</u>**

Prospects for a sustained economic expansion look favorable. Nonetheless, a realistic appraisal of the expansion must consider factors that could possibly slow its progress. Specifically, the economy remains vulnerable to a number of potential headwinds, risks, and uncertainties that could weigh on the recovery and affect growth over time. If there were continued stock market weakness and various ancillary effects of asset price deflation such as negative wealth effects, deteriorating consumer and business confidence, worsening debt burdens, or further cuts in capital spending (due to increases in the cost of capital), this could have negative impacts on consumption and investment and hence on future expansion. More substantial than expected costs of terrorism weighing on the economy may have similar effects. And energy price increases associated with conflicts in the Middle East pose a genuine risk as well. Although these risks should be considered, most economists do not regard them as significant enough to undermine the expansion.

- **<u>Prices and Inflation</u>**

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 price indicators corroborate this view. Long-term interest rates continue to trend down to near 40-year lows. Commodity prices, less special factors, are off their lows. The dollar, after some mild depreciation, remains firm. In short, when assessed over time and in conjunction with one another, forward-looking market price indicators continue to suggest that an imminent and important resurgence of inflation is not in prospect.

I. Federal Reserve Monetary Policy



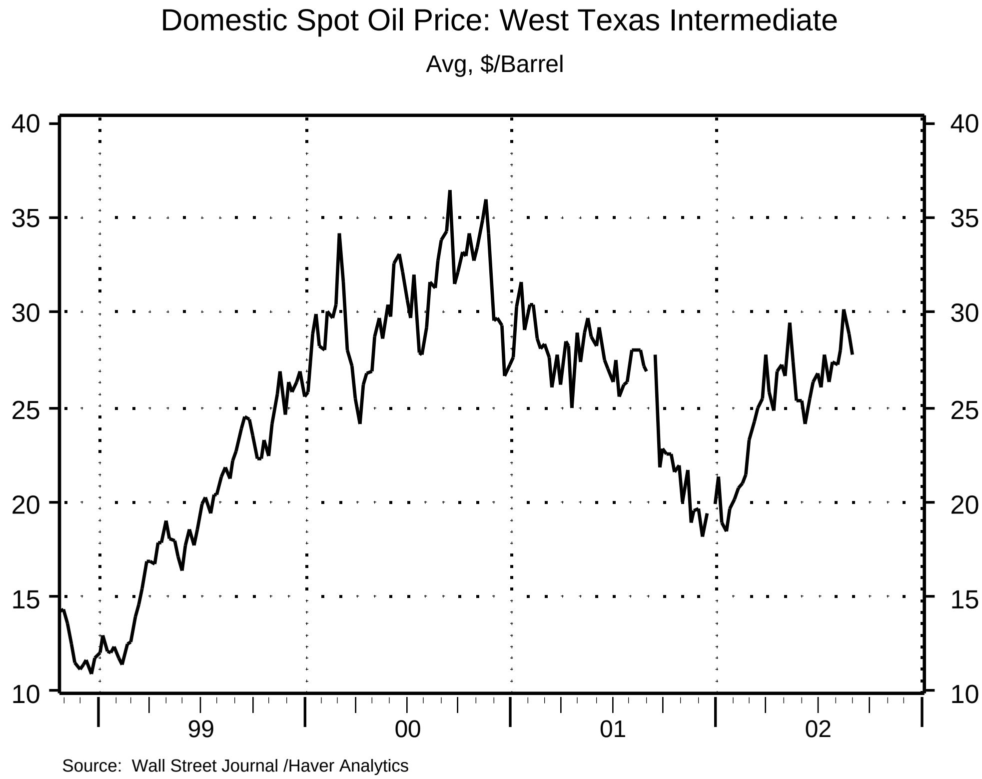
- Monetary policy has played a significant role in affecting the performance of the economy in recent years. This period has witnessed a notable reversal in the movements of short-term interest rates.

- 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 40 year low. Cuts made after the autumn 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. The Fed has maintained this low Fed funds rate since December 2001.

II. Energy Prices

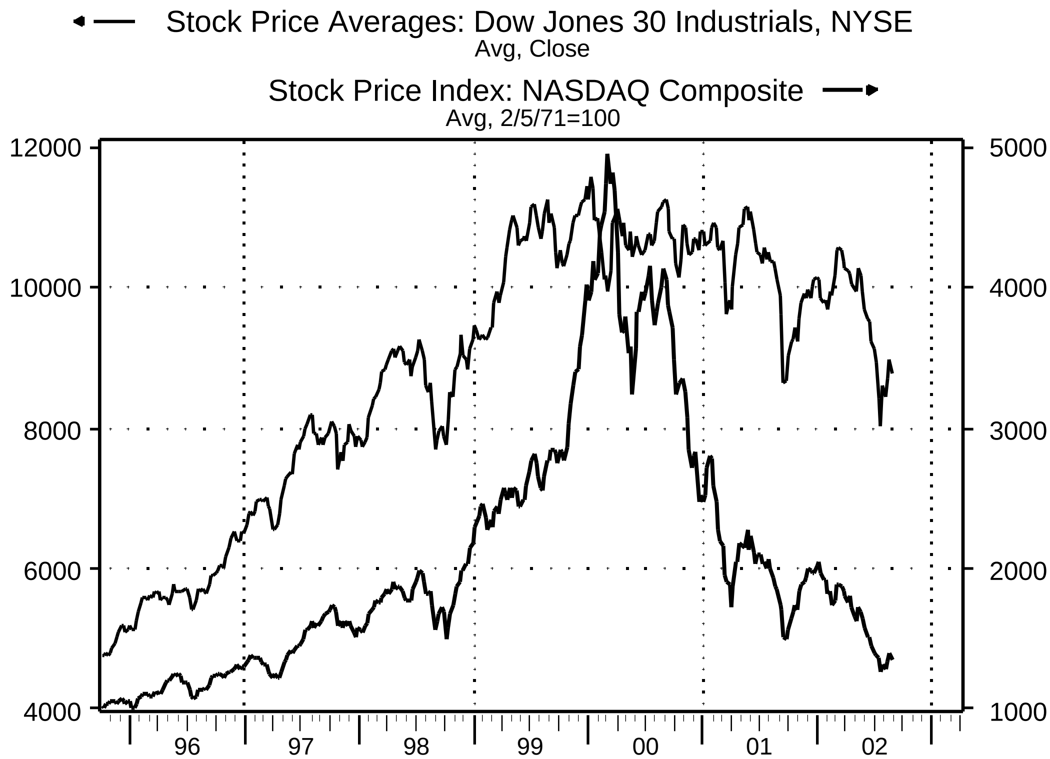


- Recent years have also witnessed significant movements in energy prices. Energy prices, for example, sharply increased in 1999 and through most of 2000. This sharp increase contributed to the economic slowdown, which began in mid-2000.

- 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. Recently, however, energy prices have increased again, posing a risk to a sustained recovery.

III. Stock Prices



Source: Wall Street Journal /Haver Analytics

- 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.

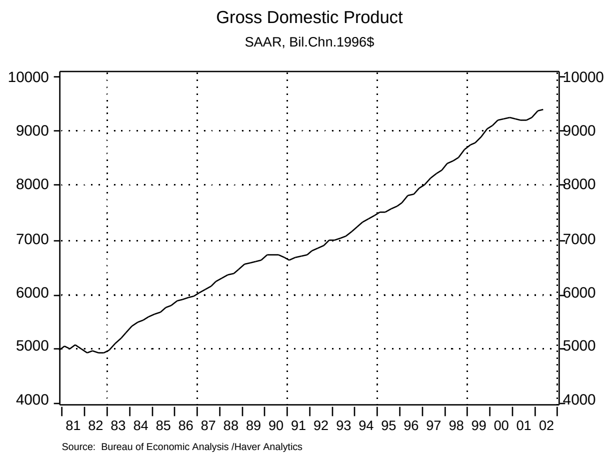
- This chart shows two well-known stock indices: the Dow Jones Industrial and the NASDAQ composite. The Dow Jones peaked in January 2000 and has trended down since then. The NASDAQ peaked in March 2000 and lost a good deal of value (and market capitalization) after that time.

- Many analysts argue that the stock market weakness may have important economic repercussions associated with asset price deflation. Such weakness raises the cost of capital, adversely impacting future investment. And the equity market's "wealth effect" that boosted consumption in earlier years could reverse itself, adversely impacting consumption as well as consumer confidence. 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, the stock market has fallen further and currently is well below its level at the start of the year. Additional weakness is a serious risk to the sustainability of the recovery.

IV. Output Measures
Gross Domestic Product

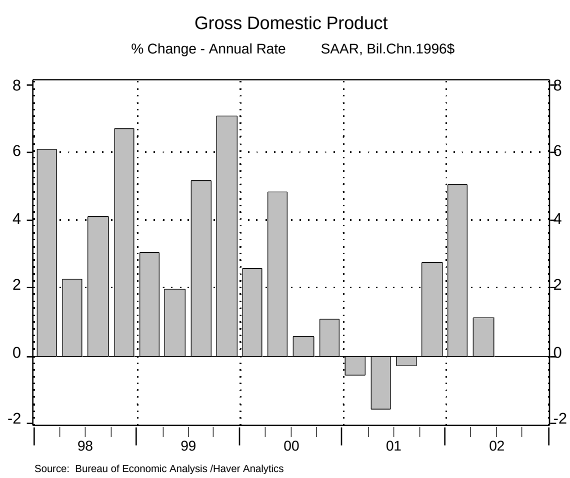
Long-Term GDP



- 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. The slowdown, of course, began months earlier, in mid-year 2000. 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 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



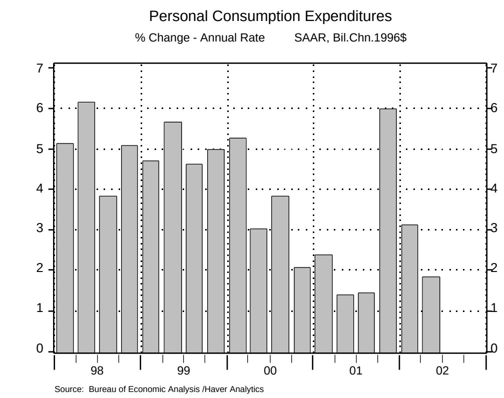
- Beginning in mid-2000, however, quarterly real GDP growth began to slow down significantly from growth rates previously recorded.

- Growth turned negative in the first quarter of 2001. Second and third quarter growth were also negative. Third quarter growth was related to the terrorist attack of September 11.

- But real GDP growth turned positive again in the fourth quarter of 2001 and in both the first and second quarters of 2002, when GDP registered annualized growth rates of 5.0 and 1.1 percent, respectively. The recession of 2001 was one of the mildest on record.

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. This slowdown continued until the third quarter, 2001. Despite this slowdown, 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 to hold up through the second quarter, 2002.

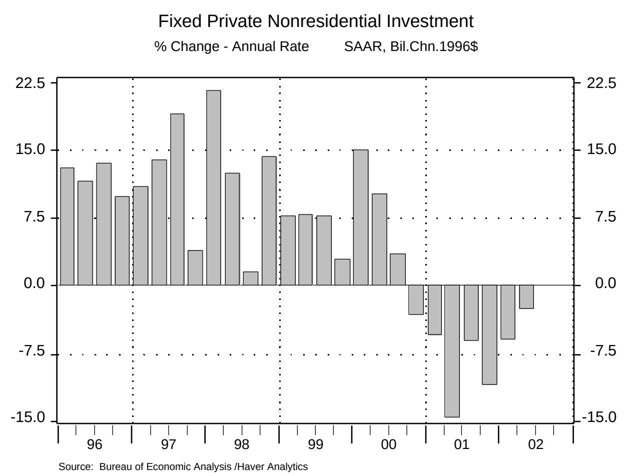
- Auto sales have contributed importantly to consumption growth in recent periods.

Recent Retail Sales

- Consumer activity can also be observed in more timely monthly retail sales data. After picking up in the fall of 2001, retail sales levels have held up better than many had expected. The underlying trend in sales has been sound.

Investment

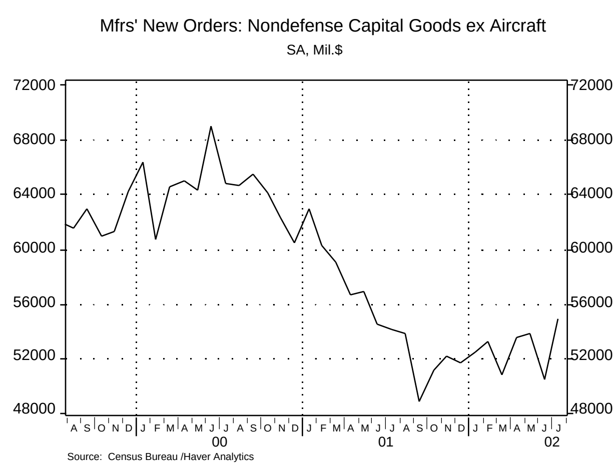
Fixed Private Non–Residential
Investment Growth



- 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.

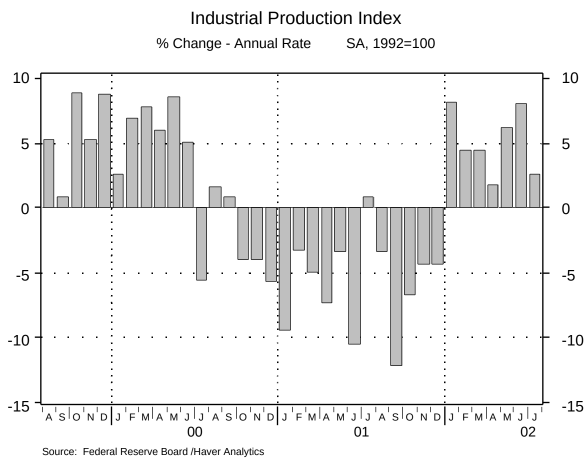
- Investment growth has slowed dramatically since mid-2000. Investment now is one of the weakest sectors of the economy. For example, private non-residential fixed investment growth fell sharply from low growth rates registered after mid-2000 (see chart). The structures component was especially weak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

New Orders for Capital Goods

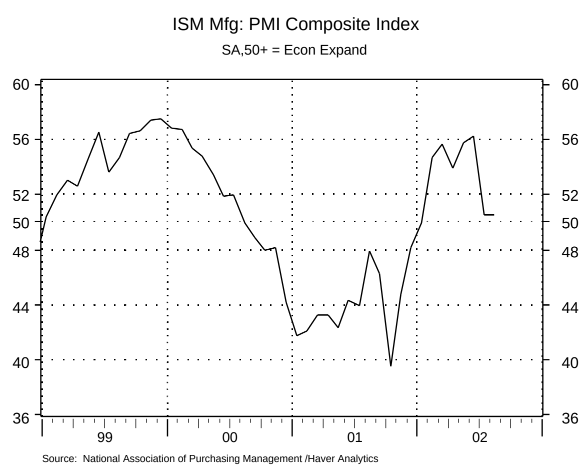


More timely information from monthly indicators that correlate with investment also provide useful insights. Manufacturers' new orders for non-defense capital goods (ex-aircraft), for example, have gradually improved after falling sharply from their peaks in mid-2000 until September, 2001.

The Manufacturing Sector

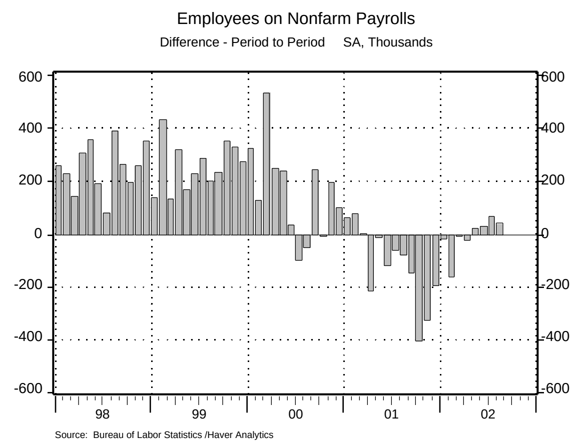


- The manufacturing sector has been weak for an extended period of time. The industrial production index, for example, peaked in June 2000.
- Changes in industrial production generally fell from mid-2000 until late 2001.
- Recently, however, industrial production has shown signs of life, registering smaller declines in the fourth quarter of 2001 and actual increases since January.



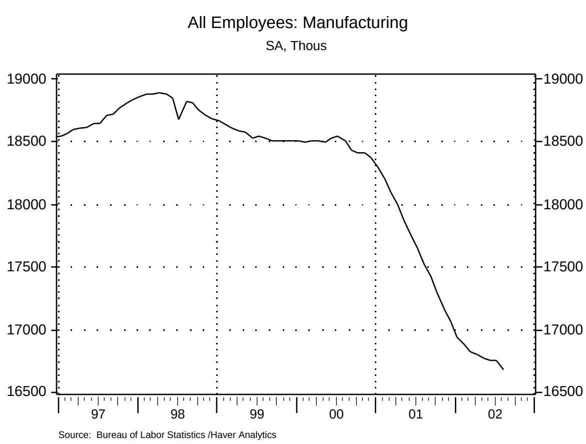
- The Institute for Supply Management's manufacturing diffusion index shows more improvement in manufacturing activity. According to this index, manufacturing activity has been improving for several months (figures above 50 denote expansion). This expansion followed contraction from mid-2000 until early 2002 (below 50 denotes contraction).
- Recently, manufacturing capacity utilization, and manufacturers' orders for durable goods (not shown) have increased as well.

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 <u>before</u> mid-year 2000. After mid-2000, however, employment gains on average slowed dramatically to a fraction of those reported earlier. In fact, most monthly changes in 2001 were declines.
- Most recently, however, employment has registered modest gains for several consecutive months.

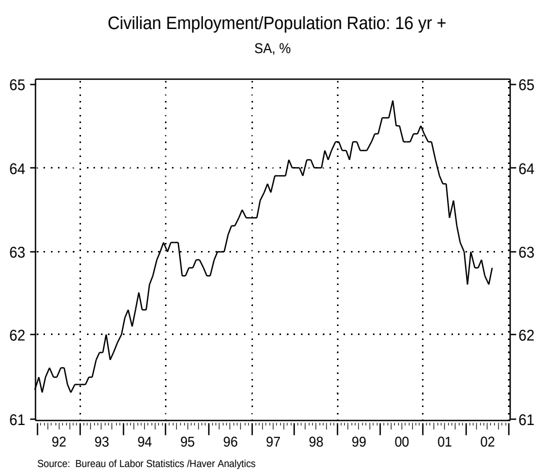
Manufacturing Employment



- 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, more than 1.8 million manufacturing jobs have been lost since July 2000.
- Recent losses, however, have generally been less severe than those registered earlier.

Unemployment

- After falling during the expansion, the unemployment rate trended up after October of 2000.
- Recently, the unemployment rate has lingered just below 6.0 percent. The August 2002 unemployment rate was 5.7 percent.



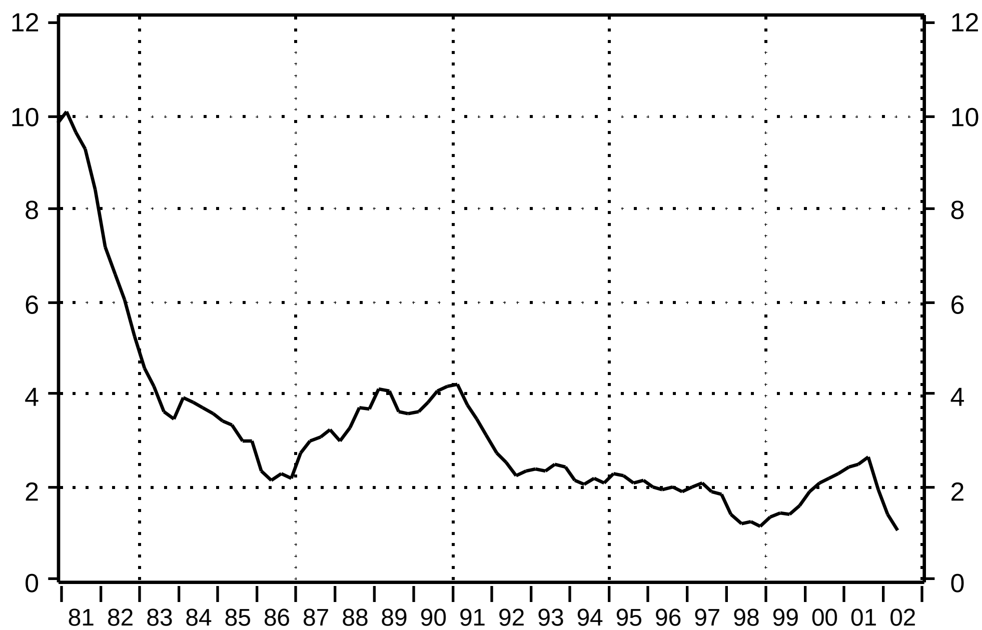
- Another important indicator of the state of the labor market is the employment–to–population ratio. This ratio indicates the percentage of the population with jobs. The ratio increased for much of the expansion.
- In April of 2000, the ratio peaked and thereafter began to trend downward.

This ratio is often inversely related to the unemployment rate.

VI. <u>Inflation Measures</u>

Gross Domestic Product: Implicit Price Deflator

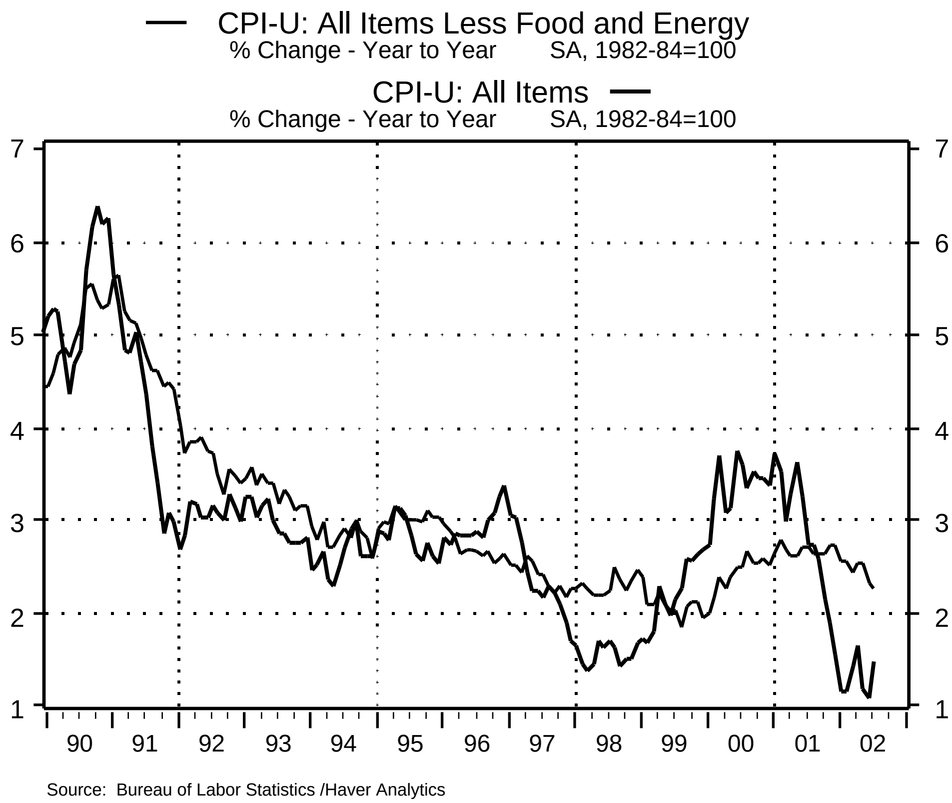
% Change - Year to Year SA, 1996=100



Source: Bureau of Economic Analysis /Haver Analytics

- 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 at this time.

According to this measure, inflation remains relatively subdued despite a recent increase and a subsequent decline (related in part to energy price movements). Furthermore, inflation is generally forecasted to remain stable.

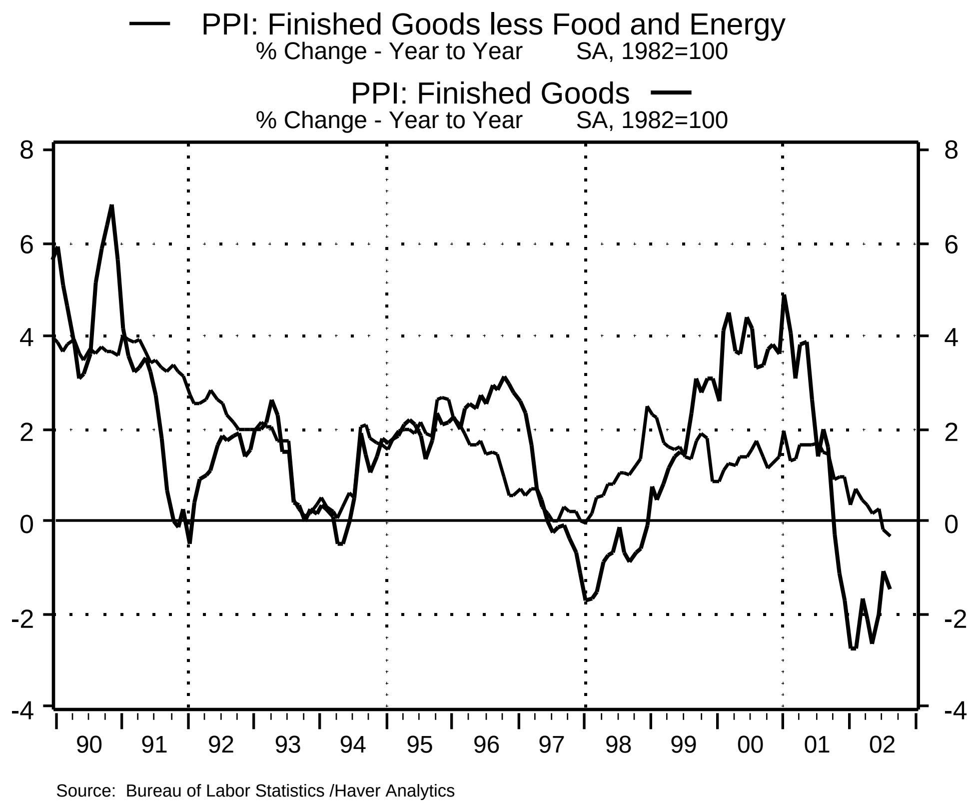


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last decade on a year-over-year basis.

- 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.

- Figures for July indicate core CPI advanced at a 2.3 percent year-over-year rate.

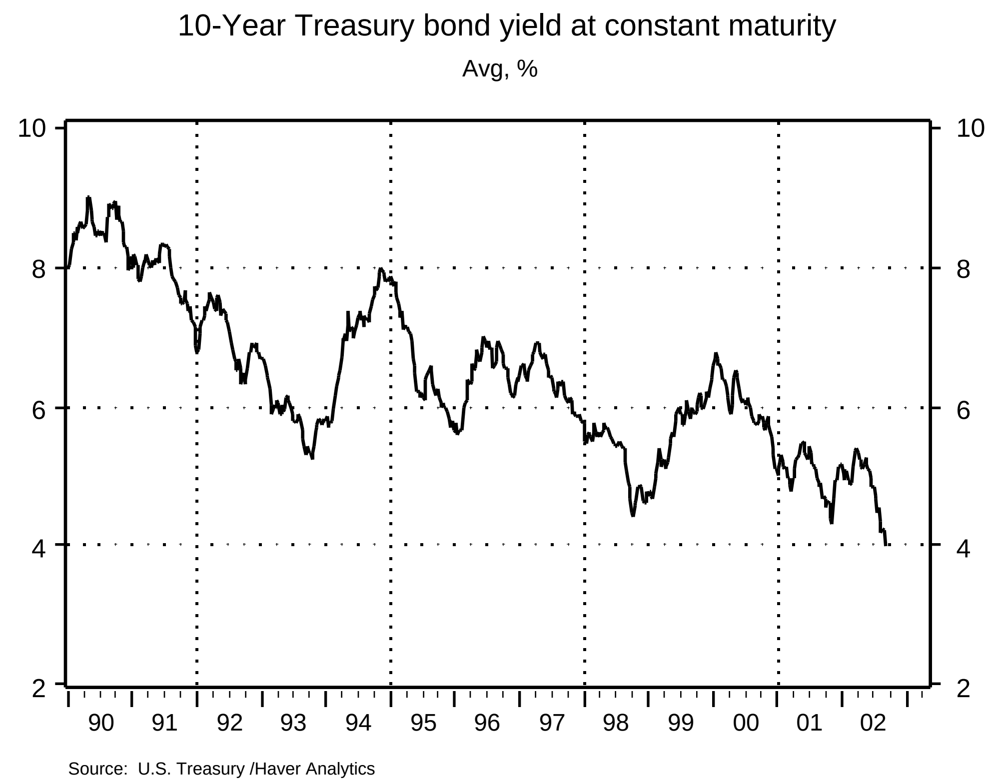


- This graph shows finished good producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown over the last decade on a year-over-year basis.

- Energy price increases boosted the total PPI figure in 1999 and 2000. Energy prices retreated in 2001, however, bringing down the 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. Both the total and core rates are currently registering negative values (on a year-over-year basis).

VII. Forward-Looking Market Price Indicators



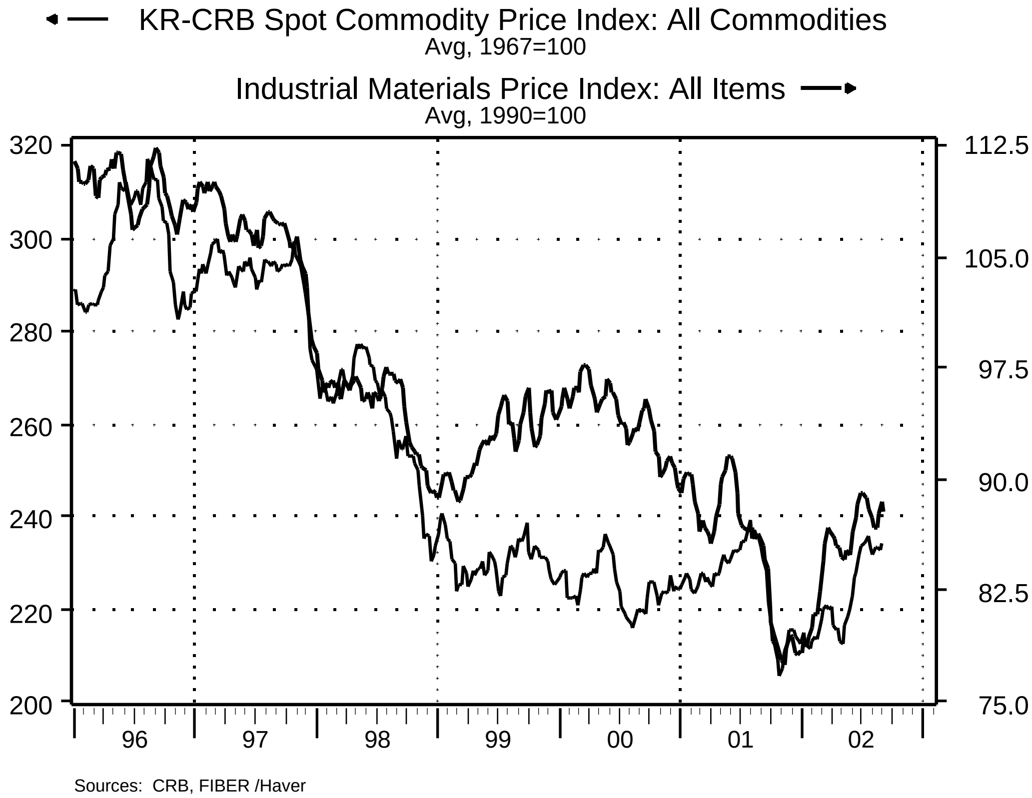
- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.

- Long-term interest rates generally have trended down for most of the past decade as inflation has diminished, and remain near 40-year lows.

- 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 in 2001, long-term Treasuries remained relatively contained, producing a positively sloped "yield spread."

Recent declines largely reflect perceptions of a weaker-than-expected economy, lower inflationary expectations, and shifting chances of a monetary policy ease. Notice these long-term rates have <u>declined</u> in the face of projections of <u>larger</u> federal budget deficits.

Commodity Prices

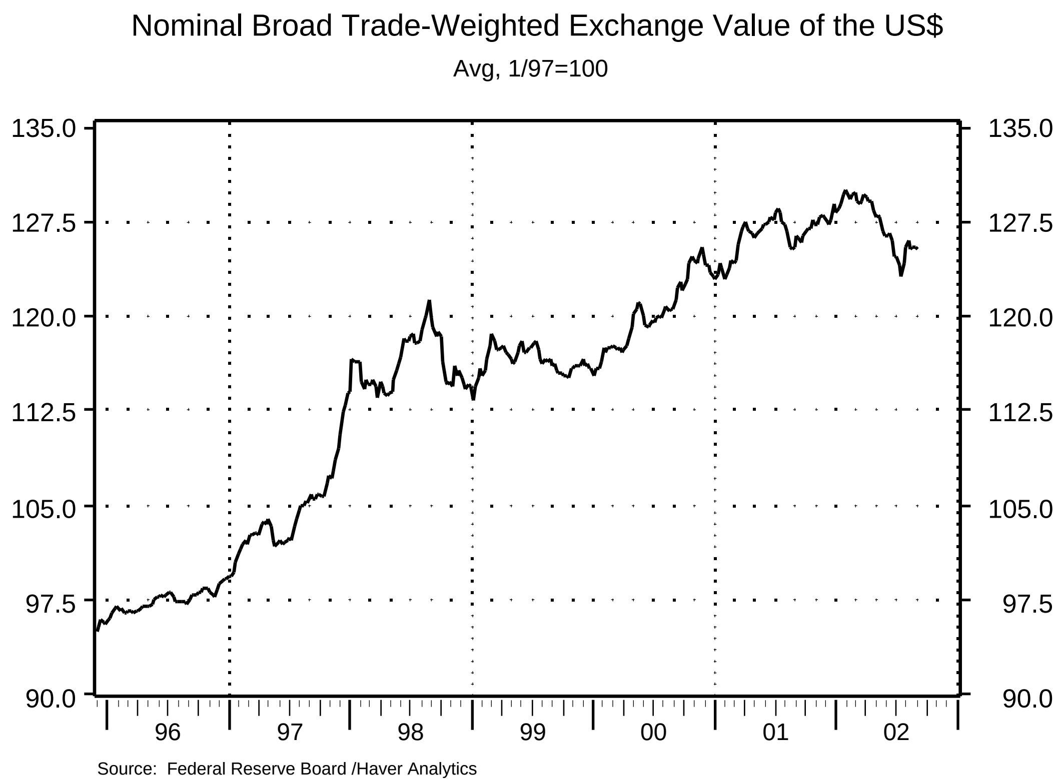


- This chart shows two commonly used broad commodity price indices — the Knight-Ridder-Commodity Research Bureau (CRB) spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.

- 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 important 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 1996-2000 period, and, despite some recent depreciation, remains at a firm level relative to its value in recent years.

- Despite some depreciation of late, 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.