CURRENT ECONOMIC CONDITIONS AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Congressman Jim Saxton

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CONTENTS

Economic Performance and Outlook[1]

- **Summary and Overview**

In recent years, the economy has displayed a remarkable degree of resilience. A dramatic economic slowdown, evident in a variety of economic data, began in mid 2000 and evolved into a mild recession in early 2001. Beset by the disruptions of 9/11, oil price increases, stock price declines, accounting scandals, and war preparations, the economy emerged from this mild recession and advanced (on average) at more than a 3 percent annual rate for four quarters before slowing in the last quarter of 2002. Several sectors (e.g., consumption and housing) consistently contributed to the economy's forward momentum, while others (e.g., investment, employment, and manufacturing) remained sluggish.

The current expansion has been importantly fueled by the Federal Reserve's move to sharply lower interest rates, timely tax relief, and a continued lack of new inflationary pressures.

While continuing to expand, however, the recovery has been halting and sluggish. Growth remains below both its potential and average growth experienced during earlier expansions; the economy is underperforming and seems to have not fully shaken off the effects of sharp ("bubble bursting") stock price declines. Further, a number of substantial downside risks and uncertainties loom on the horizon. Notably, equity markets remain sluggish, household and business debt loads remain burdensome, terrorist costs and risks remain and may prove more substantial than expected. In addition, uncertainties related to conflict in the Middle East and related oil price increases persist.

The Historical Record: Slower growth began in mid-2000

The fundamental pattern of events surrounding the slowdown of mid-2000 and recession of 2001 remain unchanged and serve as background for discussions of current economic circumstances. 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 helped set in motion a substantial economic slowdown beginning in mid-2000. Evidence that this economic slowdown 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 Current Economic Expansion

Recent data indicate that while the economy expanded at better than 3 percent on average for several quarters, 2002's fourth quarter growth was quite weak, at 0.7 percent. This slow pace is corroborated by disappointing end-of-year sales, declines in consumer confidence, and recent sluggishness in employment and production. Further, investment and the manufacturing sector remain sluggish, the international economy is weak, wealth losses have been substantial in recent years, stock market gains remain disappointing, and state and local governments are likely to raise taxes in the near-term. Despite this weakness, however, chances of a "double-dip" slowdown appear remote at this time. Consensus forecasts have the economy picking up in the second quarter and throughout 2003; certainly, there are a number of reasons to be optimistic. For example, consumption continues to expand, housing sales remain at elevated levels, incomes continue to advance, the service sector continues to improve, inflation and interest rates remain

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

low, and for the most part productivity gains remain robust. Overall, then, a mixed interpretation of the economy remains appropriate.

Causal Factors

Several factors contributed to bringing about the current economic expansion. The rebound is significantly related to the sharp Fed funds interest rate reduction from 6.5 percent to 1.25 percent undertaken by the Federal Reserve. This substantial rate reduction clearly was a most important factor in supporting interest-rate sensitive sectors (such as housing and autos). But an earlier significant energy price moderation, which occurred during 2001, also contributed to this outcome. Well-timed tax relief and the continued maintenance of price stability contributed to the expansion as well.

Prospects, Risks, and Uncertainties

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 further 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), negative impacts on consumption and investment and hence on future expansion could occur. 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 likely to undermine the expansion.

Prices and Inflation

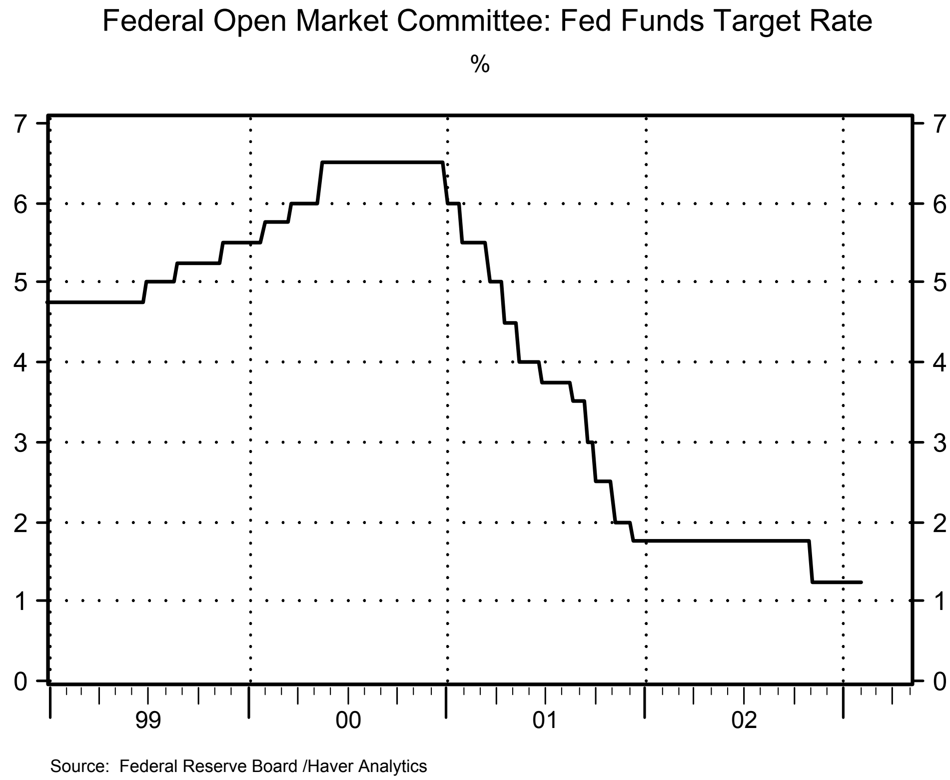
Broad measures of core inflation continue to indicate that inflation or expectations of inflation are not important problems at this time. Most forecasters are projecting a continuation of low rates of inflation. Forward-looking market price indicators corroborate this view. Long-term interest rates continue to fluctuate near 40-year lows. Commodity prices are off their lows but their levels remain below levels of a few years ago. The dollar has depreciated somewhat, especially against major currencies. 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 but that deflationary pressures have dissipated.

Policy Implications

In sum, several downside risks and headwinds face the economy. And a number of more deep-seated, fundamental problems exist as well. Although some believe that once the current cloud of uncertainty surrounding the Iraqi situation is lifted economic performance will quickly normalize, there are a number of reasons why such a prompt bounce back may not occur.

A sluggish, halting recovery, persistent low inflation, together with several downside risks suggest that some timely macroeconomic policy stimulus involving both monetary and fiscal (tax reduction) policy is in order. In the very short-run, monetary policy is well suited to stimulating demand. Despite current low interest rates, it is well established that the Federal Reserve will have no problem adopting an easier policy stance. A pro-growth tax reduction stimulus package would also be appropriate.

I. Federal Reserve Monetary Policy

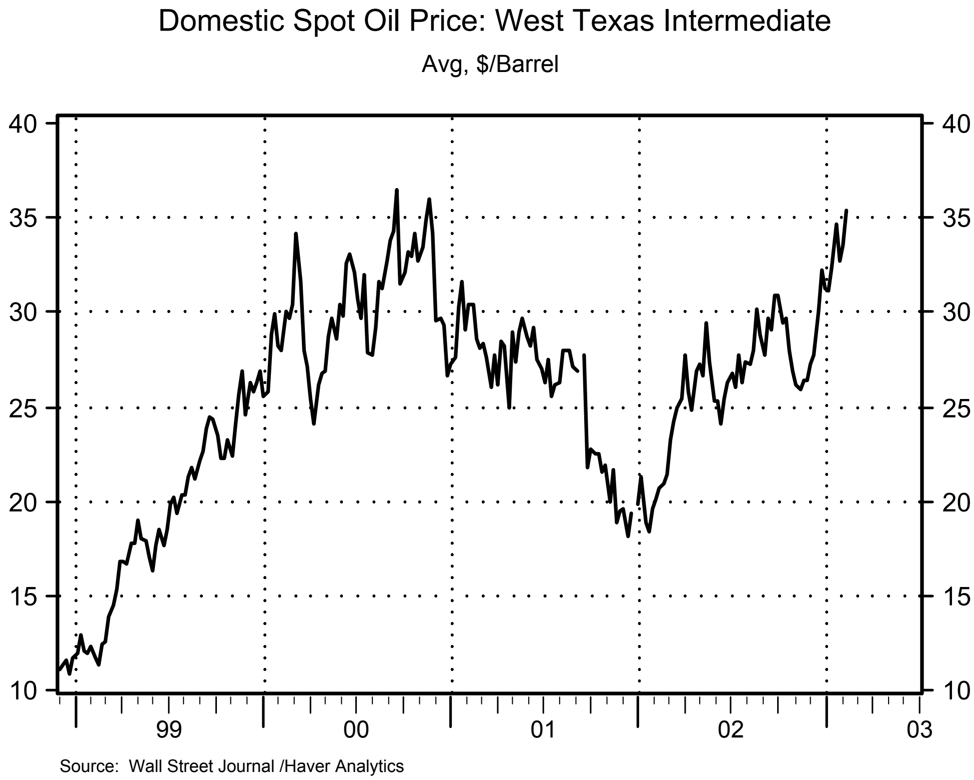


- Monetary policy has played a significant role in affecting the performance of the economy in recent years. This period has witnessed a notable reversal in the movements of short-term interest rates.

- The Federal Reserve raised interest rates 175 basis points from June 1999 to May 2000, putting the Fed funds rate at 6.5 percent. With a lag, this restrictive monetary policy affected financial markets and some interest-sensitive sectors of the economy such as certain categories of durable consumption and investment.

- The Federal Reserve subsequently lowered short-term interest rates 525 basis points beginning in January 2001, putting the Fed funds rate at 1.25 percent and a 40-year low by November 2002. This easing of monetary policy is a key reason for the economic turnaround we are currently witnessing. Contrary to some popular opinion, the Fed still has the ability to pursue an easier monetary policy stance despite low levels of interest rates.

II. Energy Prices

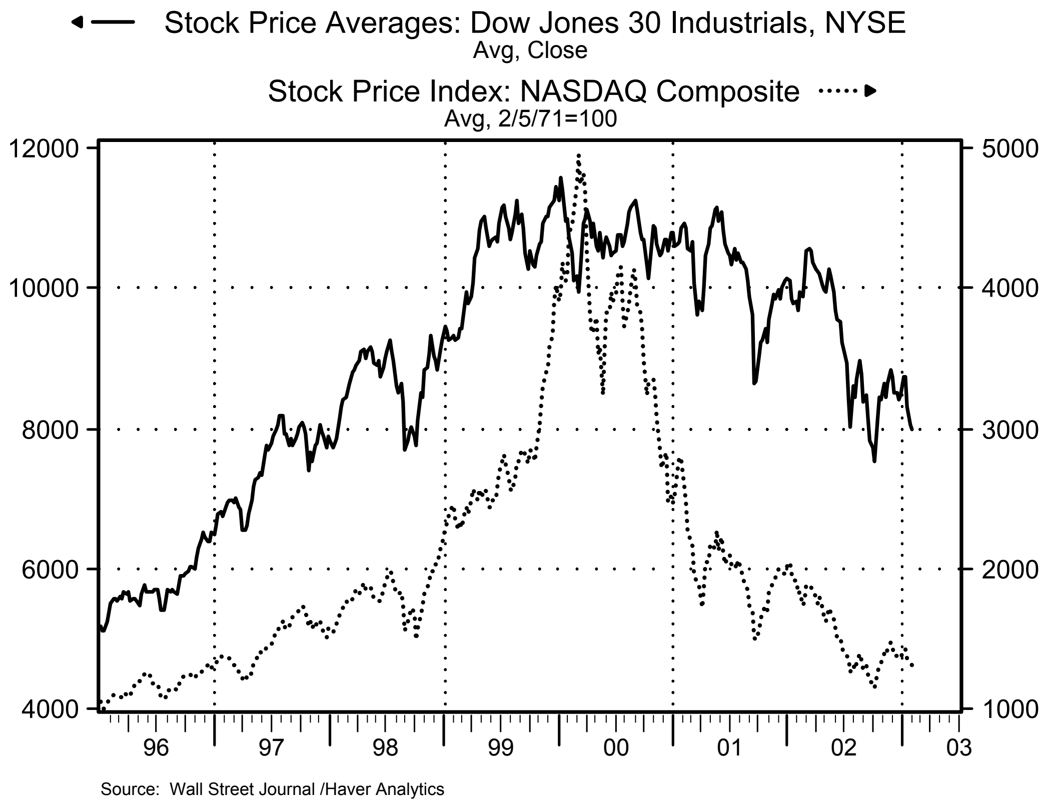


- Recent years have also witnessed significant movements in energy prices. Energy prices, for example, sharply increased in 1999 and through most of 2000. This sharp increase contributed to the economic slowdown, which began in mid-2000.

- 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. Part of this recent increase reflects expectations of conflict in the Middle East and consequent effects on oil supplies. Political disturbances in Venezuela have also had an effect. Higher oil prices pose a serious risk to the near-term economic outlook.

III. Stock Prices



- 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. Both of these indices remain weak; there is little sign of a sustained turnaround.

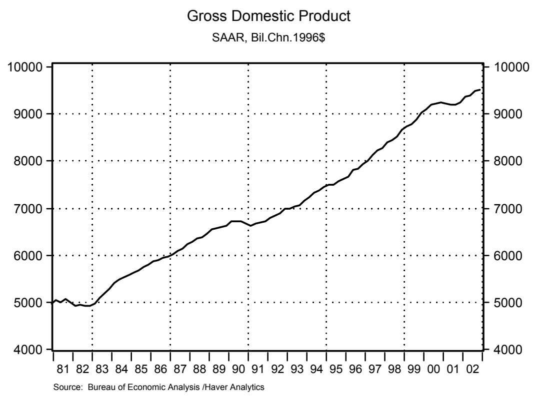
- Many analysts argue that stock market weakness may have important economic repercussions associated with asset price deflation. Such weakness raises the cost of capital, adversely impacting future investment. And the equity market's "wealth effect" that boosted consumption in earlier years could reverse 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, stock market sluggishness has continued. Additional weakness is a serious risk to the sustainability of the recovery.

IV. Output Measures

Gross Domestic Product

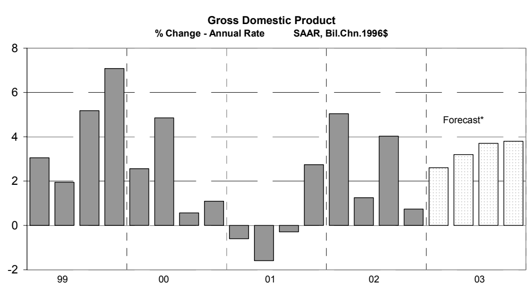
Long-Term GDP



- 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



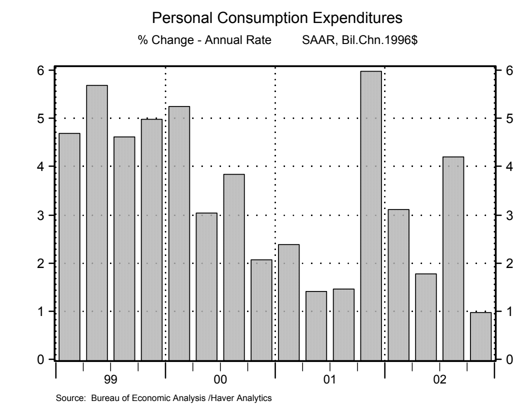
- Beginning in mid-2000, however, quarterly real GDP growth began to slow down significantly from growth rates previously recorded.

- Growth turned negative in the first quarter of 2001. Second and third quarter growth were also negative. The recession of 2001 was one of the mildest on record.

- But real GDP growth turned positive again in the fourth quarter of 2001. Growth averaged better than 3 percent for several quarters, before slowing to a 0.7 percent rate in the fourth quarter. Consensus forecasts are for continued improvement through 2003.

Consumption

Consumption Growth

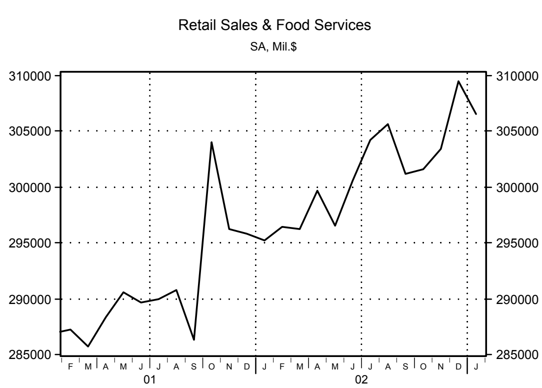


- Consumption has been a sector consistently supporting the economy in recent years. This is depicted in the accompanying quarterly real consumption growth chart.

- 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 and subsequent quarters.

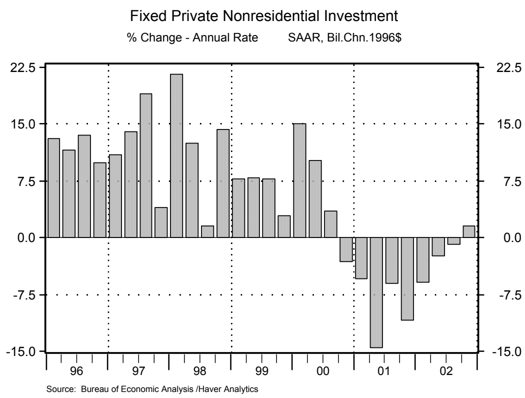
Recent Retail Sales



- 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. Despite disappointing end-of-year sales, the underlying upward trend in sales has been sustained.

Investment

Fixed Private Non–Residential Investment Growth

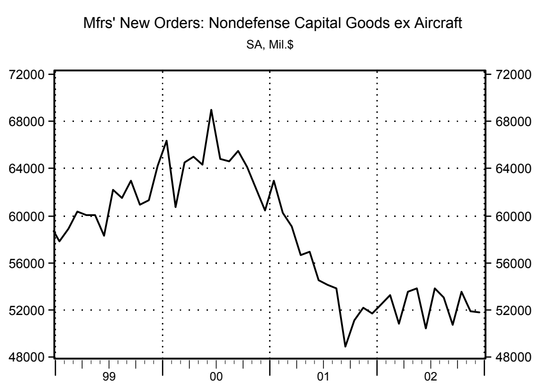


- The business investment component of real GDP has been both a leading sector in the earlier expansion and a leading sector in the recent contraction: it has grown at rates exceeding GDP both on the upside and the downside.

- Investment growth slowed dramatically beginning mid-2000. Investment remains sluggish but has become less negative in recent periods and actually expanded in the fourth quarter of 2002.

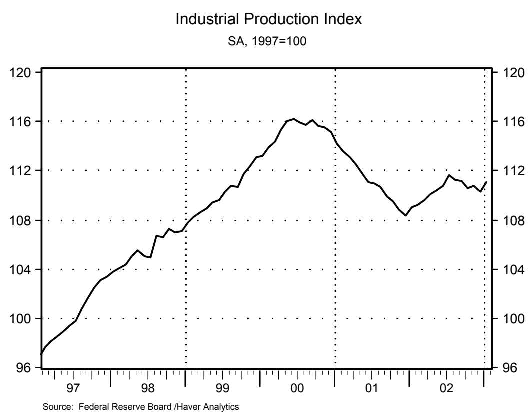
- Some components of investment have expanded in recent quarters (e.g., equipment and software) whereas others have remained sluggish (e.g., structures).

New Orders for Capital Goods

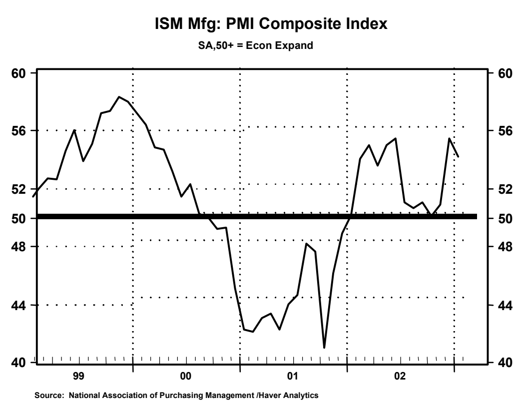


- More timely information from monthly indicators that correlate with investment also provide useful insights. Manufacturers' new orders for non-defense capital goods (ex-aircraft), for example, have stabilized after falling in 2000 and 2001 but show little signs of strengthening.

The Manufacturing Sector

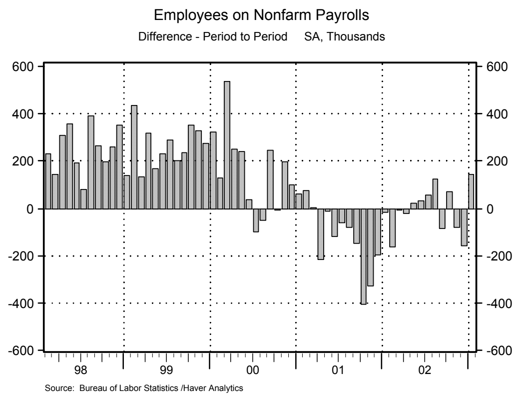


- The manufacturing sector has been weak in recent years. The industrial production index, for example, peaked in June 2000.
- Industrial production generally fell from mid-2000 until late 2001 before increasing in the first half of 2002.
- However, in four of the last six months, industrial production has fallen, signaling sluggishness.
- Lately, manufacturing capacity utilization, and manufacturers' orders for durable goods (not shown) have for the most part also shown signs of sluggishness.



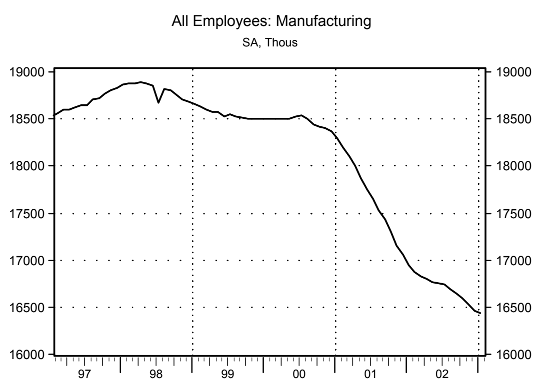
- The Institute for Supply Management's manufacturing diffusion index shows improvement in manufacturing activity. According to this index, manufacturing activity has been improving for several months (figures above 50 denote expansion). This expansion followed contraction from mid-2000 until early 2002 (below 50 denotes contraction).

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 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.
- After advancing for most of the earlier months in 2002, recently employment has fluctuated in a "saw tooth" pattern.

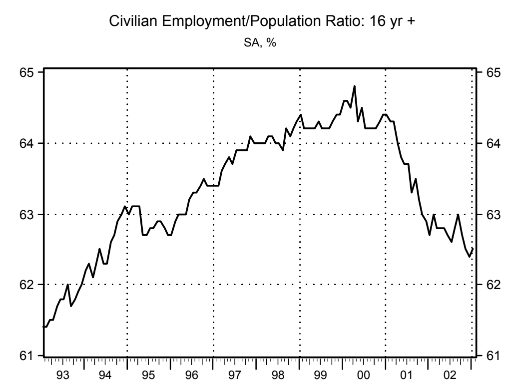
Manufacturing Employment



- 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 2.1 million manufacturing jobs have been lost since July 2000.
- As of January, manufacturing employment has declined for 30 months in a row.

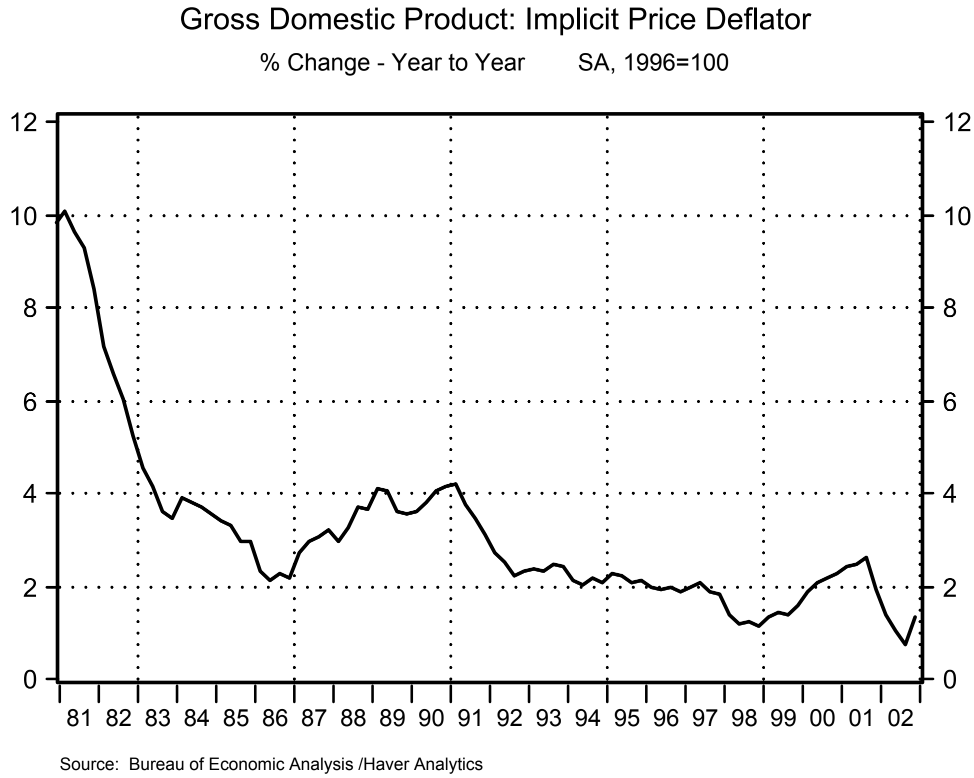
Unemployment

- After falling during the expansion, the unemployment rate trended up after late 2002.
- Recently, the unemployment rate has lingered just below 6.0 percent. The January 2003 unemployment rate was 5.7 percent.



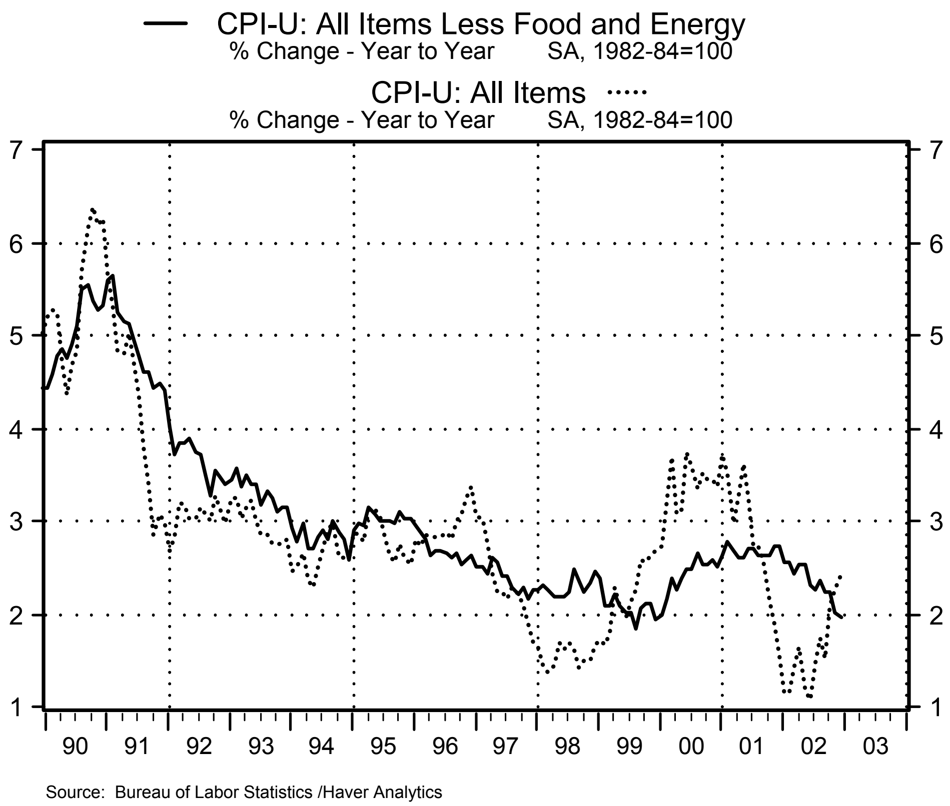
- Another important indicator of the state of the labor market is the employment–to–population ratio. This ratio indicates the percentage of the population with jobs. The ratio increased for much of the expansion.
- In April of 2000, the ratio peaked and thereafter began to trend downward.
- This ratio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

VI. 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 at this time.

- According to this measure, inflation remains relatively subdued despite recent increases and declines (related in part to energy price movements). Furthermore, inflation is generally forecasted to remain stable.

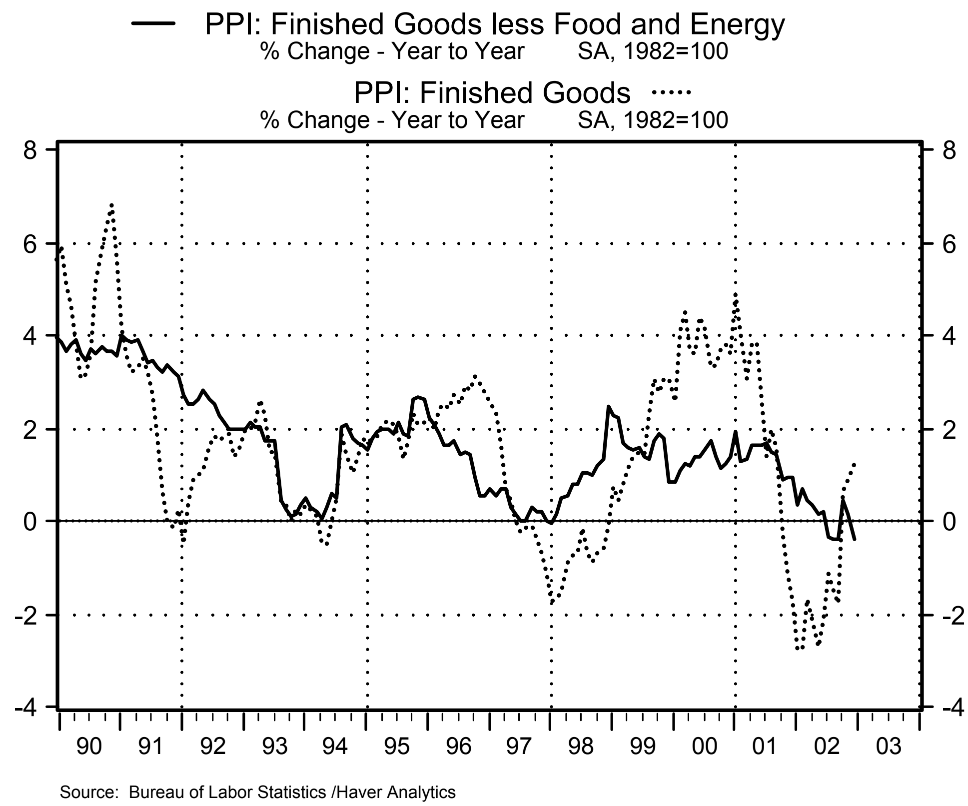


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last decade on a year-over-year basis.

- Changes in energy prices have caused some 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 may have some impact on 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 December indicate core CPI advanced at a 2.0 percent year-over-year rate.

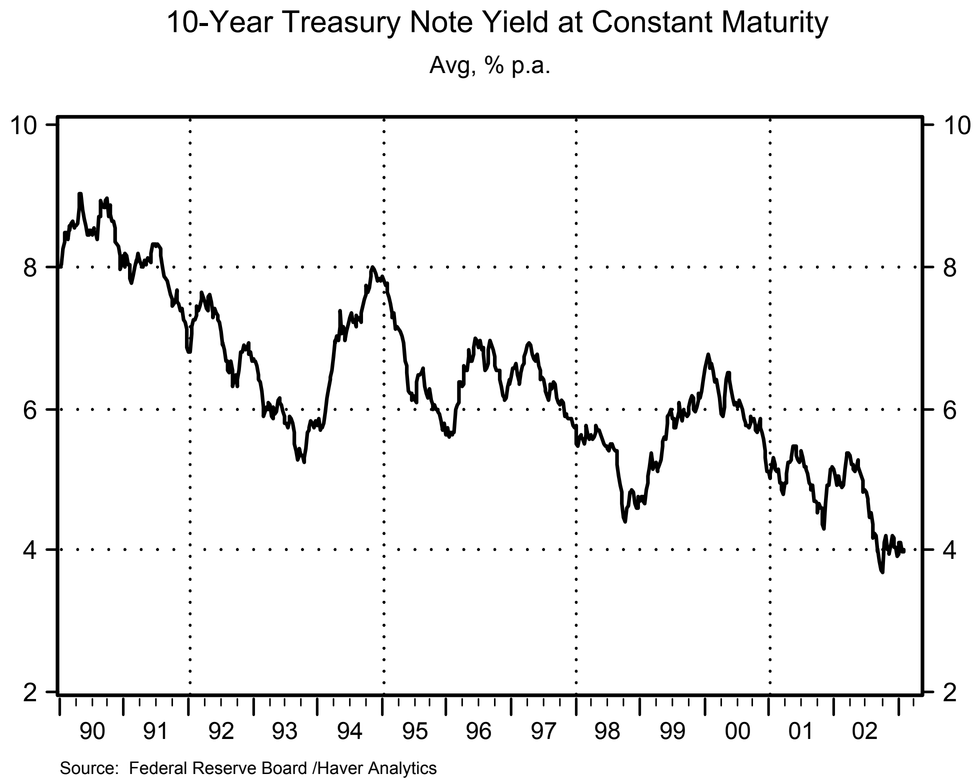


- This graph shows finished good producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown over the last decade on a year-over-year basis.

- 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. The core rate for December registered negative -0.4 percent (on a year-over-year basis).

VII. Forward-Looking Market Price Indicators



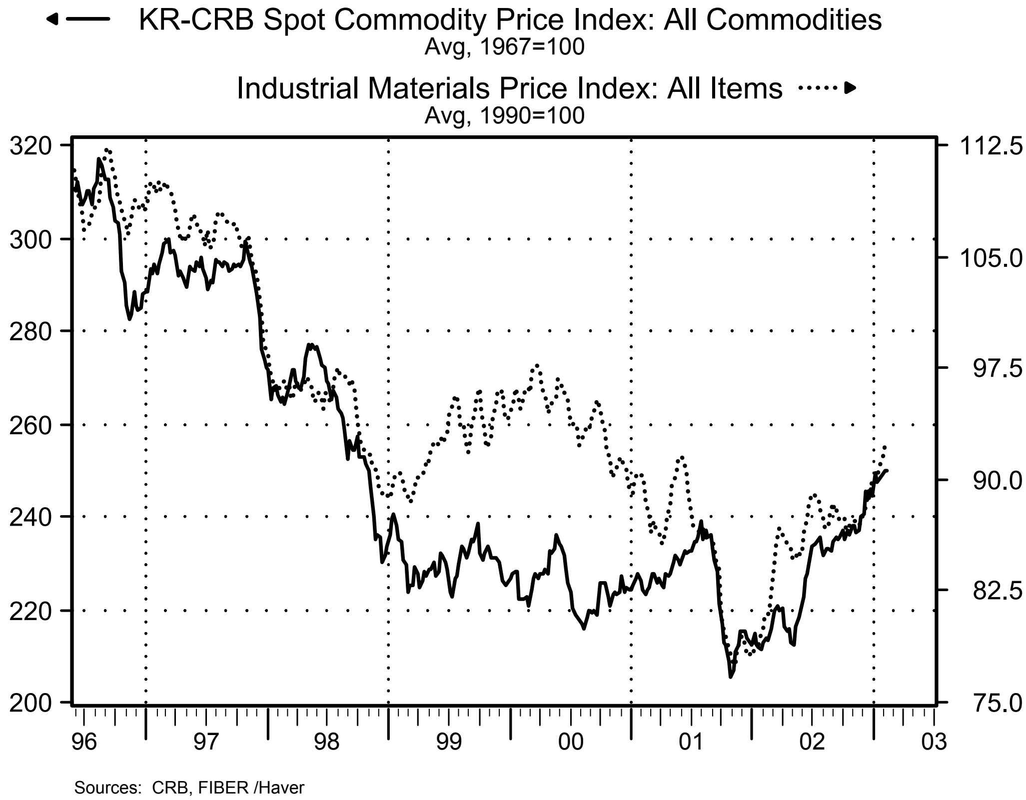
- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term 10-year Treasuries.

- 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 until recently, these rates have generally trended down because of a lessened concern about future inflation, a weaker than expected economy, and anticipations of, and reaction to, Federal Reserve policy easing. Notably, significant reductions in the Fed funds rate during 2001 were accompanied by smaller reductions in long-term Treasuries, thereby producing a positively sloped "yield spread."

- Recently, long-term rates have declined in the face of projections of larger 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.

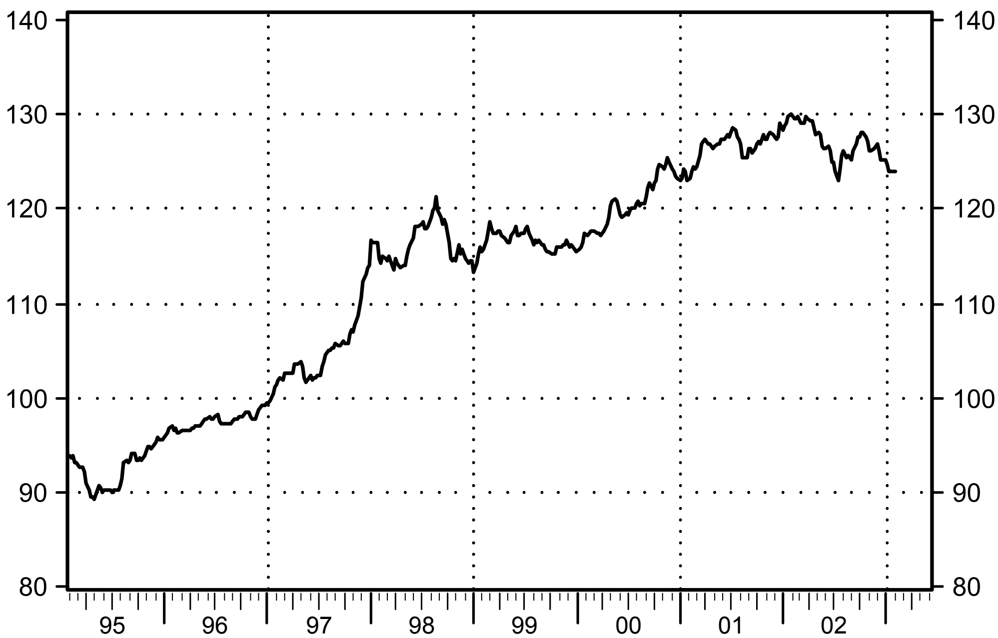
- The industrial materials index contains industrial commodity prices including energy prices. It fell for several years but increased in 1999 (related to energy price hikes) and fell again in 2000 and 2001. Most recently, this index has increased again due in part to energy price increases. Nonetheless, 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. Both indices remain below levels of a few years ago. The recent increases suggest the threat of deflation is dissipating and giving way to some reflation. These indices, however, should be closely monitored. These price indices continue to suggest that inflation is not an important problem at this time.

Nominal Broad Trade-Weighted Exchange Value of the US$

Avg, 1/97=100



Source: Federal Reserve Board /Haver Analytics

- This chart 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 1995-2001 period, and, despite some recent depreciation, remains at a relatively firm level compared to its value in recent years.

- Recently dollar depreciation has been concentrated against major currencies such as the Euro. In part, this reflects lowered expected returns on dollar denominated assets. Nonetheless, when viewed from a longer-term perspective, this depreciation is not worrisome.

- Taken together and properly assessed in conjunction with one another over a longer-term perspective, these forward-looking market price indicators – commodity prices, long-term interest rates, and the foreign exchange rate value of the dollar – suggest that the threat of deflation has dissipated and as of now, no major resurgence of inflation is imminent.