# CURRENT ECONOMIC CONDITIONS AND OUTLOOK

## JOINT ECONOMIC COMMITTEE

**Prepared for Congressman Jim Saxton**

## Data as of April 19, 2001

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# CONTENTS

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

## Summary and Overview

- Against the historical backdrop of remarkably sustained and robust economic growth, in recent quarters the macroeconomy shows unambiguous signs of a significant slowdown. The evidence shows that this slowdown began by mid-year 2000. Nonetheless, the slowdown substantially increases the economic risks facing policymakers in Congress and the new administration. The magnitude and the speed at which the slowdown developed surprised most economic forecasters; these prognosticators have revised down their latest forecasts and extended the slowdown's expected duration. Several factors contributed to this slowdown.

  First, 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 level since 1991. Further, as the effect of this move began to impact credit markets and longer-term interest rates weakened, the Fed held short-term rates up, exacerbating existing policy tightness. Moreover, those tightening moves were undertaken during a period when the Federal Reserve's loan officer survey indicated commercial banks were adopting more restrictive credit/lending standards. The resulting restrictive monetary policy has affected financial markets and interest-sensitive sectors of the economy such as certain categories of consumer durables and investment. Recognizing these effects, the Federal Reserve lowered interest rates by 200 basis points beginning in January. Because of lags, however, the economic effects of these recent rate cuts will not be felt in the near term. Despite these lowered short-term rates, several indicators of monetary policy continue to suggest that policy remains relatively tight.

  Second, energy (oil, natural gas, electricity) price hikes have also affected the economy. Consumers, spending more on higher-priced energy products, have less to spend on other consumer products of a discretionary nature. Further, higher costs of energy inputs have squeezed earnings and profits, thereby adversely affecting equity markets. Third, these interest rate and energy price factors taken together have worked in concert with other forces to weaken a somewhat overvalued stock market, which, in turn, may reverse that market's "wealth effect" boost to consumption. The associated higher cost of capital could also contribute to a slowdown in investment activity. Fourth, the tax burden or "fiscal drag" has been growing. Tax revenues have been growing far faster than the economy. Currently, Federal tax revenue as a proportion of GDP is at the highest level since World War II. Most of the effects of all of these factors were evident by mid-2000.

- Quarterly GDP growth, while "backward looking", has decreased sharply since mid-2000. Moreover, higher frequency and more timely data portend continued weakness. For example, weaker retail sales together with falling consumer confidence, faltering employment gains, lower hours worked, a declining ratio of household net worth to disposable income, high interest payment burdens, and rising unemployment claims together with waning job security all suggest significantly weaker consumption in the near future. Similarly, weaker durable-good orders, declining earnings, profits and equity values, falling production and capacity utilization numbers suggest near-term investment sluggishness. Further, the slowing of private-sector employment growth, hours worked, and increased unemployment claims all suggest near-term softening of the labor market.

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

- Key measures of broad price movements continue to indicate that trends in core inflation remain contained. While special factors (especially energy price increases) have affected major price indices in recent months, excluding these influences removes much of the measured price increases. Most forecasters are projecting additional moderation of inflation trends.

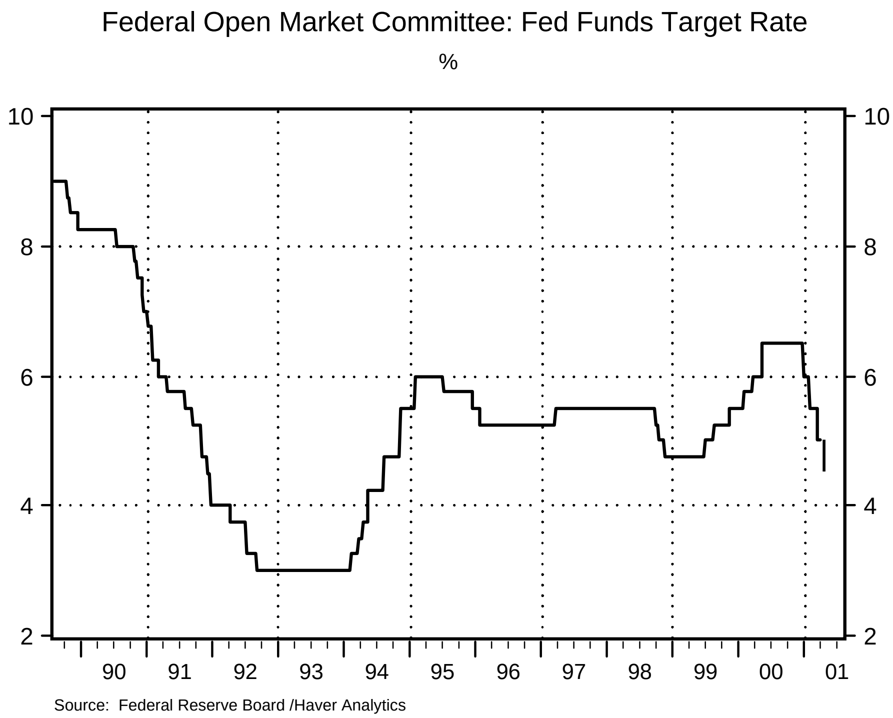
- Forward-looking indicators of inflation and expectations of inflation also suggest that inflationary pressures remain benign. Commodity price measures excluding energy prices, for example, remain flat and indices including energy prices recently have fallen. The dollar remains very strong, both on a trade-weighted basis and against major currencies such as the Euro and the Yen. Long-term bond yields have generally retreated. Overall, these indicators jointly assessed continue to suggest monetary policy remains tight, and no resurgence of inflation is imminent. Their signals leave room for further interest rate reductions by the Federal Reserve.

- Consensus forecasts[2] indicate the following:

| | 2001 | | | | 2002 | |
|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 |
| Real GDP | 0.9 | 1.4 | 2.4 | 3.1 | 3.5 | 3.5 |
| CPI Inflation | 3.8 | 2.3 | 2.3 | 2.3 | 2.4 | 2.4 |

[2] Source: Blue Chip Economic Indicators, April 10, 2001.

# I. Federal Reserve Monetary Policy




- 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. Further, as the effect of this move began to impact credit markets and longer-term interest rates weakened, the Fed held short-term rates up, exacerbating existing policy tightness. 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, the restrictive monetary policy has affected financial markets and interest-sensitive sectors of the economy such as durable consumption and certain categories of investment.

- Recognizing these effects, the Federal Reserve subsequently lowered interest rates 200 basis points beginning in January. Because of lags, the economic effects of these recent rate cuts will not be felt in the near-term. The Fed continues to indicate that the risks remain on the downside, suggesting that further interest rate cuts are likely in the future. The markets expect such cuts.

# II. Energy Prices

Spot Oil Price: West Texas Intermediate [Prior'82=Posted Price]

$/Barrel


- This chart shows the nominal price of oil since the late 1970s. Recently, oil prices have increased sharply, moving above $30/barrel, before moderating.

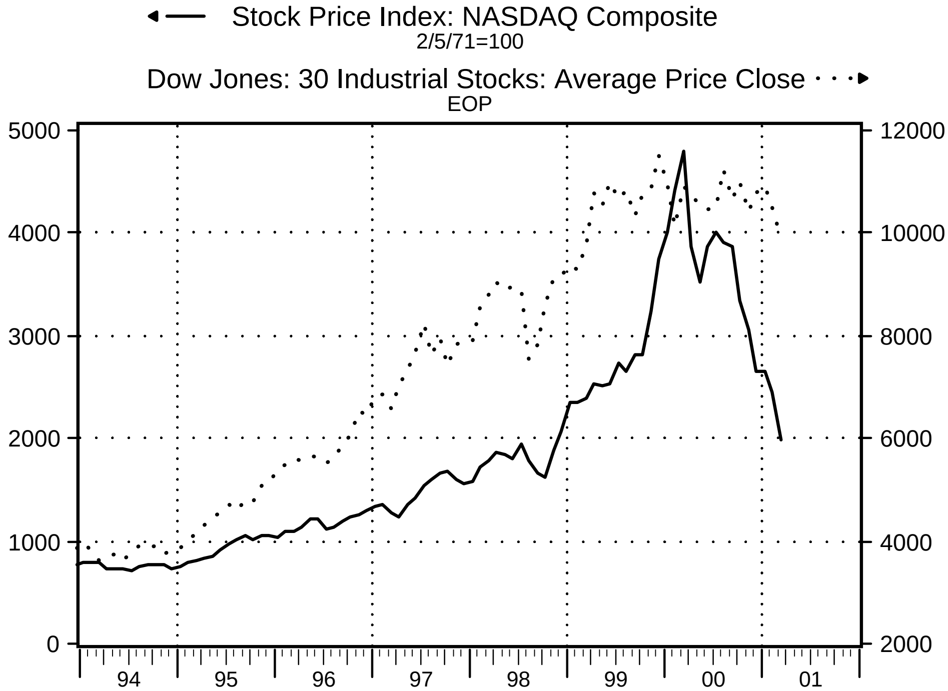
- Such oil price moves raise costs, reduce aggregate supply, and lead to output reductions.

- This oil price increase also will have a negative impact on economic growth, since it transfers 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.

- Natural gas prices (not shown) also increased sharply, but have since moderated significantly. And California has been plagued by an electricity crisis.

- Consumers, spending more on higher-priced energy products, will have less to spend on other consumer products of a discretionary nature. Higher costs of energy inputs also have squeezed businesses' earnings and profits, thereby adversely impacting the stock market.

# III. Stock Prices



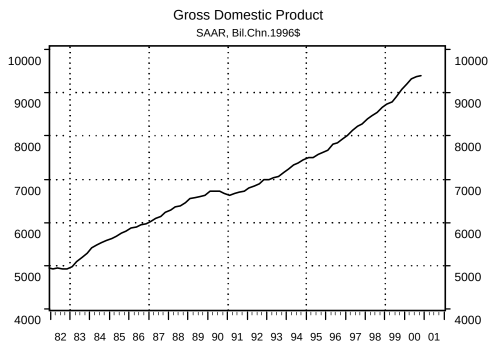

- Federal Reserve tightening and sharp energy price increases -- along with other factors -- have impacted corporate profits, earnings, and arguably an overvalued equity market.

- This chart shows two well-known stock indices (on a monthly basis): the Dow Jones Industrial and the NASDAQ composite indices. The Dow Jones has been flat for well over a year before declining, while the NASDAQ has lost a good deal of value (and market capitalization) since 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 will 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.

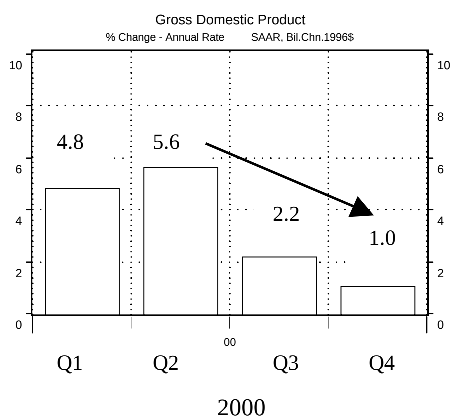
# IV. Output Measures
## Gross Domestic Product

Long-Term GDP Growth




- Recent events, however, should be considered against a backdrop of the lengthy economic growth of the last two decades.
- The current economic expansion is now about 10 years old and the longest expansion on record. It followed the 1980's expansion (the second longest peacetime expansion on record). In short, we are now experiencing back-to-back two of the longest economic expansions in American history.
- The recession that occurred between these record-breaking expansions was exceptionally short (8 months).

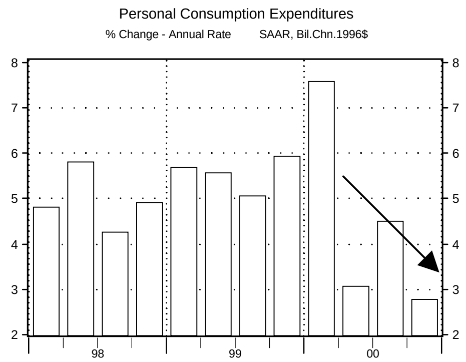
Recent Quarterly GDP Change




- Recent GDP quarterly growth, however, portends a significant slowdown.
- The data indicate that this slowdown began in the second half of 2000.
- After healthy growth in the first half, the $3^{rd}$ and $4^{th}$ quarter real GDP slowed significantly to 2.2% and 1.0%, respectively. The fourth quarter advance was the slowest in 5½ years.
- The speed and degree of this slowdown surprised most economic forecasters. A great deal of uncertainty clouds the economic outlook.

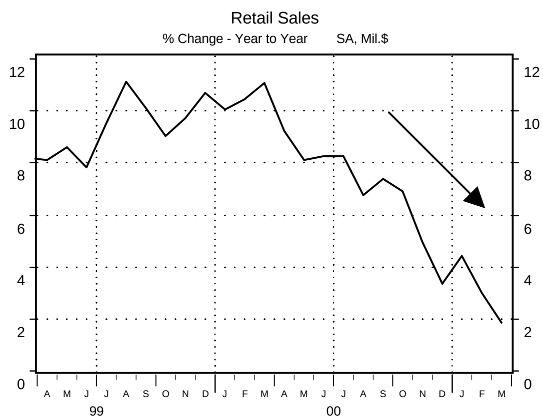
# Consumption

Recent Consumption Growth




- Quarterly real consumption growth has been a leading sector throughout most of this expansion; its growth has generally exceeded that of GDP.
- Recently, however, there are signs of a slowdown (see chart). Consumer confidence has fallen along with stock prices. Energy price hikes have squeezed consumer budgets and previous Federal Reserve interest rate increases affected consumer durable purchases.
- Fourth quarter durable goods purchases (not shown) actually fell 3.1 percent.

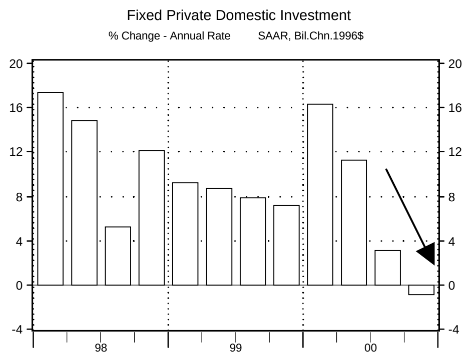
Recent Retail Sales




- This is perhaps more readily observed in more timely monthly retail sales data. The recent slowdown of retail sales growth underscores the speed and sharpness of the slowdown. (The chart shows year-over-year data.)
- Auto sales (not shown) significantly contributed to this slowdown evident since the second half of 2000.
- Consumer confidence (not shown) has also fallen sharply in recent months.

# Investment

Fixed Private Investment Growth

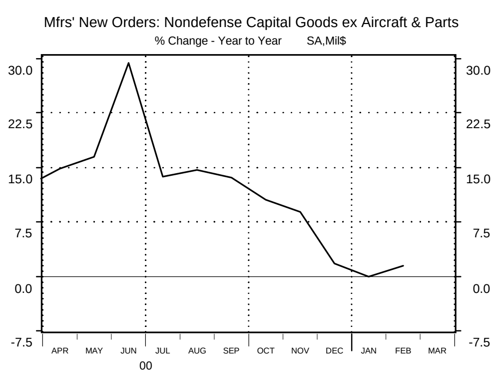



- The investment component of real GDP has also been a leading sector in this expansion; it has grown at rates exceeding GDP growth.

- Recently, there is evidence that investment growth has slowed. For example, fixed private domestic investment growth in the third and fourth quarter slowed to 3.1% and –0.9%, respectively, from faster rates registered earlier (see chart).

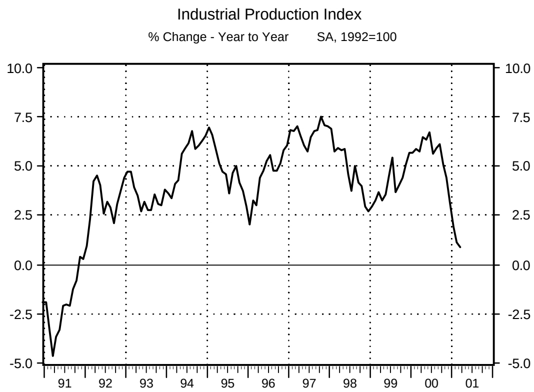
- An earnings slowdown, lower capacity utilization, and an increased cost of capital also portend a continued investment slowdown. Further, as the economy slows, there are increasing risks of additional diminished investment growth.

New Orders for Capital Goods

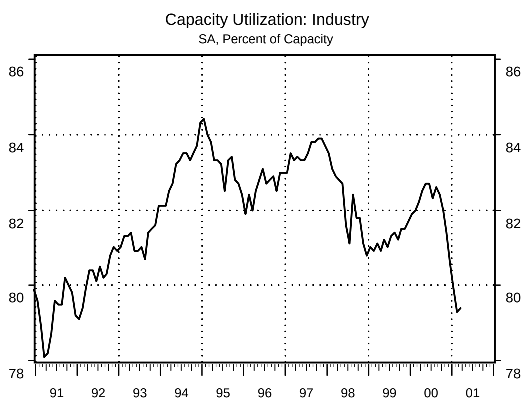



- More timely information from indicators that correlate with investment also portend an investment slowdown. Manufacturers' new orders for non-defense capital goods (ex aircraft and parts), for example, depict a sluggish investment outlook. The figures in the chart are year-over-year figures.

# The Manufacturing Sector

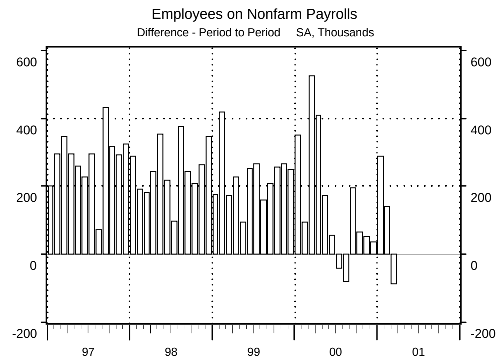



- The manufacturing sector has been weak for some time.
- The year-over-year change in industrial production has slowed dramatically in recent months (see chart). These year-over-year figures do not reflect the monthly increase in March, which many analysts attribute to shifts in auto production.
- The National Association of Purchasing Managers Index (not shown) has trended down in recent months. This index, which measures manufacturing activity, remains at levels lower than at any time since the recession in the early 1990s.




- Despite a small uptick in March, capacity utilization of industry remains near its lowest levels since the early 1990s (see chart).
- Manufacturing employment has actually fallen for an extended period and the manufacturing workweek has recently fallen to lower levels.

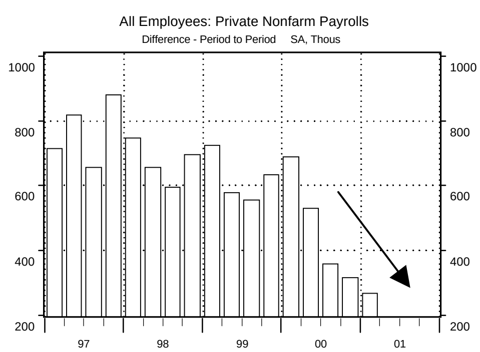
# V. The Labor Market




- This chart shows the monthly gains in total employment on non-farm payrolls in recent years. Until recently, these monthly gains in total employment have been quite healthy.

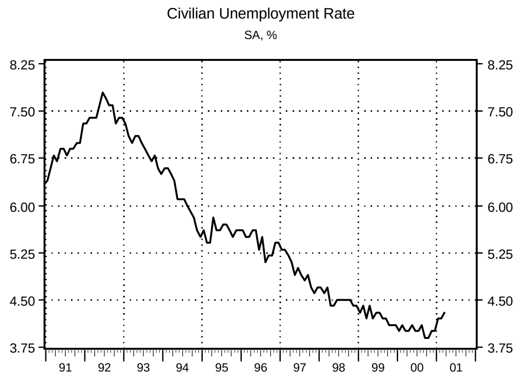
- Recent gains, however, have slowed dramatically from gains recorded earlier. This slowdown is evident in the chart and began about mid-year, 2000. Payroll employment actually declined in March by 86,000, reflecting a spread of the slowdown outside of manufacturing.

- Gains in total non-farm payrolls, for example, averaged about 246,000 per month for the 2½ years prior to mid-2000 and about 64,000 per month after mid-year, 2000.

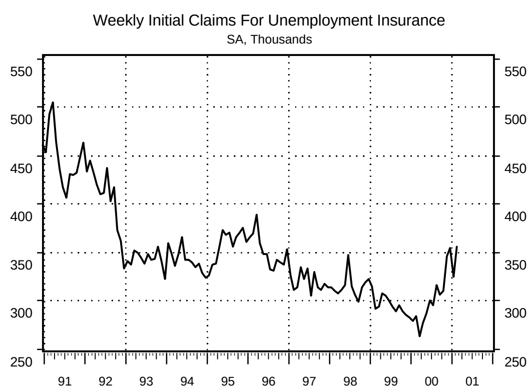



- This chart shows quarterly private sector payroll employment gains. These gains also show a similar, but clearer pattern. The slowdown in private sector employment is clearly visible around mid-year 2000.

# Unemployment

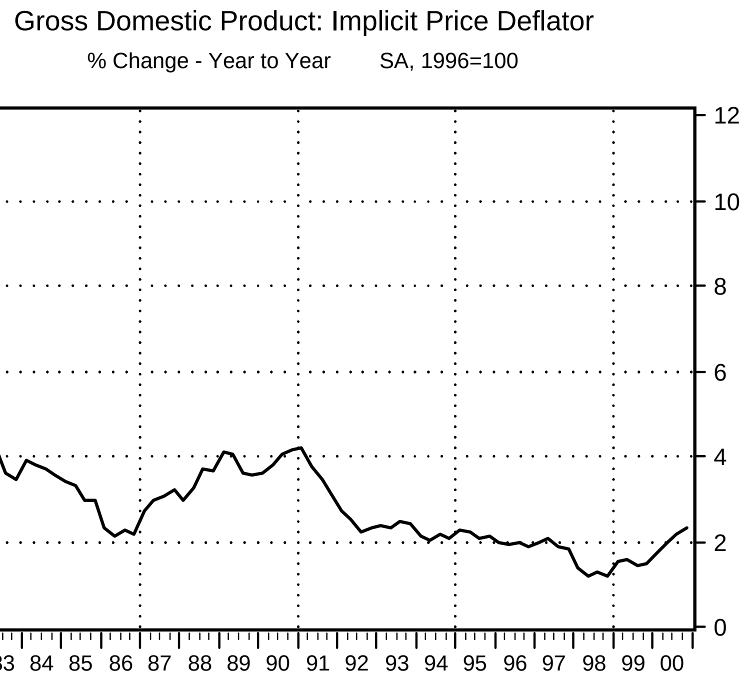



- The unemployment rate has trended down in recent years and has remained low.
- The March unemployment rate was 4.3 percent, close to a 30 year low, suggesting that labor markets remain tight.
- Unemployment, however, is a lagging economic indicator. There are signs that the labor market is beginning to cool, portending an increase in the unemployment rate.




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

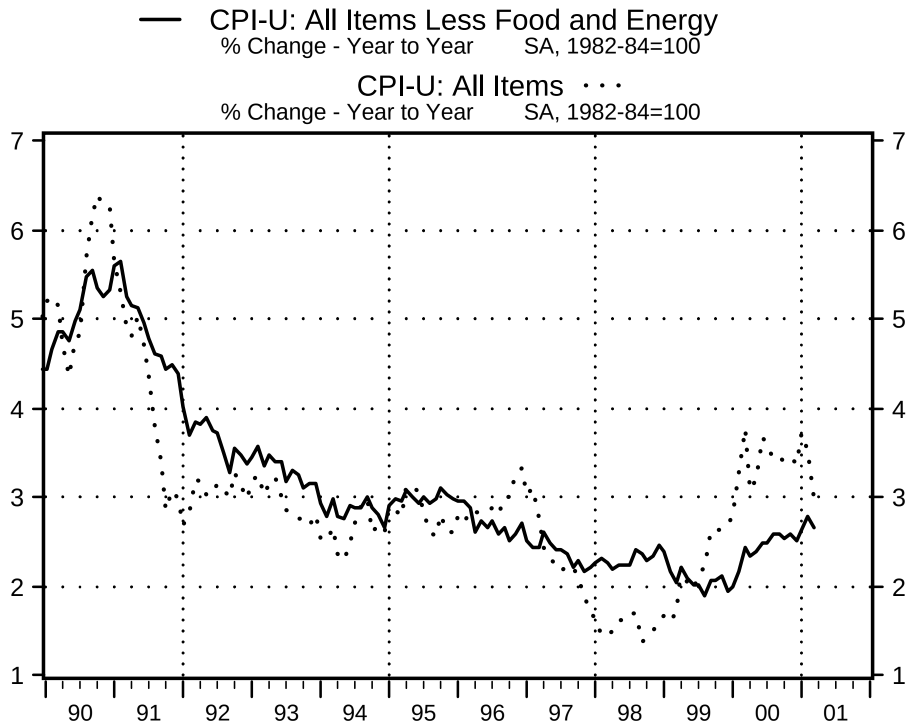
# VI. Inflation Measures




- 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 increases). Nonetheless, despite being contained, it appears that inflation is no longer falling.

- It is interesting to note that despite robust real economic growth and relatively low unemployment in recent years, inflation remained relatively benign.

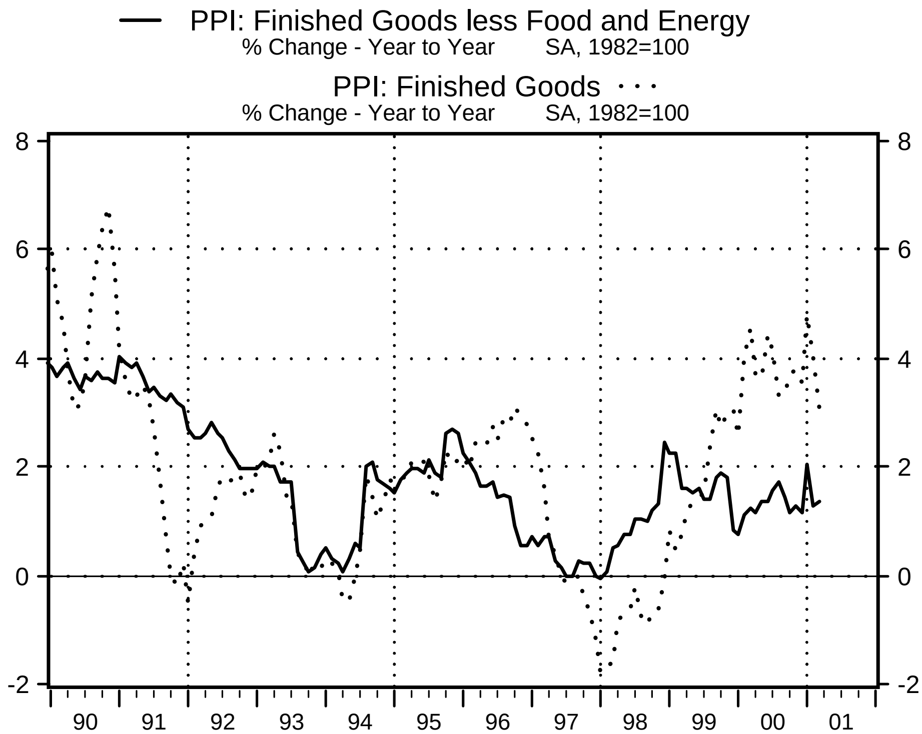



- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last ten years on a year-over-year basis.

- Increases in energy prices caused the total CPI to increase in recent months. If special factors are removed, however, core CPI inflation gains look less worrisome, although they have ticked up.

- 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 2.7 percent year-over-year rate.

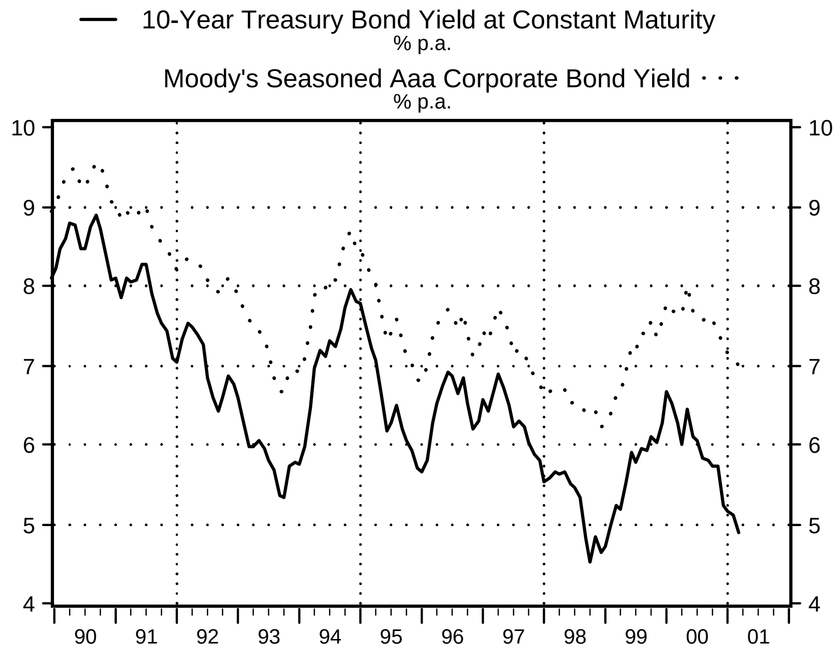



- This graph shows producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- Recently, increases in energy prices have boosted the total PPI. If the volatile food and energy components are removed, however, we can see that core PPI inflation remains below 2.0 percent (on a year-over-year basis). In fact, the "core" rate has trended down since early 1999 (year-over-year).

- March data indicated that the total inflation figure edged down and the "core" number inched up to 1.4 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."

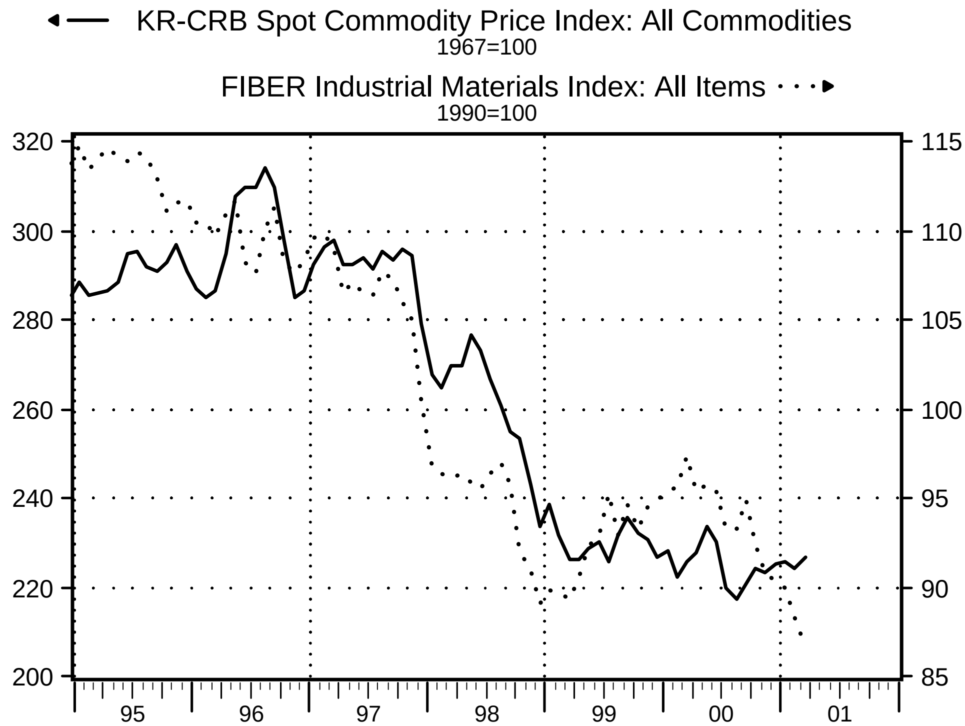
# VII. Forward-Looking Market Price Indicators




- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term Treasuries and contrasts them with the yields of long-term, high-quality corporate bonds.

- 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 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 reductions in the Fed funds rate, long-term Treasuries remain relatively contained, producing a narrow "yield spread."

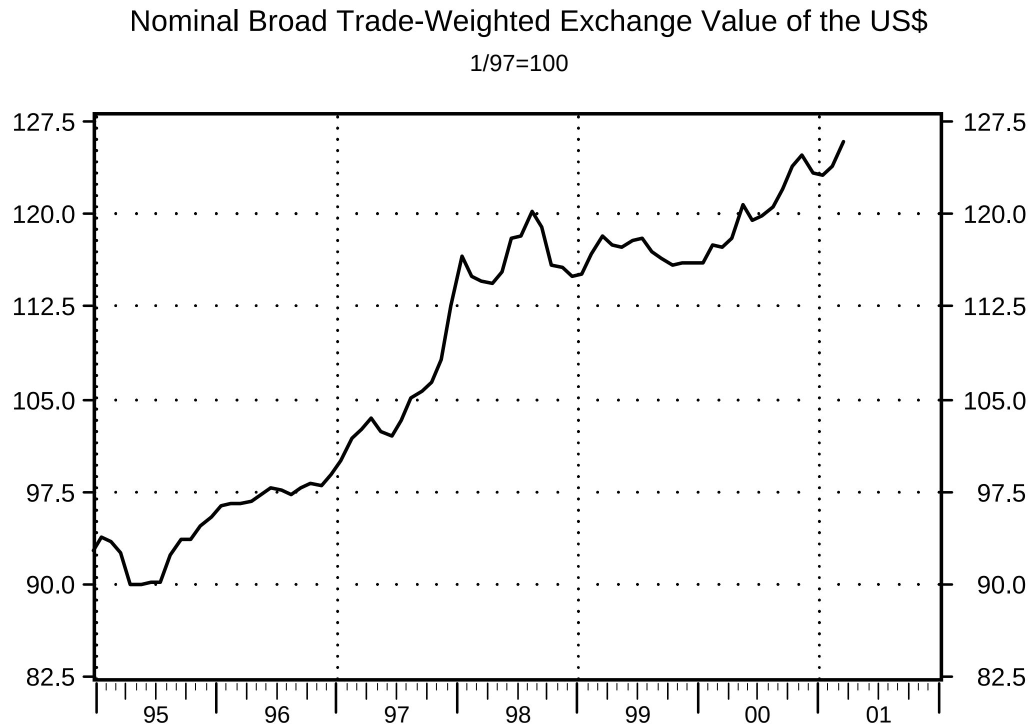



- This chart shows two commonly used broad commodity price indices -- the Knight-Ridder-Commodity Research Bureau spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.

- The FIBER index contains industrial commodity prices <u>including energy prices</u>. It has fallen for several years but increased in 1999 (related to energy price hikes) and fell again in 2000 and into 2001. It remains below levels of a few years ago.

- The CRB spot index <u>does not include energy prices</u>. It has not increased recently and remains weak.

- These commodity price indices show little sign of future inflation.




- 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 its trading partners.

- The foreign exchange value of the dollar has generally strengthened during much of the 1995-2000 period, and remains at a very firm level.

- Recently, the dollar has strengthened against both the Euro and the Japanese Yen.

- Taken together and assessed in conjunction with one another, these forward-looking market price indicators suggest a resurgence of inflation is not imminent, and suggest that Federal Reserve Monetary policy remains tight. 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.