JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #109-1
February 15, 2005

Economic Perspectives: February 2005

Key economic information, critical in assessing the overall economic outlook, was released by government agencies in recent days. Specifically, the Commerce Department's Bureau of Economic Analysis released the "advance" fourth quarter real GDP number, the Labor Department's Bureau of Labor Statistics reported on labor market conditions in its January Employment Report, and the Federal Reserve reported on the monetary policy decisions made at its February FOMC meeting.

Real GDP

As indicated in the accompanying chart, after an inevitable period of adjustment to the "bursting of the stock market bubble," the U.S. economy has entered its fourth year of an expansion in which investment and housing made particularly strong contributions. The mid-2003 acceleration of real GDP growth (observable in the chart) followed the Bush 2003 tax cut. Real GDP growth during 2004 approached 4.5%, and while fourth quarter growth was 3.1 percent, it is expected to be revised upward next month. Consensus forecasts project solid economic growth over the next two years. Continued investment strength, low inventory-sales ratios, household wealth gains, persistent strong productivity advances, low interest rates and low inflation, all auger well for further sustained economic growth. Barring any policy mistakes, then, the current expansion should sustain itself through 2005 and beyond.

Real Gross Domestic Product
% Change - Annual Rate; SAAR, Bil.Chn.2000$

Source: Bureau of Economic Analysis/Haver Analytics/ *Blue Chip Consensus

The Employment Situation

Non-farm payrolls advanced 146,000 in January, and have now increased 20 months in a row. The number of non-farm payroll jobs created since August, 2003 now is at 2.7 million and these payrolls now stand at historic highs. The January private non-farm payroll diffusion index increased and this index has been expanding (above 50) for 14 months.

Service-providing job growth contributed significantly to January's advance. Overall, consensus forecasts predict that total payrolls will advance by about 190,000 per month through 2005.

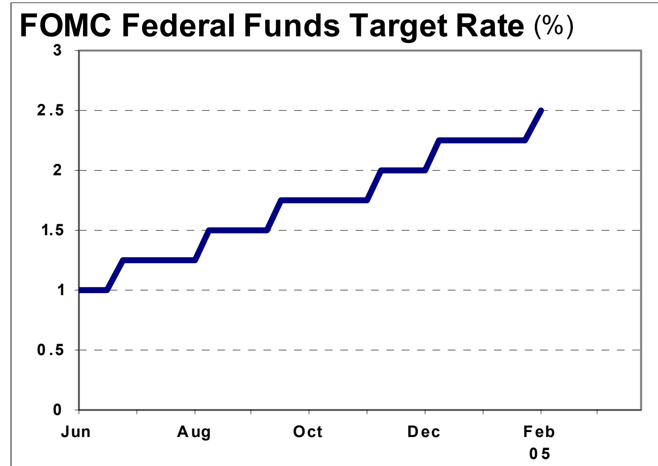
Furthermore, studies have shown that U.S. productivity growth has proven to be resilient; i.e., it has continued to advance at healthy annual rates despite repeated negative shocks.

Employees on Nonfarm Payrolls
Difference - Period to Period; SA, Thousands

The **unemployment rate** fell from 5.4% to 5.2%, in January. At 5.2%, the unemployment rate remains lower than the rate at comparable stages of earlier business cycles. In fact, the rate of unemployment is lower than the average unemployment rate during the decades of the 70's, the 80's and the 90's. In addition, unemployment rate is expected to gradually drift down through 2005.

Monetary Policy

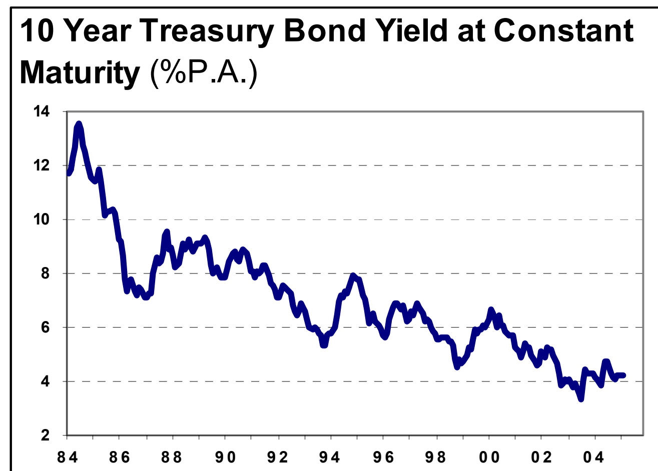
Public documents issued by the Federal Reserve reveals that the Federal Open Market Committee (FOMC) believes the current stance of monetary policy is "accommodative" or "too easy." This, they believe, together with persistent robust productivity growth is providing significant support to the U.S. economy. Given that inflationary expectations remain contained, recent FOMC strategy translates into a position of gradually removing the existing over-accommodative stance by slowly increasing the fed funds rate in small, 25 basis point increments until a "neutral" position is attained whereby monetary policy is neither too "easy" nor too "tight."



FOMC documents have been quite specific in indicating that tightening movements will take place in a "measured," incremental fashion (i.e., in 25 basis point increments). In this way, the Federal Reserve has come to "manage" market expectations of Fed policy moves such that no surprises occur (since Fed moves match those expectations already built into the market). As the accompanying chart shows, for example, all six moves of the fed funds rate since June, 2004, have been 25 basis point moves immediately following scheduled FOMC meeting. That is, both the timing and the magnitude of these policy changes have been well publicized and built into the market. Accordingly, monetary policy has been more transparent, relative to earlier experiences.

Long-term Interest Rates

Another unusual characteristic of the current recovery is persistent low long-term interest rates (which have helped interest–sensitive sectors, like housing). Indeed, long-term interest rates have remained low despite the recovery, sizeable budget deficits, various shocks to the economy, and six hikes of Fed controlled short-term interest rates. The current level of the long-term rate is lower than when the government was experiencing budget surpluses and lower than when the Federal Reserve began raising short-term rates in June, 2004. The behavior of the long-term rate together with Fed-induced increases in short-rates implies that the yield spread has narrowed significantly and policy is less stimulative.



A number of explanations have been offered to explain these long-term rates. The fact that inflation and inflationary expectations have remained relatively low is clearly one explanatory factor. But long-term changes in Federal Reserve behavior is another explanation. Indeed, the Federal Reserve (and other central banks) have gained a good deal of credibility with regard to controlling inflation. As a consequence of this enhanced credibility, long-term interest rates are not as affected by movements in variables such as oil price increases or rising fiscal deficits. This enhanced credibility, therefore, works to calm and stabilize long-term interest rates.