ECONOMIC PERFORMANCE AND OUTLOOK

JOINT ECONOMIC COMMITTEE

Prepared for Vice Chairman Jim Saxton

Data as of December 15, 2000

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Economic Performance and Outlook [1]

Summary and Overview

- Against the backdrop of remarkably sustained economic growth, the macroeconomy shows signs of slowing as the economic risks facing the new administration grow. There are several reasons for the slowing of economic activity. The Federal Reserve raised interest rates six times and 175 basis points from June 1999 to May 2000. This put the federal funds rate at 6.5 percent, the highest level since 1991. Since changes in monetary policy impact the economy with an uncertain lag, it is difficult to predict the precise timing or magnitude of these moves on the economy. But the effect of this tightening has apparently already affected financial markets and interest-sensitive sectors of the economy such as auto purchases, some categories of investment, and the housing market. Oil price hikes will also impact the economy, but these effects are expected to be milder than those experienced in the 1970s. Taken together, however, these disturbances apparently have worked in concert with other factors to weaken a somewhat overvalued stock market which, in turn, could reverse that market's "wealth effect" boost to consumption. Moreover, as economic growth moderates, the macroeconomy in turn becomes more vulnerable to potential economic disturbances such as, for example, further oil or equity market disruptions, international disturbances, or bank-induced "credit crunches."

- Despite these risks, the economy continues to expand, albeit at a more moderate pace. The latest figures indicate the economy's inflation-adjusted GDP expanded at a modest 2.4 percent rate in the third quarter after registering 5.6 and 4.8 percent rates in the second and first quarters, respectively. The growth of key components of GDP -- consumption and non-residential investment -- slowed, but remain respectable.

- Key measures of broad price movements continue to indicate that trends in core inflation remain subdued. 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. Nonetheless, recent data suggest that inflation is no longer falling and, by some gauges, has edged up.

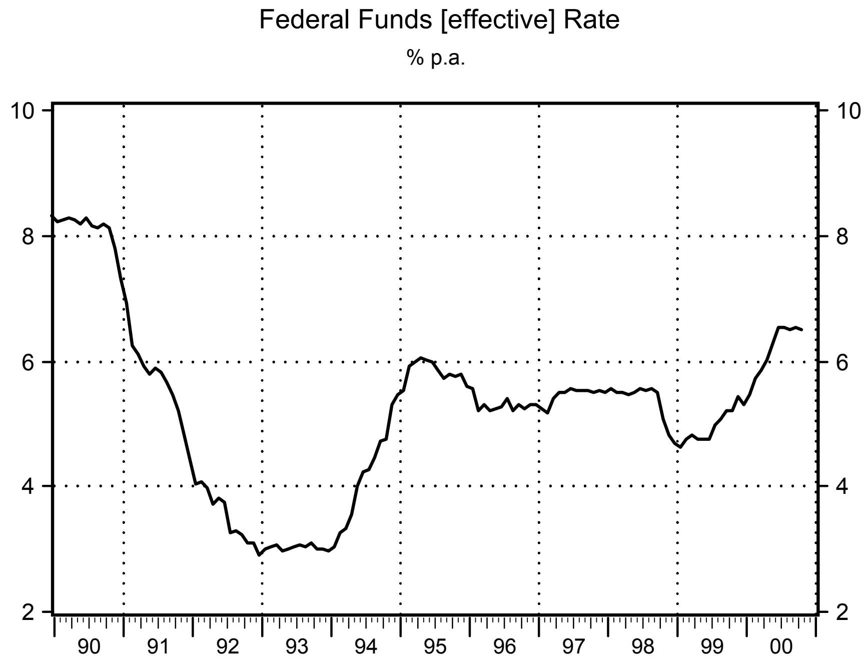
- Nevertheless, several forward-looking indicators of inflation and expectations of inflation suggest that inflationary pressures remain benign. Commodity price measures excluding energy prices, for example, remain flat. The dollar remains strong, especially against the Euro and on a trade-weighted basis. Long-term bond yields have recently retreated. Overall, these indicators jointly assessed continue to suggest no resurgence of inflation is imminent.

- Consensus forecasts indicate the following:

	2000	2001			
	Q4	Q1	Q2	Q3	Q4
Real GDP	3.2	3.3	3.2	3.3	3.2
CPI Inflation	3.0	2.8	2.7	2.6	2.6

[1] The source for all graphs in these *Briefing Materials* is Haver Analytics.

I. Federal Reserve Monetary Policy



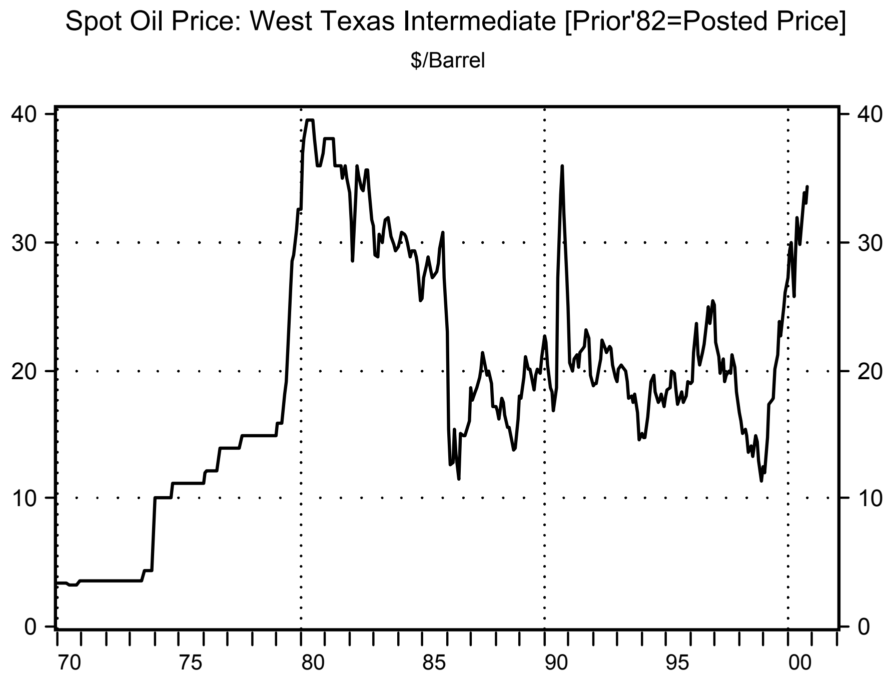
- Short-term interest rates are importantly influenced by Federal Reserve monetary policy. This chart shows the federal funds rate (a short-term interest rate closely controlled by the Fed).

- The Fed has raised interest rates six times and 175 basis points between June 1999 and May 2000. This puts the Fed funds rate at 6.5 percent, the highest level 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, interest-sensitive sectors of the economy and financial markets have apparently been affected by this tightening and there are signs that the macro economy's growth rate is beginning to slow.

- The Federal Reserve is widely expected to adopt a "neutral bias" at its December FOMC meeting. Furthermore, the market currently expects an interest rate reduction early in the new year.

II. Oil Prices



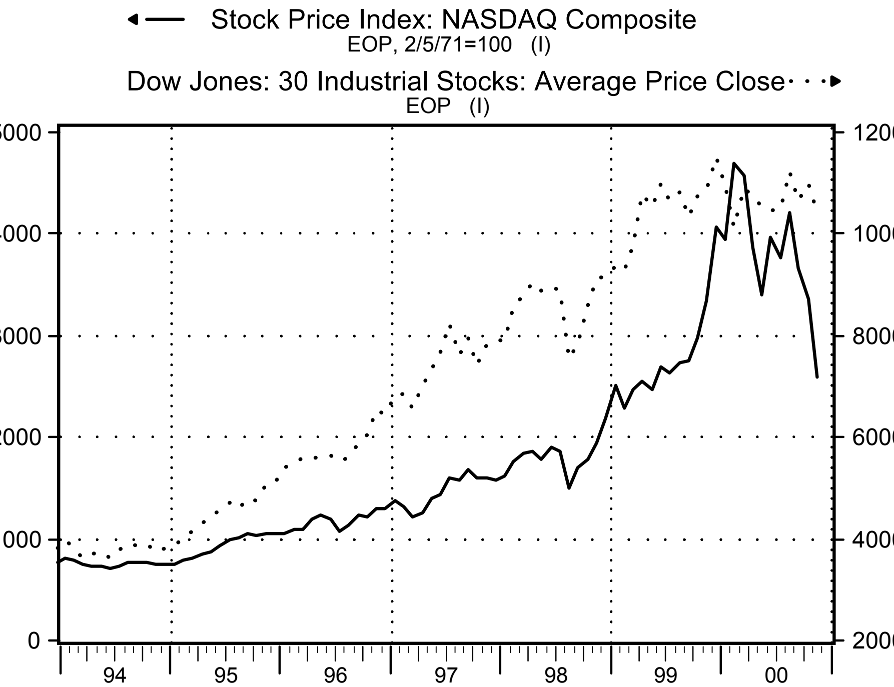
- This chart shows the nominal price of oil since 1970. Recently, oil prices have increased sharply, moving above $30/barrel.

- This oil price increase 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.

- Consumers, spending more on higher-priced energy products, will have less to spend on other consumer products of a discretionary nature.

- The impact, however, is expected to be milder than that experienced in the 1970s because the real price of oil (i.e., the price of oil relative to the price of other goods) is not so high and the economy is less dependent on oil than it was in the late 1970s.

III. <u>Stock Prices</u>

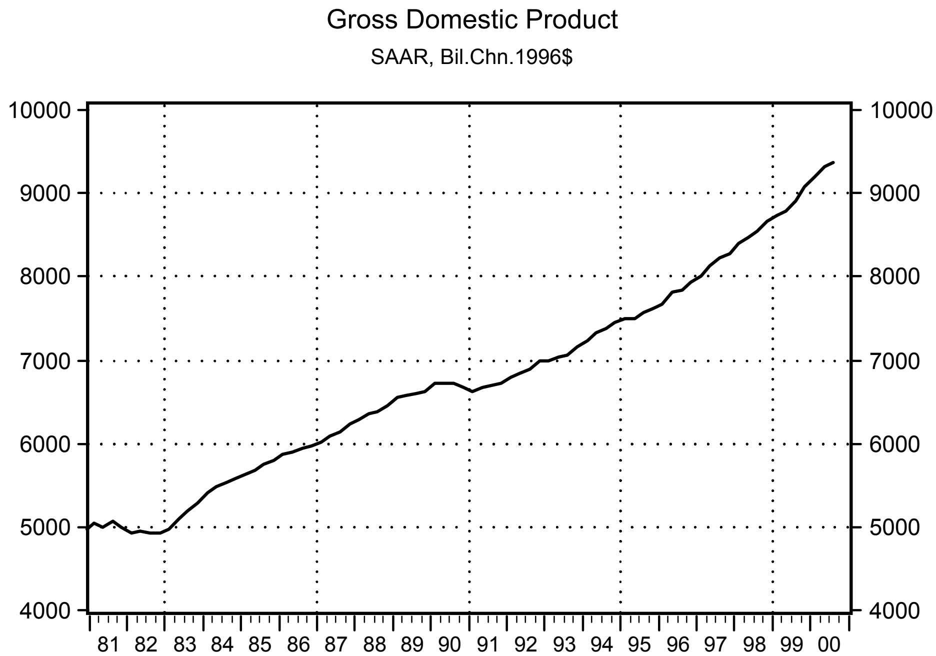


- Federal Reserve tightening and the oil price increase -- along with other factors -- have impacted corporate earnings and arguably an overvalued equity market.

- This chart shows two well-known stock indices: 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) in recent months.

- This has led some analysts to suggest that the stock market weakness may have important repercussions. It will raise the cost of capital, adversely impacting future investment. And the equity market's "wealth effect" that boosted consumption in recent years will weaken (or possibly even reverse itself).

IV. Output Measures

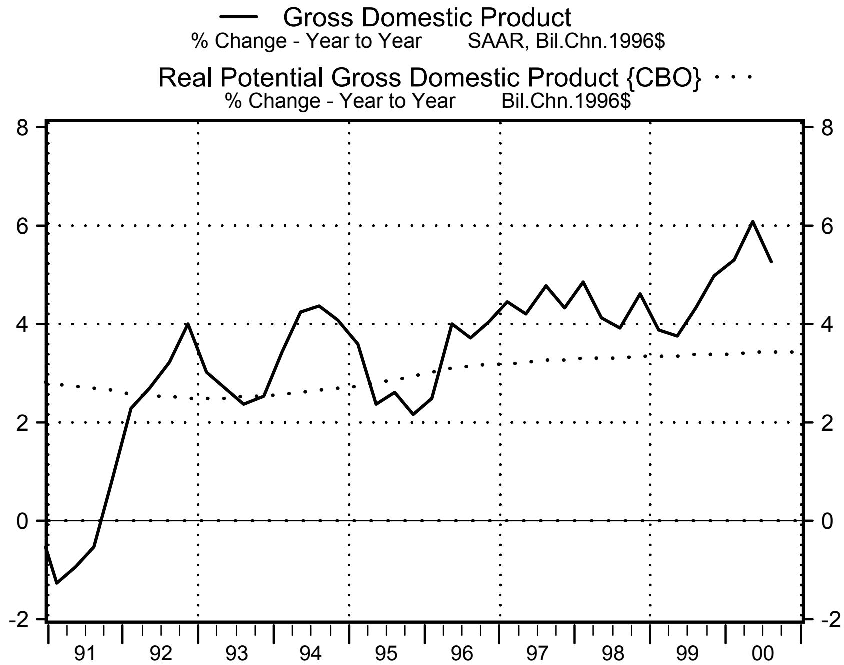


- Recent events, however, should be considered against a backdrop of the remarkably sustained growth of the U.S. economy.

- The current economic expansion is now more than nine and a half years old (116 months) and the longest expansion on record.

- This expansion followed the 1980's expansion, which is the second longest peacetime expansion on record (92 months). 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).

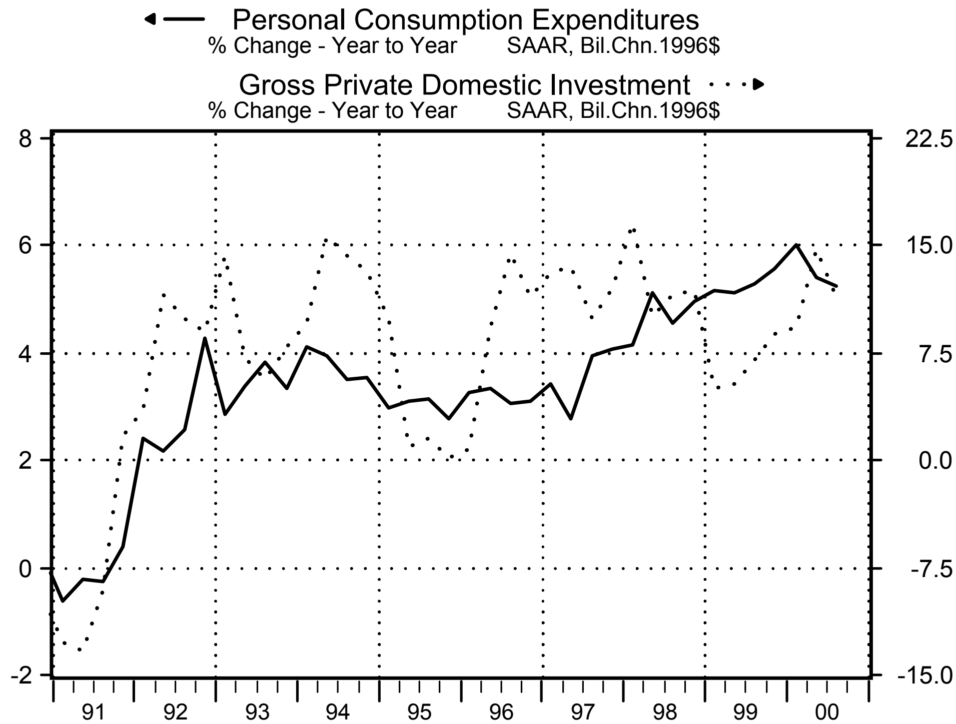


- This chart shows real GDP growth relative to “potential” GDP growth as calculated by the Congressional Budget Office (CBO). These variables are shown from the early 1990s (both on a year-over-year basis).

- As shown in the chart, recently real GDP has persistently grown at a rate well above its estimated “potential” on a year-over-year basis.

- The latest data indicate that real GDP has slowed from its earlier rapid pace. On an annualized basis, real GDP grew at a 2.4 percent pace in the third quarter, after registering 5.6 percent and 4.8 percent rates in the second and first quarters, respectively.

- Major components of GDP continue to post gains, although moderating growth is expected for the near-term horizon.



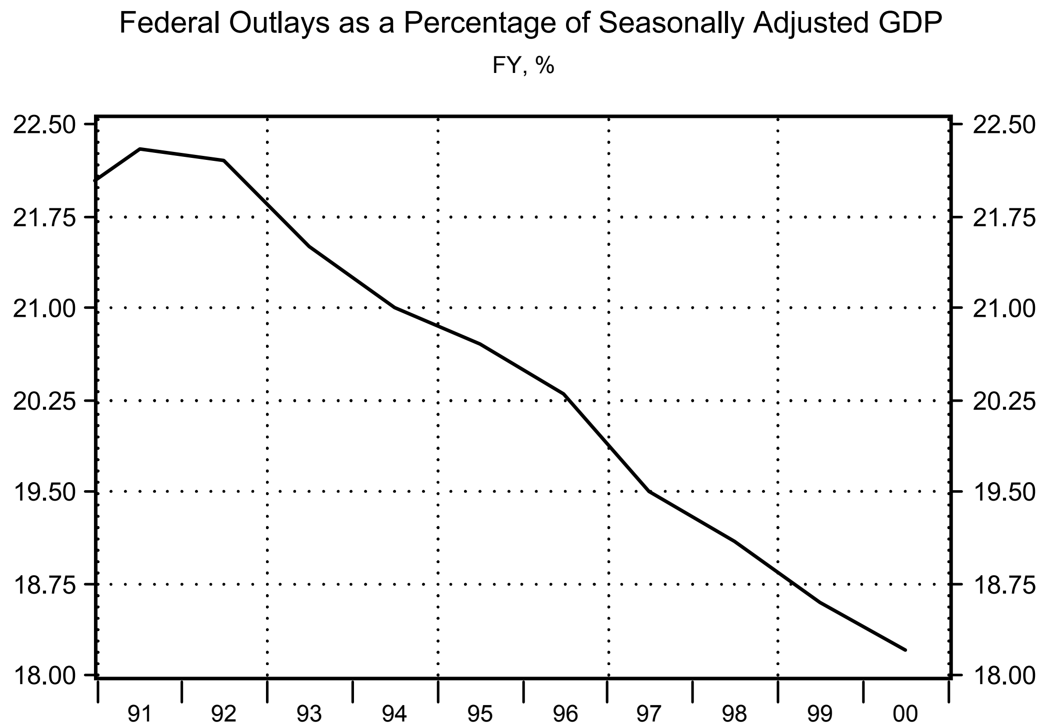
- Both the consumption and investment components of real GDP have been leading sectors in this expansion. They have grown at rates exceeding aggregate GDP. The figures in the chart are year-over-year changes of quarterly data.

- The left axis pertains to consumption growth while the right axis pertains to the growth of investment.

- Reasons for the strength of investment during most of this expansion include the decline of inflation (see below), reduced interest rates, increased real value of investment tax deductions, and technological advancements.

- Very recent data suggest some moderation of interest-sensitive durable good consumption spending (not shown), such as auto sales.

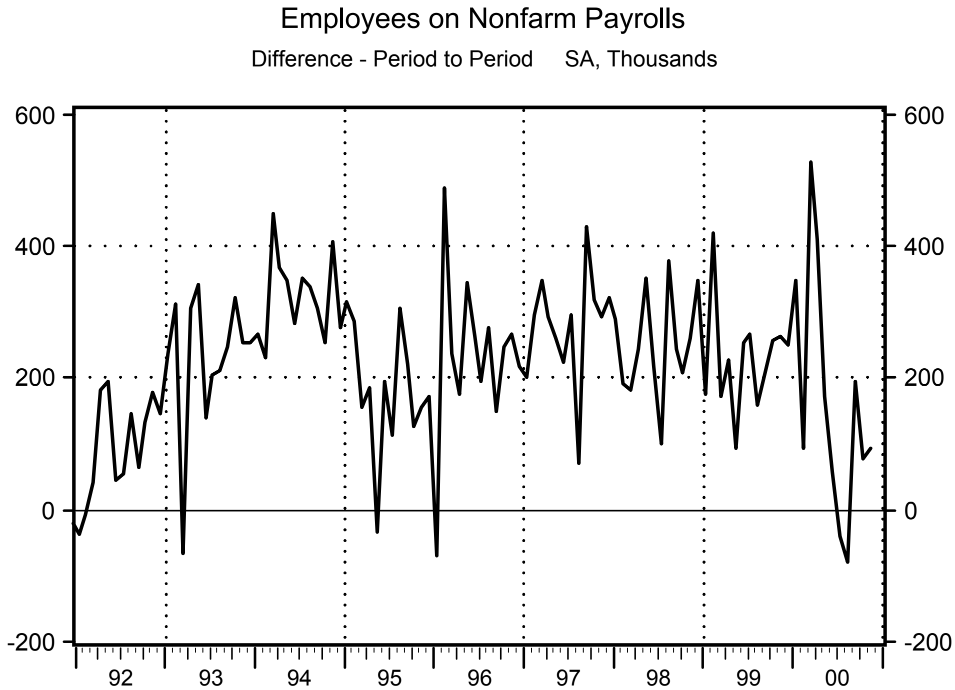
- While housing activity (not shown) has slowed, it remains at elevated levels.



- One sector that has not grown as rapidly as GDP during this expansion is federal government spending. The chart shows that federal government spending as a percentage of GDP has fallen during this sustained expansion. Figures from 1997 through 2000 have been recalculated by Haver to reflect July 2000 GDP revisions and FY2000 budget data. (Source: Department of Treasury, OMB and BEA as published in the *Economic Report of the President* and maintained by Haver.)

- Federal government spending on goods and services (a measure from the national income and product accounts, which excludes transfer payments), has declined in real (inflation-adjusted) terms during much of this expansion. An important reason for this has been the cutbacks in defense spending.

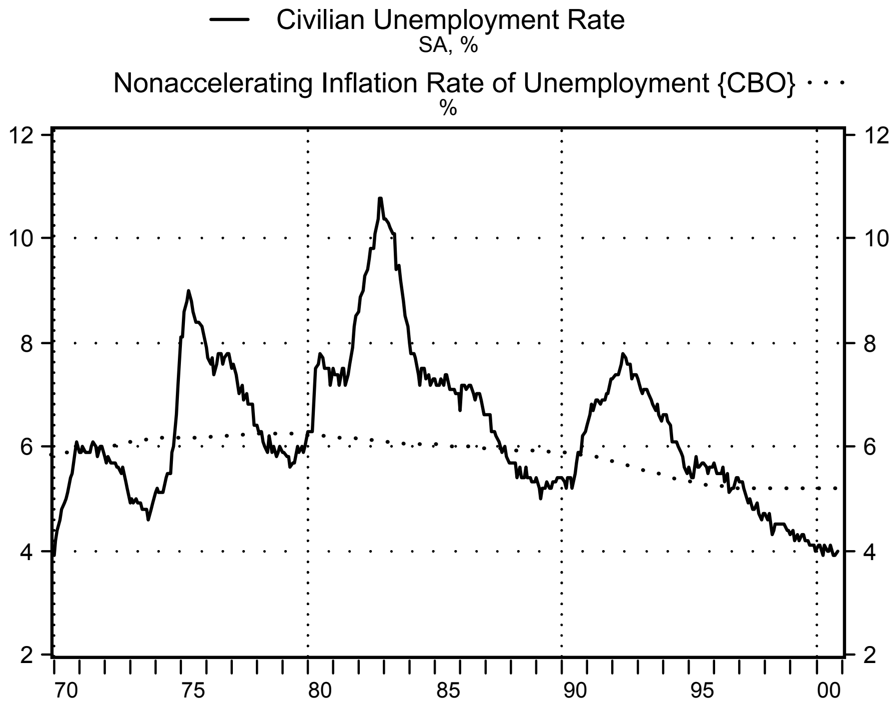
V. The Labor Market



- This chart shows the monthly gains of employment on non-farm payrolls. Employment gains during this record expansion have been substantial with more than 23 million new jobs added.

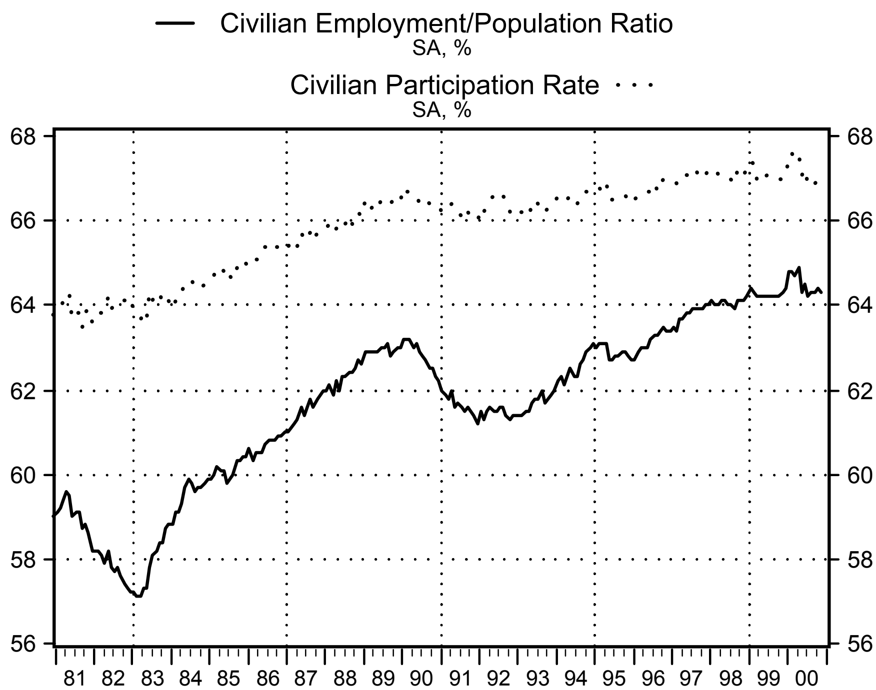
- Very recent monthly gains, however, have slowed from gains recorded earlier. This slowdown is also evident for employment in private non-farm establishments (not shown).

- Private employment gains since mid-year, for example, have averaged 122 thousand per month, down from 186 thousand during the first half of the year and 202 thousand during 1999.



- The November unemployment rate increased slightly to 4.0 percent, close to a 30-year low. The jobless rate has been in a 3.9 - 4.1 percent range since October 1999.

- This unemployment rate is well below the so-called NAIRU (non-accelerating inflation rate of unemployment), yet trends in productivity-adjusted costs and core prices continue to remain relatively subdued.

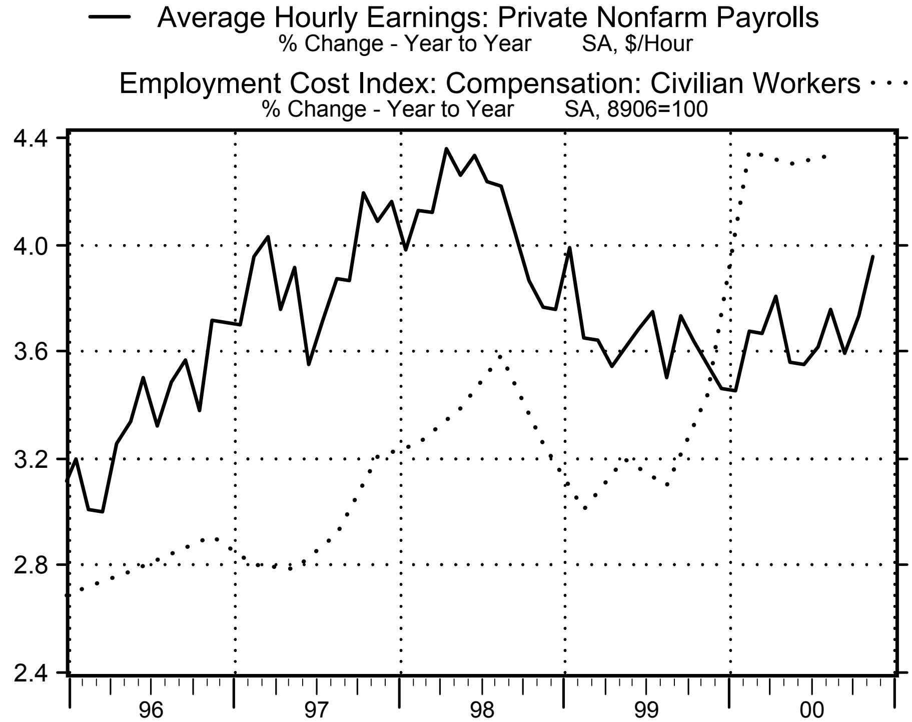


- Both the employment-to-population ratio and the participation rate remain modestly below their all-time highs.

- The high employment-to-population ratio means that a higher proportion of the population age 16 and older has jobs now relative to the past.

- The high participation rate means that more people are participating in the labor force (i.e., either have jobs or are seeking work) now than in the past.

- Both measures suggest the labor market is tight relative to historical norms.

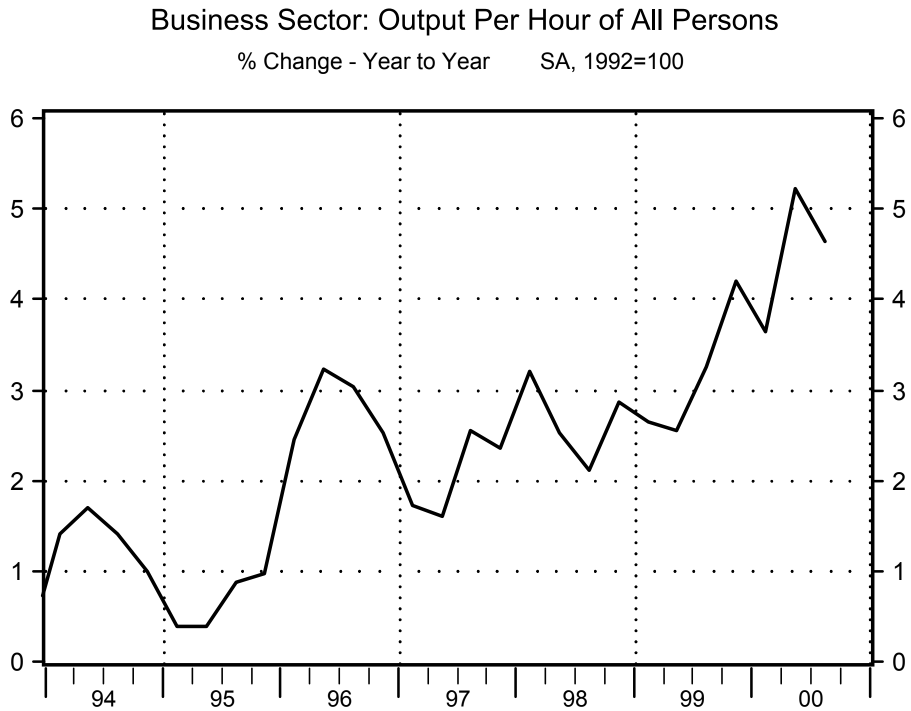


- Despite continued job gains and a low unemployment rate, key measures of wage "inflation" have generally remained relatively contained, especially if productivity gains are taken into account.

- Average hourly earnings increased 4.0 percent on a year-over-year basis in November.

- The Employment Cost Index increased 4.3 percent on a year-over-year basis in the third quarter. The Employment Cost Index measures changes in compensation costs, which include wages, salaries, and benefit costs. The recent increase was due in part to gains in benefit costs.

- With recent large productivity increases taken into account (see next chart), these wage increases translate into subdued wage cost pressures. This is evident in unit labor costs (not shown), which rose 0.27 percent in the third quarter (on a year-over-year basis).

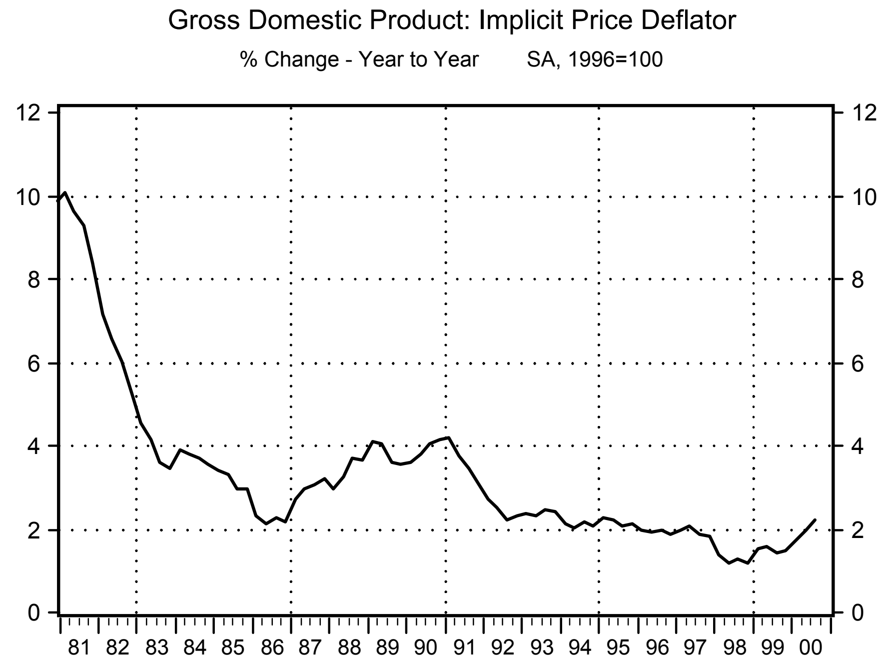


- In recent years, productivity or output per unit of input has advanced at a healthy pace. Productivity is usually discussed with reference to a unit of labor input, or worker productivity. This chart shows output per hour of all persons in the business sector.

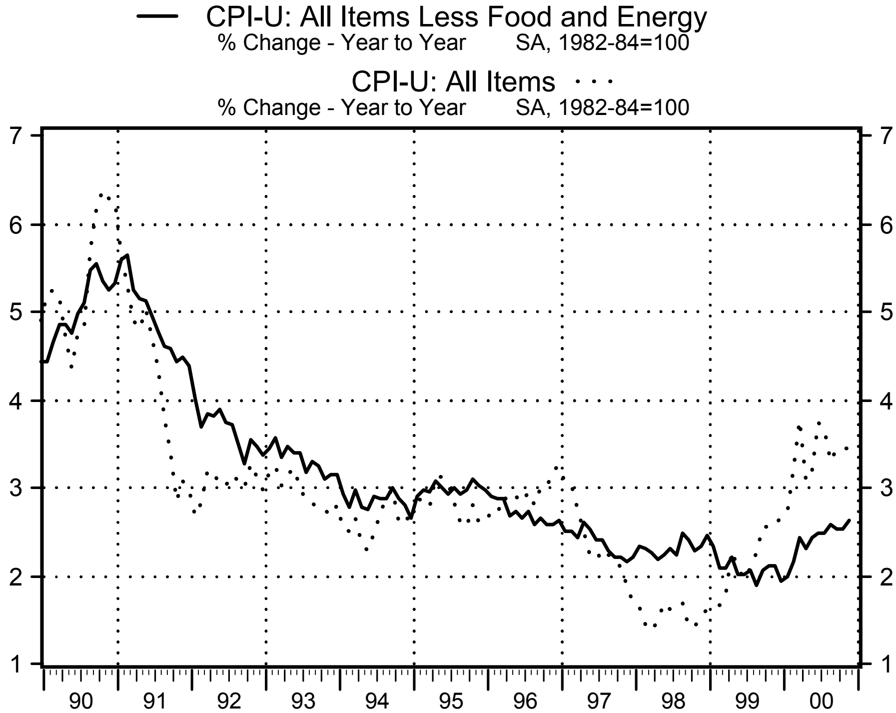
- Worker productivity is the key to improvements in the standard of living. As long as workers are becoming more efficient, their employers can afford to pay them more without having to boost the prices of their products.

- Strong productivity advances explain why wages can increase at a healthy pace without inflation becoming a concern.

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, it appears that inflation is no longer falling.
- Despite robust real economic growth and relatively low unemployment in recent years, inflation remains relatively benign.
- This long-term decline of inflation is due to persistent Federal Reserve anti-inflation monetary policy, which has reduced inflation, lowered interest rates, and thereby helped to foster the economic expansion.

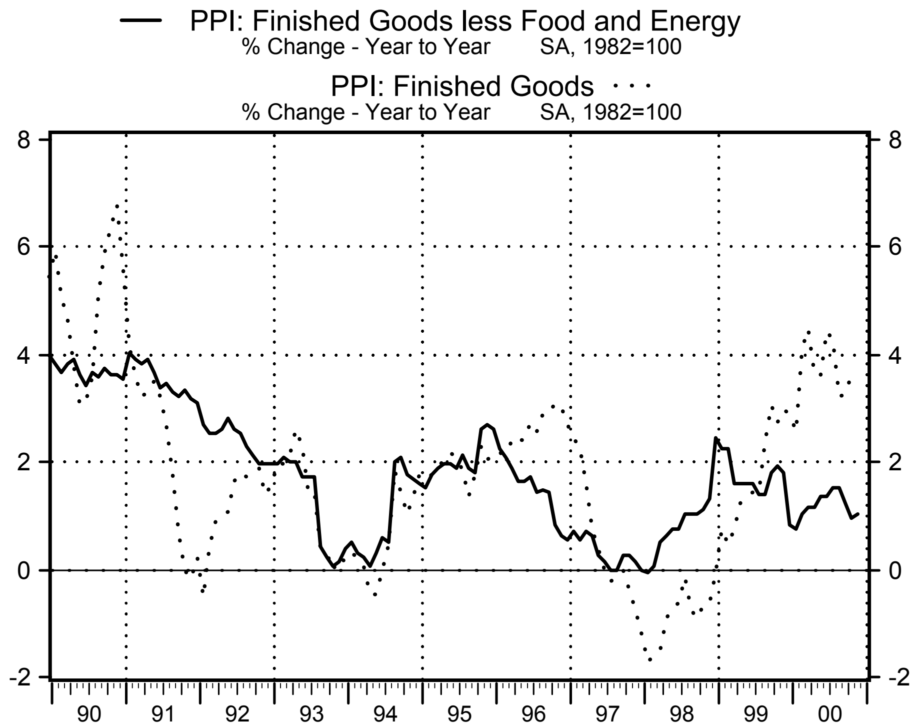


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation during the decade of the 1990s on a year-over-year basis.

- 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.

- November figures indicate core CPI advanced at a 2.6 percent year-over-year rate.

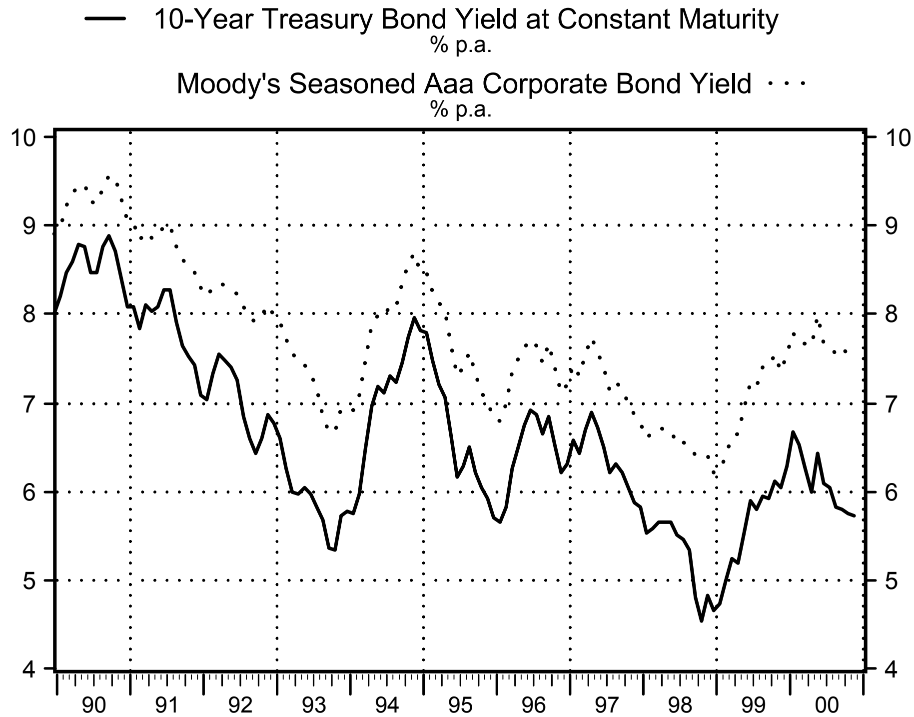


- This graph shows producer prices. Both the total finished good (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- 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).

- November figures indicated that energy prices pushed up the total figure and the increase in the "core" number remained at 1.0 percent on a year-over-year basis.

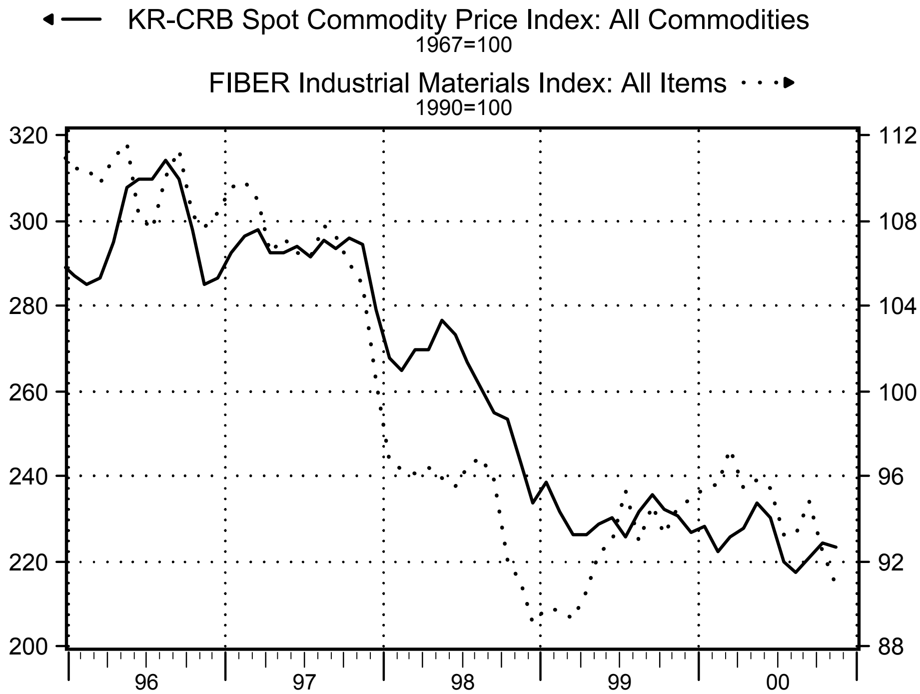
VII. Forward-Looking Market Price Indicators



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

- More recently, however, these rates have moderated and come down somewhat because of a lessened concern about future inflation and reduced fears of Fed tightening. (Treasury rates also have fallen partly because of less issuance.) Notably, long-term Treasuries are below the Fed funds rate, thereby producing an inverted "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.

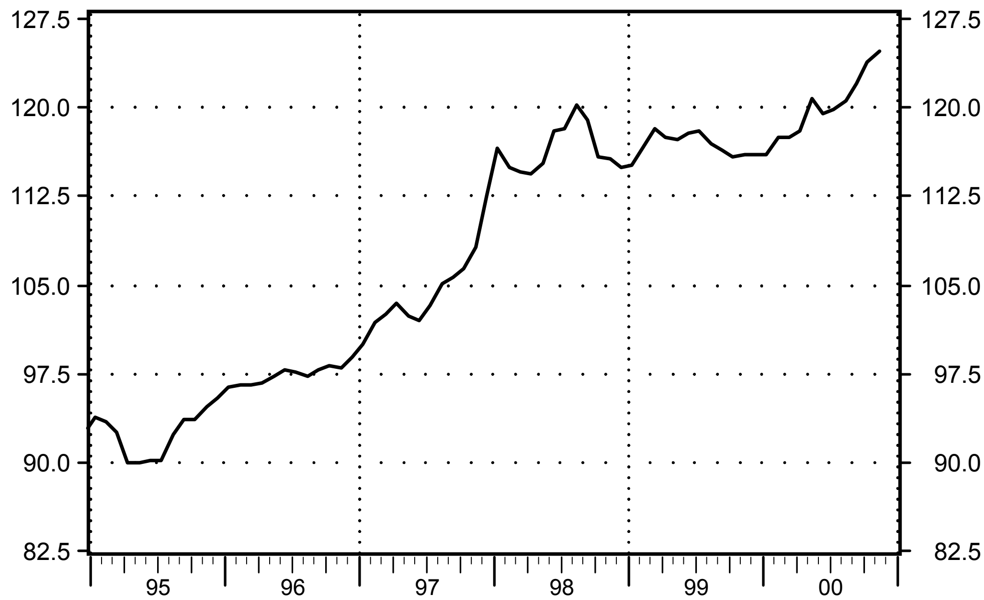
- The FIBER index contains industrial commodity prices including energy prices. It has fallen for several years but increased in 1999 (related to energy price hikes) and fell again in 2000. It remains below levels of a few years ago.

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

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

Nominal Broad Trade-Weighted Exchange Value of the US$

1/97=100



- 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 firm level.

- Recently, the dollar has strengthened against the Euro, and has stabilized against the Japanese yen.

- Taken together and assessed in conjunction with one another, these market price indicators suggest a resurgence of inflation is not imminent.

VIII. Reasons for Circumstances of Healthy Growth with Low Inflation

Lower Inflation Actually Improves Growth.
- Lowers interest rates
- Reduces unnecessary uncertainty and volatility in financial markets
- Causes 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)

Government Spending Has Fallen as a Percentage of GDP.
- We have experienced a significant decline in federal government spending as a percent of total output: the federal government spent over 22 percent of GDP in 1992, compared with about 19 percent today
- This enables resources to be used more productively, fostering more growth without inflation

Lower Marginal Tax Rates Remain in Place.
- We are reaping long-run effects of lower tax rates (despite increases in 1990 and 1993)
- Marginal tax rates remain lower than they were in the 1950s, 1960s, and 1970s

Investment Has Worked to Expand Capacity.
- Investment in equipment has been a leading sector in this expansion
- This helps growth without causing inflation
- The information revolution has increased productivity
- Technological change has improved productivity

Global Competition and Freer Trade Have Fostered Growth.
- A reduction in tariff barriers helps economic growth while promoting lower prices
- The international sector has increased in size and exports have been a leading sector in this expansion
- Inflation is declining in many countries
- The combination of global competition and technological change has forced corporate restructuring, making the economy more efficient