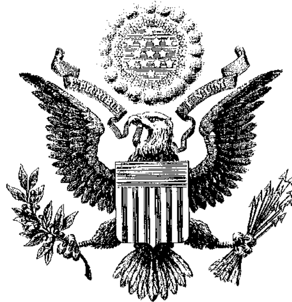
CURRENT ECONOMIC CONDITIONS AND OUTLOOK



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Prepared for Chairman Jim Saxton

Data as of August 22, 2001

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Economic Performance and Outlook[1]

Summary and Overview

- Against the backdrop of historically unprecedented sustained economic growth, the macroeconomy has slowed dramatically since mid-year 2000. Yet the current expansion continues and is the longest economic expansion on record. Nonetheless, this dramatic slowdown, which surprised most economic forecasters, poses substantial challenges for policymakers in Congress and the administration. While monetary and fiscal policies have responded to these developments and energy prices have retreated, to date there exists little concrete evidence that a turnaround has taken place. And a number of substantial risks and uncertainties loom on the horizon.

- Several factors contributed to the slowdown in mid-2000. First, the Federal Reserve raised interest rates from June 1999 to May 2000, putting the fed funds rate at the highest level since 1991. This restrictive monetary policy affected financial markets and some interest-rate-sensitive sectors of the economy such as certain categories of consumer durables and investment. Second, energy price hikes 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 squeezed earnings and profits, thereby adversely affecting equity markets. Third, these interest rate and energy price factors taken together worked in concert with other forces to weaken a somewhat overvalued stock market, which, in turn, countered and could reverse that market's "wealth effect" boost to consumption. The associated higher cost of capital also contributed to a slowdown in investment activity. Fourth, the tax burden or "fiscal drag" has been growing. Tax revenues have been growing faster than the economy. Currently, Federal tax revenue as a proportion of GDP is close to the highest level since World War II. Most of the effects of these factors were evident by mid-2000.

- Most of these factors, however, have now moderated, stabilized, or reversed themselves. The Federal Reserve, for example, lowered short-term interest rates by 300 basis points beginning in January. Energy (and especially natural gas) prices have retreated significantly from their peaks. A major tax relief package was passed by the Congress. And equity prices have stabilized for now and are no longer such a drag on the economy. The effects of these reversals, however, impact the economy with a lag. As a consequence, most economic forecasters expect an economic turnaround to begin by the fourth quarter and into 2002.

- The latest economic data do not yet reflect the impact of these reversals. And so, to date, there is no concrete evidence of an economic turnaround. Data that are available underscore the fact that economic growth slowed dramatically since mid-2000, but nonetheless continues to move forward; the historic expansion continues. Quarterly real GDP growth, for example, while "backward looking", slowed sharply since mid-2000. Most key components of GDP reflect this slower growth. While consumption growth has slowed, for example, it has held up well and sustains the economy's forward momentum. Auto sales and the housing market contributed to this forward momentum. A paring of inventories also portends well for future growth. The growth of investment, however, has weakened sharply, with little evidence from orders, earnings, or profits of a near-term turnaround.

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

The manufacturing sector, in effect, is in recession. Further, the slowing of employment growth, hours worked, and other indicators portend a softening of the labor market.

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

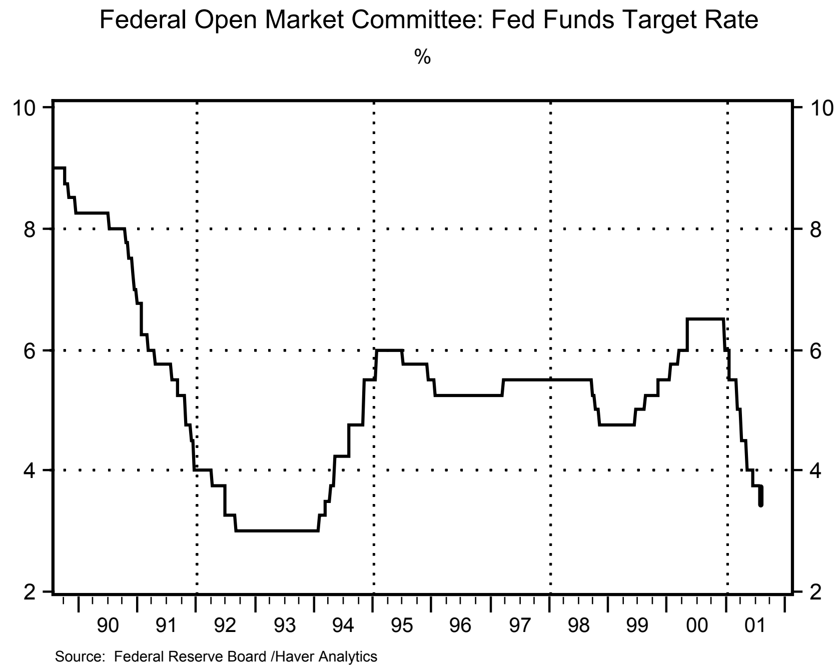
- Forward-looking indicators of inflation and expectations of inflation also suggest that inflationary pressures remain benign. Commodity price measures, for example, remain flat and below levels of a few years ago. The dollar remains firm, both on a trade-weighted basis and against most major currencies such as the Euro and the Yen, despite moderating 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.

- Consensus forecasts[2] indicate the following:

	2001		2002			
	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	1.7	2.8	3.2	3.3	3.4	3.5
CPI Inflation	2.4	2.3	2.5	2.4	2.5	2.6

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

I. Federal Reserve Monetary Policy



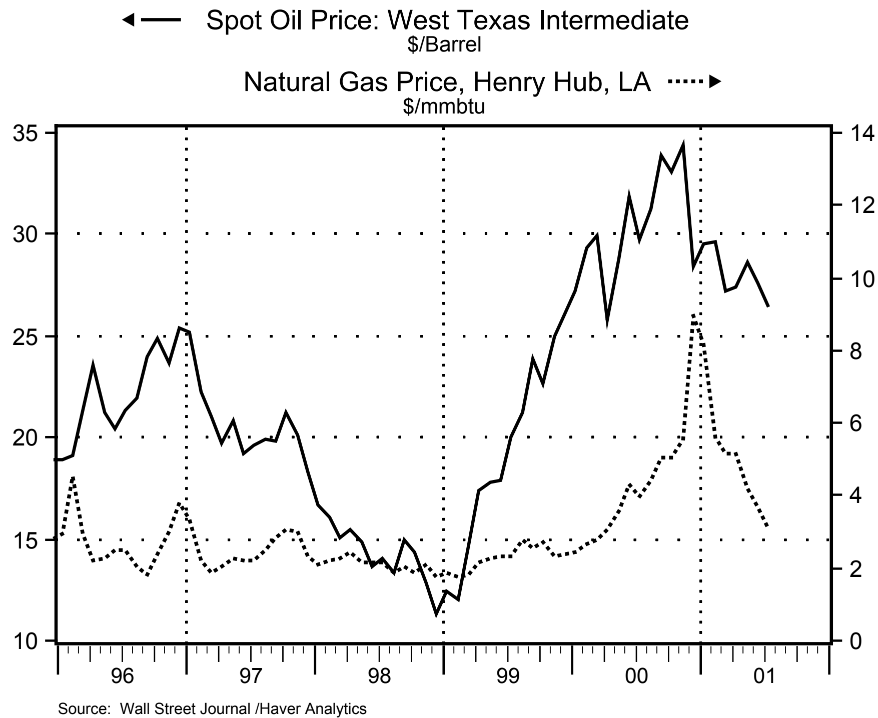
- The last two years have witnessed a reversal in the movements of short-term interest rates.

- 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 300 basis points beginning in January. Because of lags, the economic effects of these recent rate cuts will not be felt until later in the year. The Fed continues to indicate that the economic risks remain on the downside, suggesting that further interest rate cuts are possible in the future.

II. Energy Prices



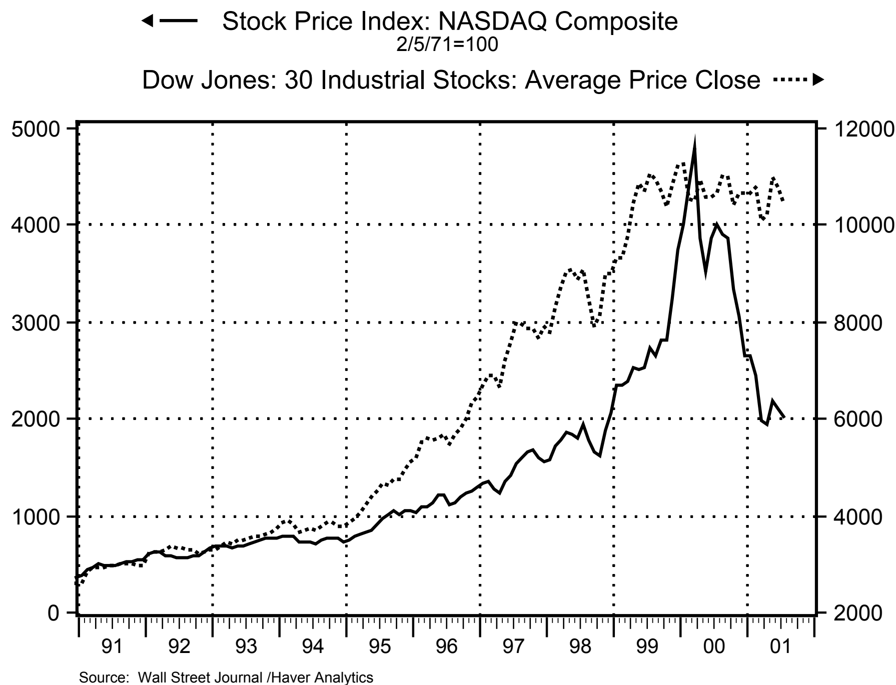
- Recent years have witnessed significant movements in energy prices. Energy prices, for example, sharply increased in 1999 and through most of 2000. This sharp increase contributed to the economic slowdown beginning in mid 2000.

- 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 bolster economic growth, all other things equal.

III. Stock Prices



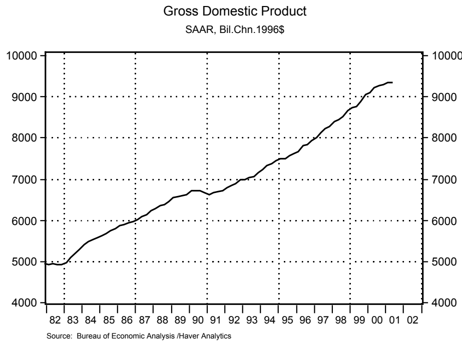
- Federal Reserve tightening and sharp energy price increases -- along with other factors -- impacted corporate profits, earnings, and arguably an overvalued equity market.

- This chart shows two well-known stock indices (on a monthly basis): the Dow Jones Industrial and the NASDAQ composite indices. The Dow Jones has been flat for well over a year, while the NASDAQ has lost a good deal of value (and market capitalization) since March 2000. Recently, however, these indices have been more stable.

- 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.

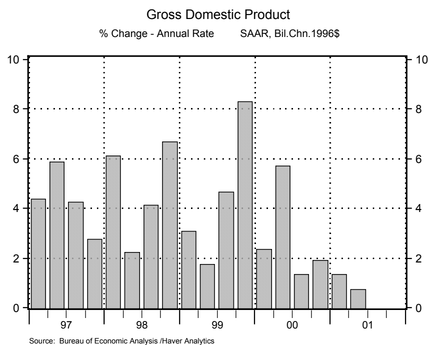
IV. Output Measures
Gross Domestic Product

Long-Term GDP



- GDP growth has slowed of late. But recent events should be considered against a backdrop of the lengthy economic growth of the last two decades.
- The current economic expansion 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 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).

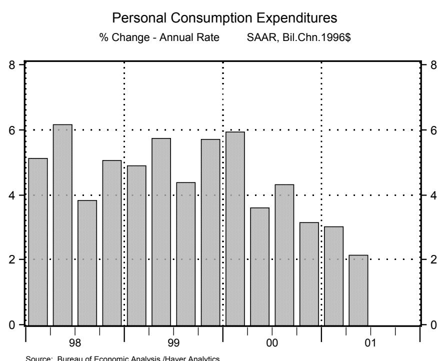
Recent Quarterly GDP Change



- Recent GDP quarterly growth, however, 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 about a 1.3 percent annual rate.
- The second quarter of GDP gain of 0.7 percent was the smallest gain in 8 years.

Consumption

Recent Consumption Growth



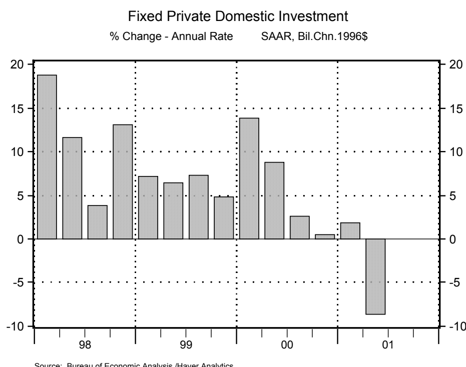
- Quarterly real consumption growth has been a leading sector throughout most of this expansion; its growth has generally exceeded that of GDP.
- Recently, however, real consumption growth has slowed along with GDP. But consumption growth has held up better than some had expected. Auto sales and purchases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

Recent Retail Sales

- This 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

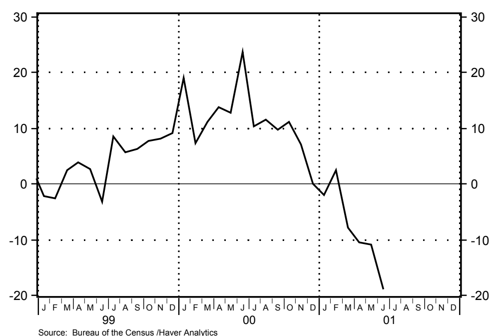
Fixed Private Investment Growth



- 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.

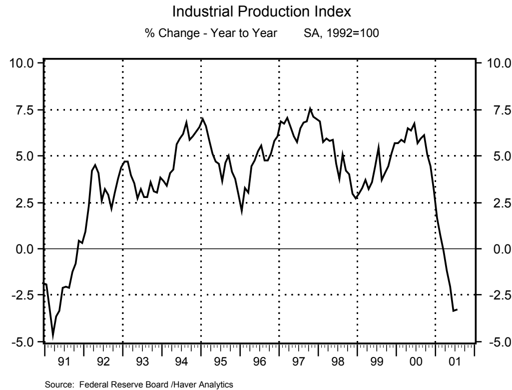
- Recently, however, investment growth has slowed dramatically since mid 2000. Investment now is one of the weakest sectors of the economy. For example, fixed private domestic investment growth in the second quarter fell sharply from low growth rates registered after mid 2000 (see chart). The equipment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

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

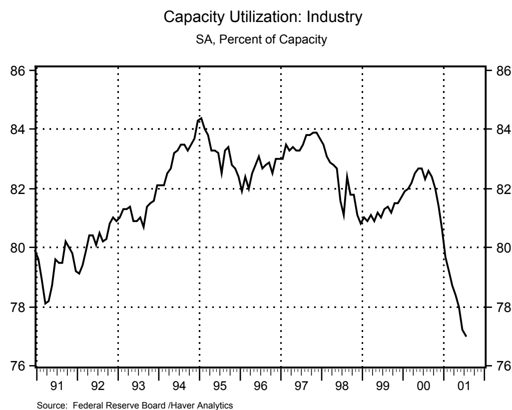


- More timely information from indicators that correlate with investment also portend continued investment weakness. Manufacturers' new orders for non-defense capital goods (ex aircraft), for example, depict a sluggish investment outlook. The figures in the chart are year-over-year figures.

The Manufacturing Sector

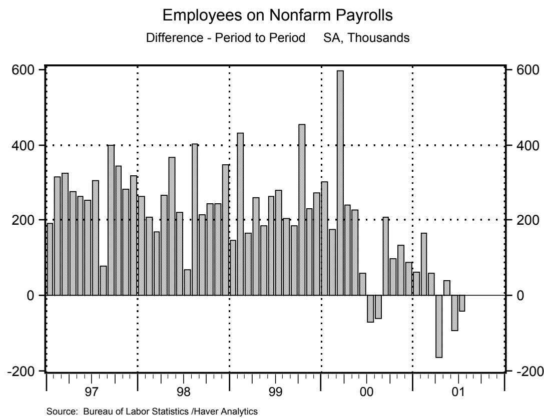


- The manufacturing sector has been weak for some time.
- The year-over-year change in industrial production has slowed dramatically in recent months (see chart). These year-over-year figures are the weakest since the recession in the early 1990s.
- The National Association of Purchasing Managers Index (not shown) has generally trended down since last year, although it has stabilized in recent months. This index, which measures manufacturing activity, remains at levels lower than at any time since the recession in the early 1990s.



- 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



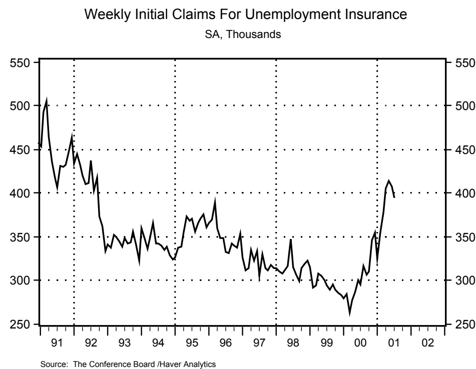
- This chart shows the monthly gains in total employment on non-farm payrolls in recent years.
- Employment gains were relatively strong in the period before mid-year 2000. More recent gains since mid 2000, however, have on average slowed dramatically to a fraction of those reported earlier.
- Gains in total non-farm payrolls, for example, averaged about 256,000 per month for the 2½ years prior to mid-2000 and only about 33,000 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.

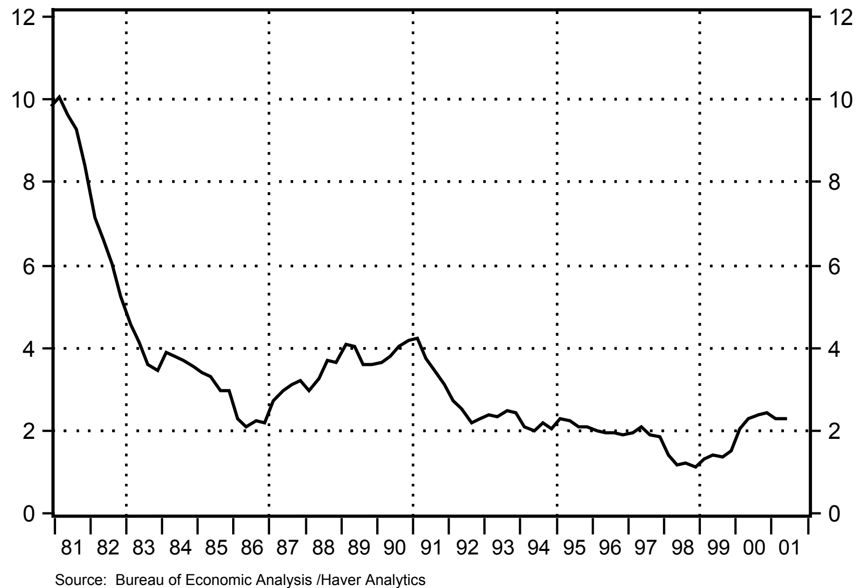
Unemployment

- The unemployment rate has trended down in recent years and despite increasing in recent months, remains low historically.
- The July unemployment rate was 4.5 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.



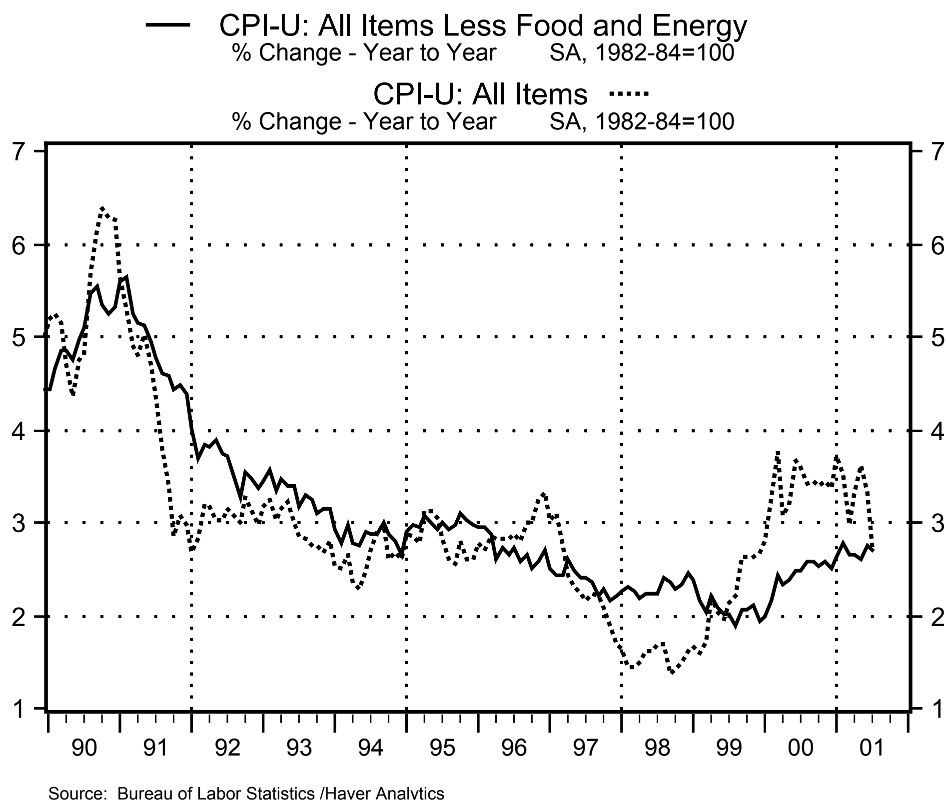
- In addition to slowing employment growth, initial claims for unemployment generally have increased in recent weeks, suggesting an increase in future unemployment.
- Additionally, the number of hours worked has fallen (not shown), and help-wanted advertising has fallen which often occurs before layoffs 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 increases). Furthermore, inflation is generally forecasted to moderate. Nonetheless, despite being contained, it appears that currently, this measure of inflation is no longer falling.

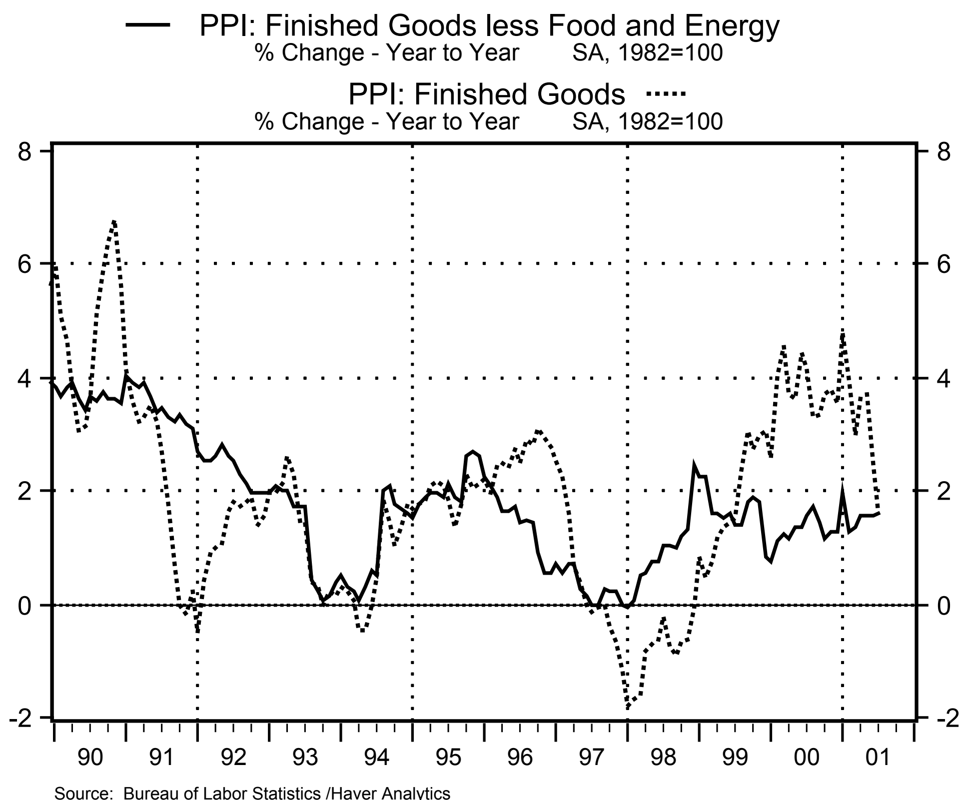


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation over the last ten years on a year-over-year basis.

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

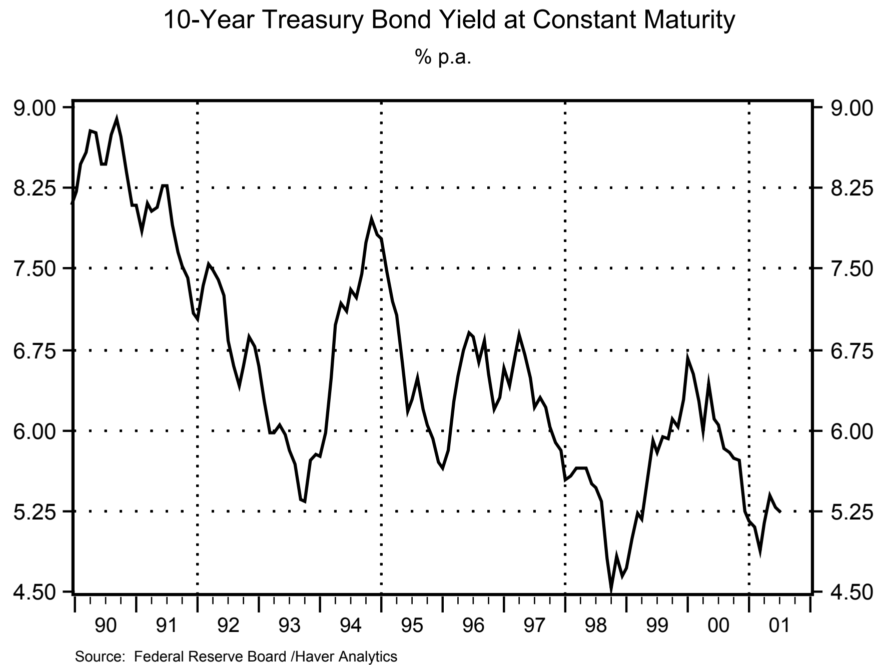


- This graph shows producer prices. Both the total finished goods (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- 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 below 2 percent. If the volatile food and energy price components are removed, the resulting "core" also remains below 2 percent. In fact, the "core" rate has trended down since early 1999 on a year-over-year basis.

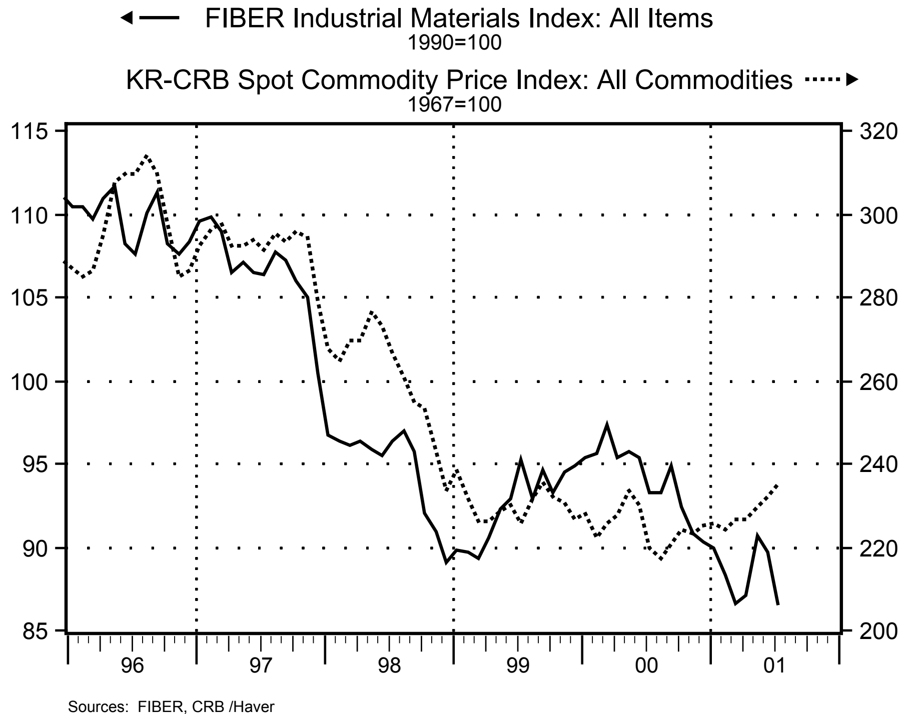
- July data indicated that the total inflation figure fell significantly and the "core" number edged up to 1.6 percent on a year-over-year basis. Core intermediate goods prices and core crude goods prices indicate that there is no inflation in the stage-of-processing "pipeline."

VII. Forward-Looking Market Price Indicators



- This chart shows long-term interest rates. Specifically, the chart shows the yields of long-term Treasuries.
- 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, producing a positively sloped "yield spread."

Commodity Prices

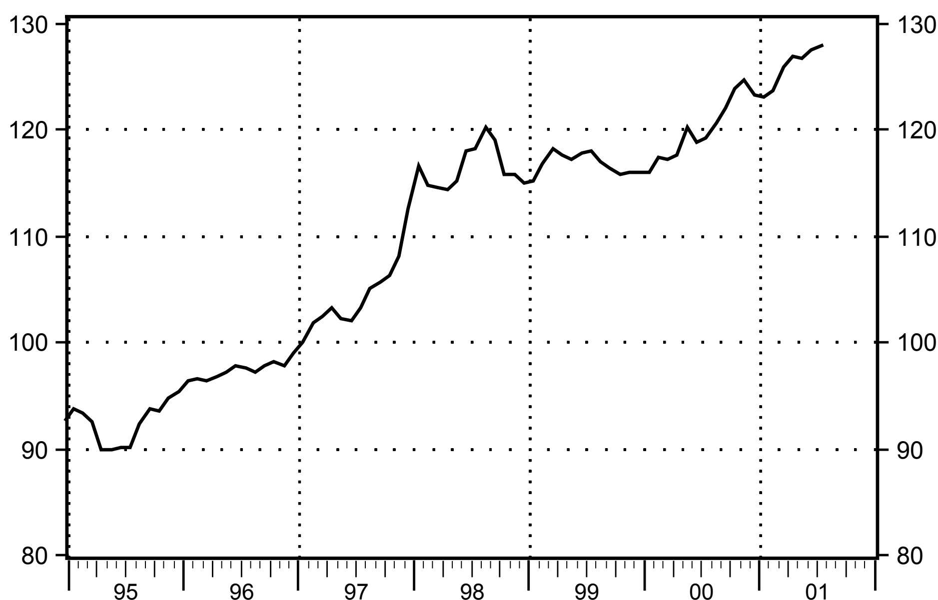


- This chart shows two commonly used broad commodity price indices -- the Knight-Ridder-Commodity Research Bureau spot index and the Foundation for International Business and Economic Research (FIBER) Industrial Materials Index.

- The 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 2001. It remains below levels of a few years ago.

- The CRB spot index <u>does not include energy prices</u>. It remains below levels of a few years ago. Food-related commodities account for the recent modest increase 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.