BRIEFING MATERIALS ON THE ECONOMY

JOINT ECONOMIC COMMITTEE

Prepared for Vice Chairman Jim Saxton

Data as of October 20, 2000

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CONTENTS

Briefing on the Economy[1]

Summary and Overview

- The Federal Reserve raised interest rates six times and 175 basis points since June of 1999. 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 impacted financial markets and some interest sensitive sectors of the economy. Oil price hikes will also impact the economy, but these effects are expected to be somewhat milder than those experienced in the 1970s.

- The economy continues to expand, albeit at a more moderate pace. The latest figures indicate the economy's inflation-adjusted GDP expanded at a robust 5.6 percent rate in the second quarter after registering 4.8 and 8.3 percent rates in the first quarter and last year's fourth quarter, respectively. The expansion is broad-based. Key components of GDP -- consumption and investment -- remain healthy. The growth of some (interest rate sensitive) sectors has moderated, but continues to expand.

- Key measures of broad price movements continue to indicate that trends in <u>core</u> 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.

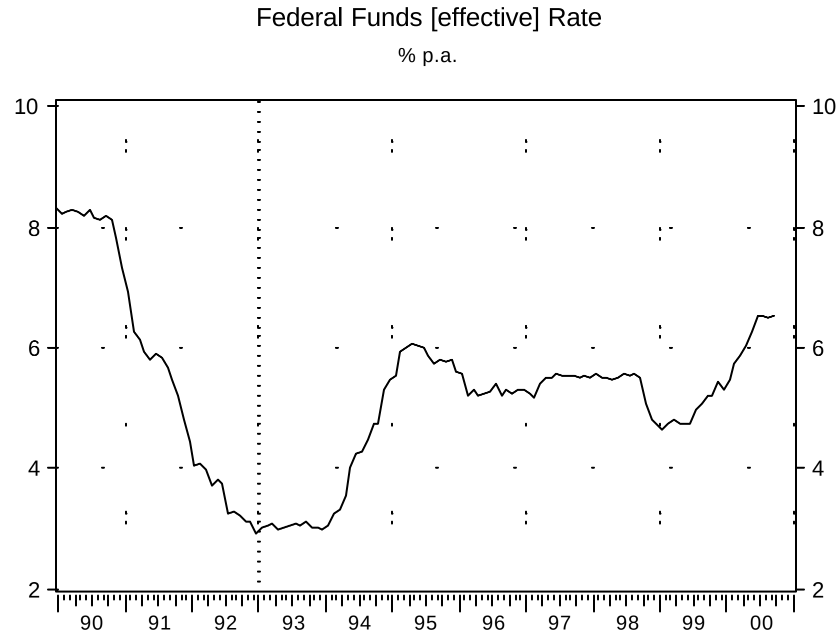
- Several forward-looking indicators of inflation and expectations of inflation suggest that inflation is no longer falling and may have ticked-up from low levels. Commodity price measures, which include energy prices, for example, have ticked-up -- albeit from low levels -- but have since moderated. Commodity price measures that do not include energy prices remain flat. Long bond yields also have increased, but have recently retreated a bit. The dollar remains strong, especially against the Euro and on a trade-weighted basis. Overall, these indicators continue to suggest no major resurgence of inflation is imminent.

- Consensus forecasts indicate the following:

	2000		2001	
	Q3	Q4	Q1	Q2
Real GDP	3.4	3.2	3.0	2.7
CPI Inflation	2.9	2.8	2.8	2.7

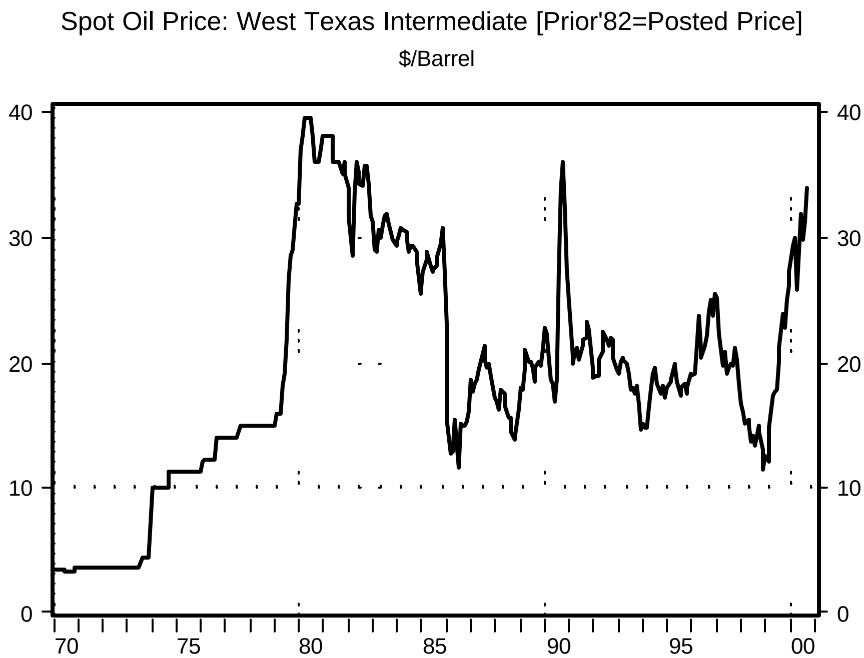
[1] The source for all graphs in these *Briefing Materials* is Haver Analytics.

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 since June of last year. 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, there are signs that the economy's growth rate may be beginning to slow.
- The October FOMC press release indicated the Fed believes the future risks facing the economy are weighted toward heightened inflation pressures in the near-term. The market currently expects no interest rate moves in the near future.
- The next FOMC meeting is November 15.

II. Oil Prices

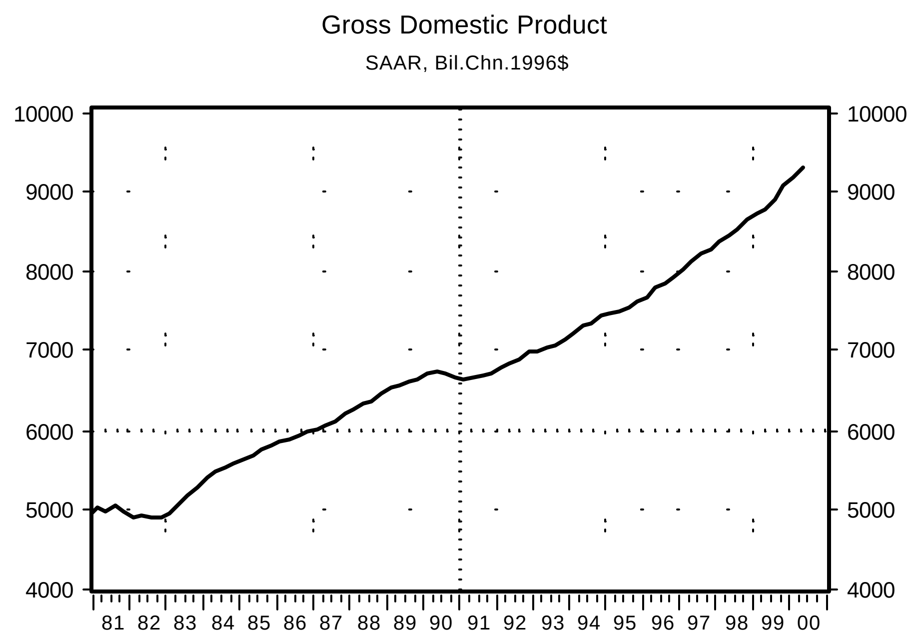


- This chart shows the nominal price of oil since 1970. Recently, oil prices have increased sharply, moving above $30/barrel.

- 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 in part depend on how oil producers use their increased oil revenue.

- 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.

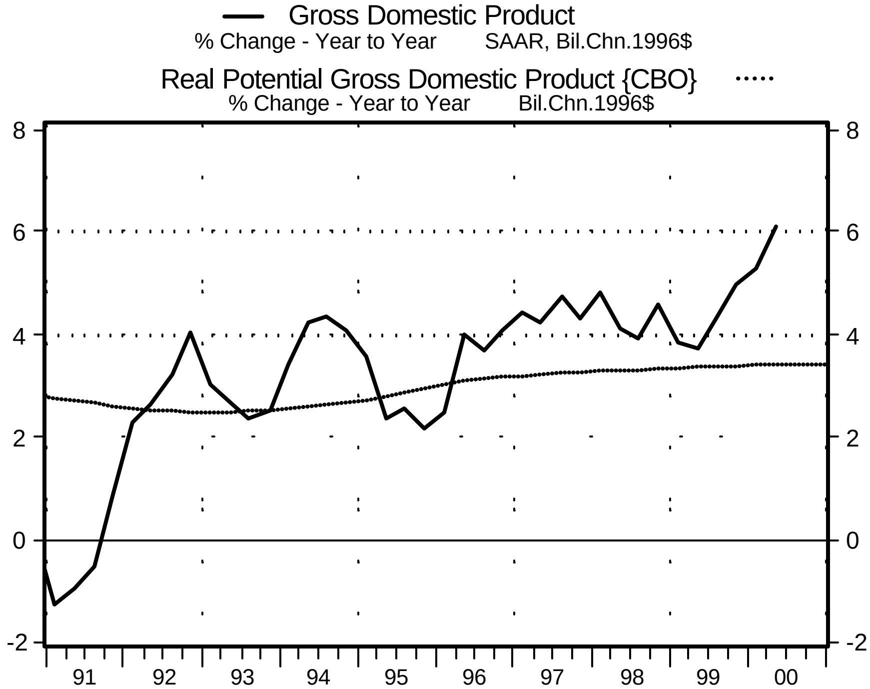
III. <u>Output Measures</u>



- The current economic expansion is now more than nine years old (114 months) and the longest expansion on record.

- This expansion followed the 1980s 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 expansions in American history.

- The recession that occurred between these record-breaking expansions was exceptionally short (8 months).

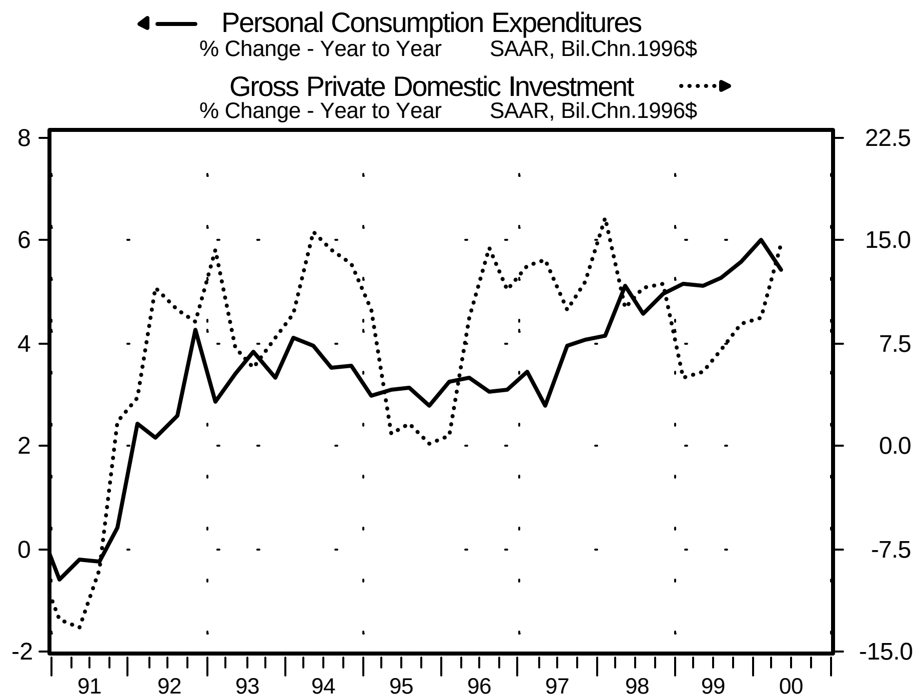


- This chart shows real GDP growth relative to "potential" GDP growth as calculated by the Congressional Budget Office (CBO) since the early 1990s (both on a year-over-year basis).

- 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 continues to expand rapidly. On an annualized basis, real GDP grew at a 5.6 percent pace in the second quarter, after registering 4.8 percent and 8.3 percent rates in the first quarter and last year's fourth quarter, 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 figures.

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

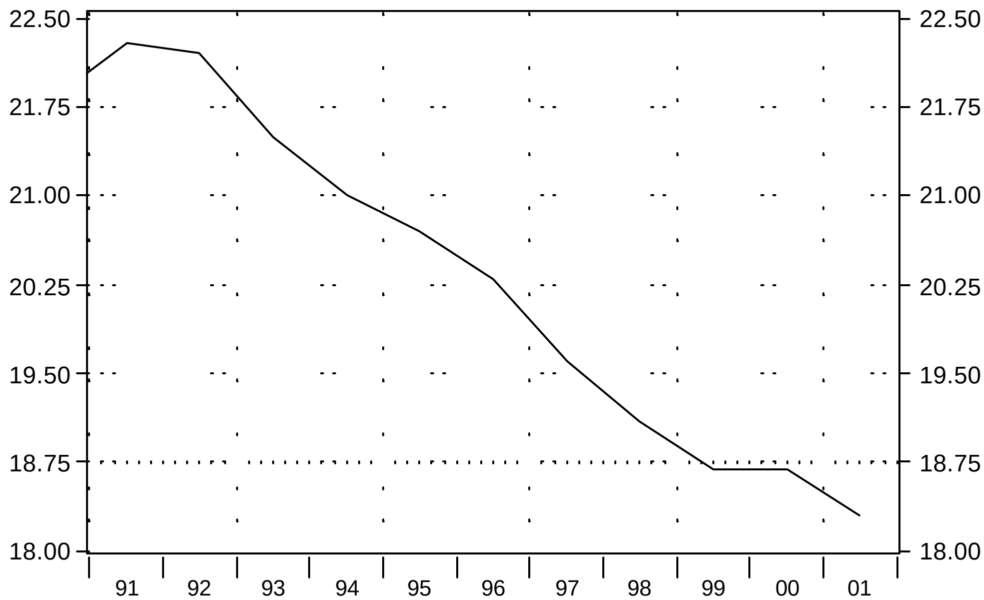
- Reasons for the strength of investment in this expansion include the decline of inflation (see below), reduced interest rates, increased real value of investment tax deductions, and technological advancements.

- Recent data suggest some moderation of durable good consumption spending (not shown).

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

Federal Outlays as a Percentage of GDP

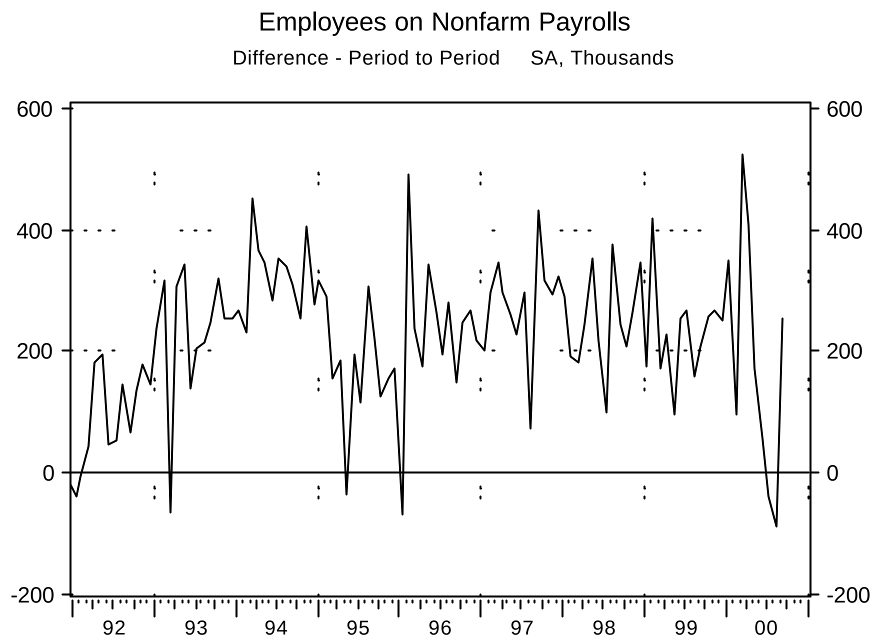
%, NSA



- 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 for 2000 and 2001 are estimates. (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.

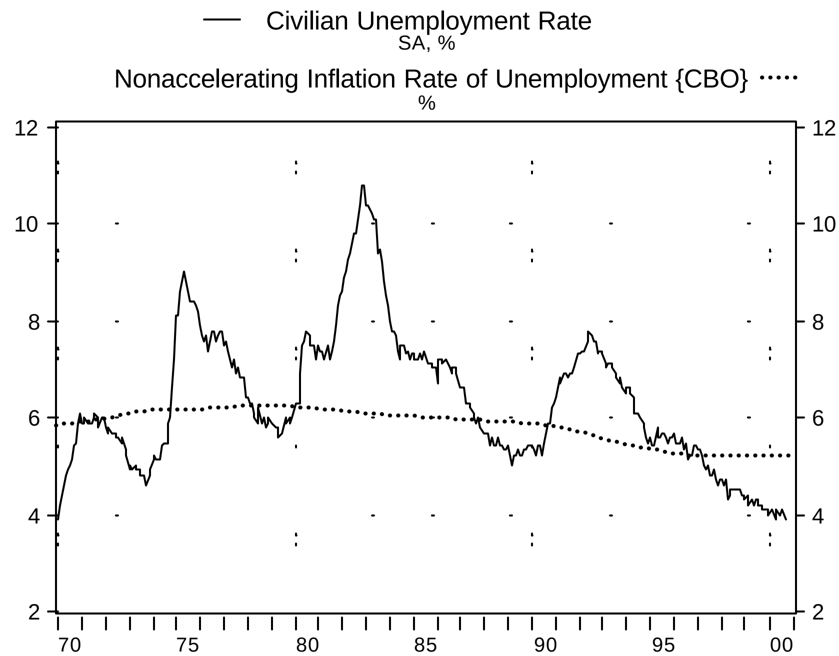
IV. The Labor Market



- 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.

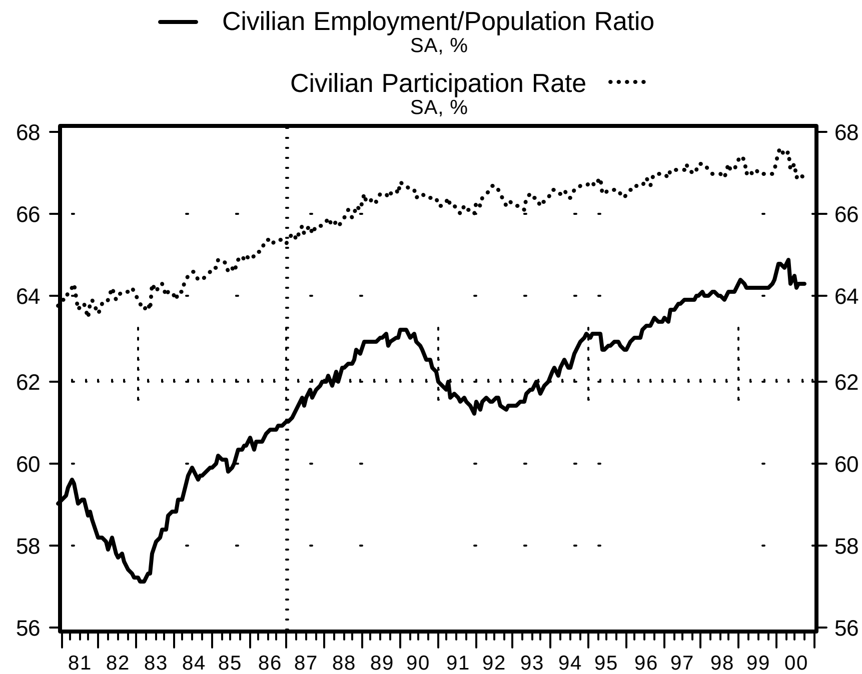
- Very recent monthly gains, however, have slowed from gains recorded earlier. This slowdown is also evident for employment in <u>private</u> non-farm establishments (not shown), as temporary hiring for the government census has masked the total figure slowdown.

- Employment gains for the third quarter have averaged significantly less than gains recorded earlier for both the total and private sector payroll categories.



- The September unemployment rate was 3.9 percent, matching 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.

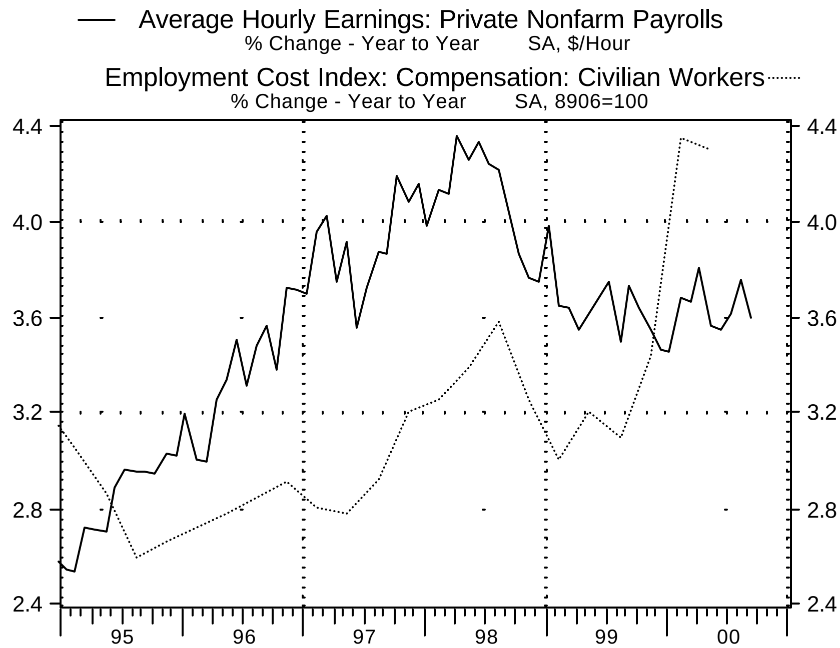


- Both the employment-to-population ratio and the participation rate remain modestly below their all-time highs.

- 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.

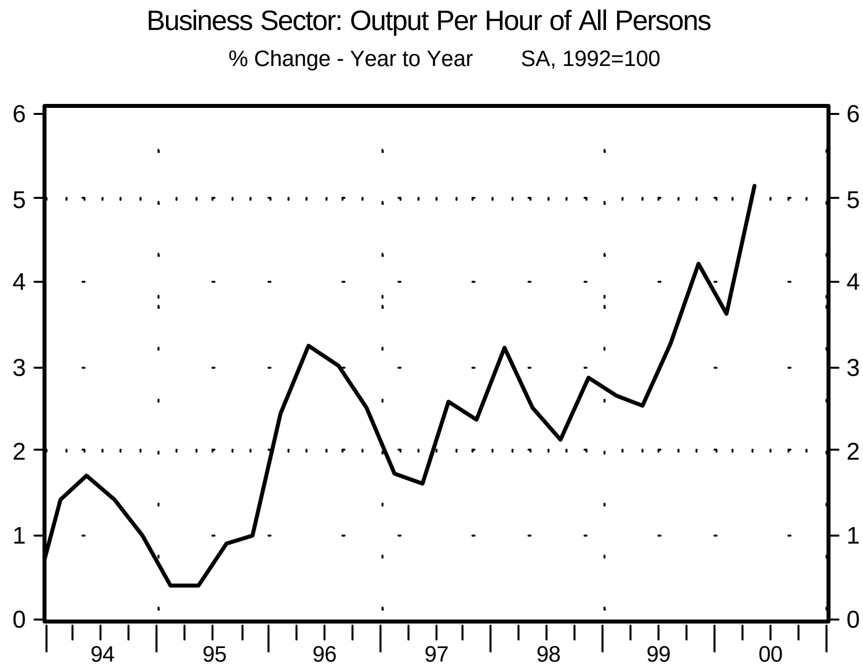


- Despite continued job gains and a low unemployment rate, key measures of wage "inflation" have generally remained contained, especially if productivity gains are taken into account.

- Average hourly earnings increased 3.6 percent on a year-over-year basis in September.

- The Employment Cost Index increased 4.3 percent on a year-over-year basis in the second 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 below), these wage increases translate into subdued wage cost pressures. This is evident in unit labor costs (not shown), which fell -0.36 percent in the second quarter (on a year-over-year basis).

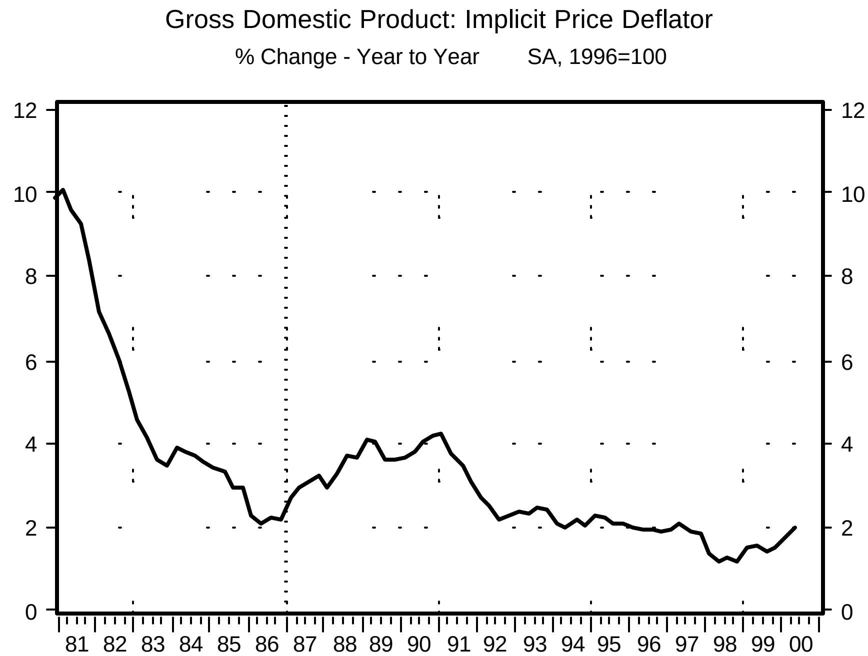


- In recent years, productivity has advanced at a healthy pace. This chart shows output per hour of all persons in the business sector.

- This rapid productivity growth helps to explain why the economy can advance at a robust rate and unemployment can decline to low levels without important inflationary consequences.

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

V. Inflation Measures

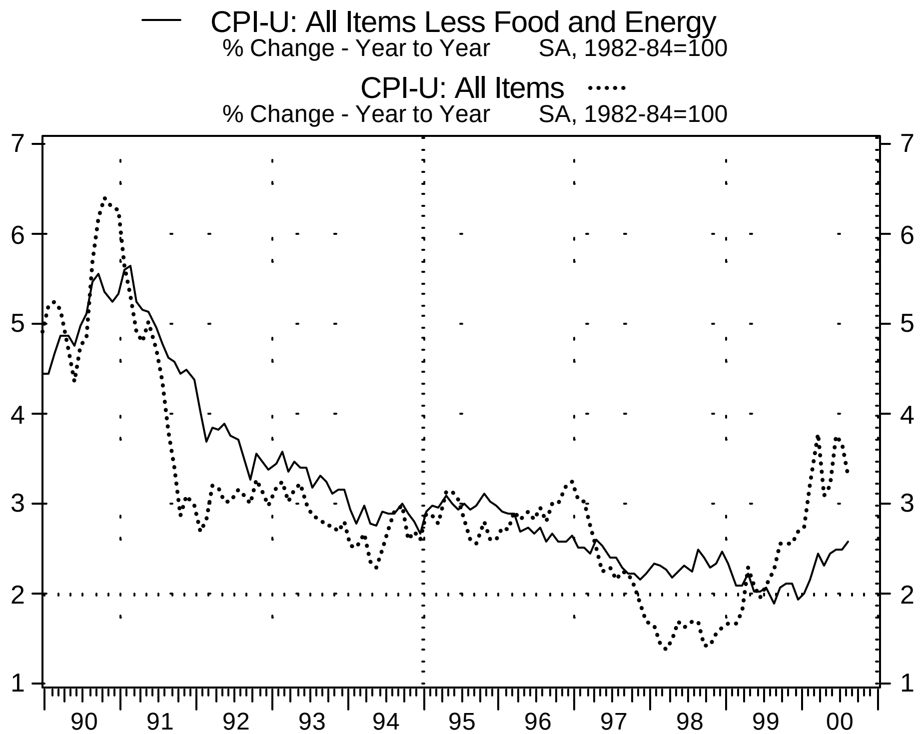


- This chart shows the broad GDP deflator, on a year-over-year basis over a long time frame.

- 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.

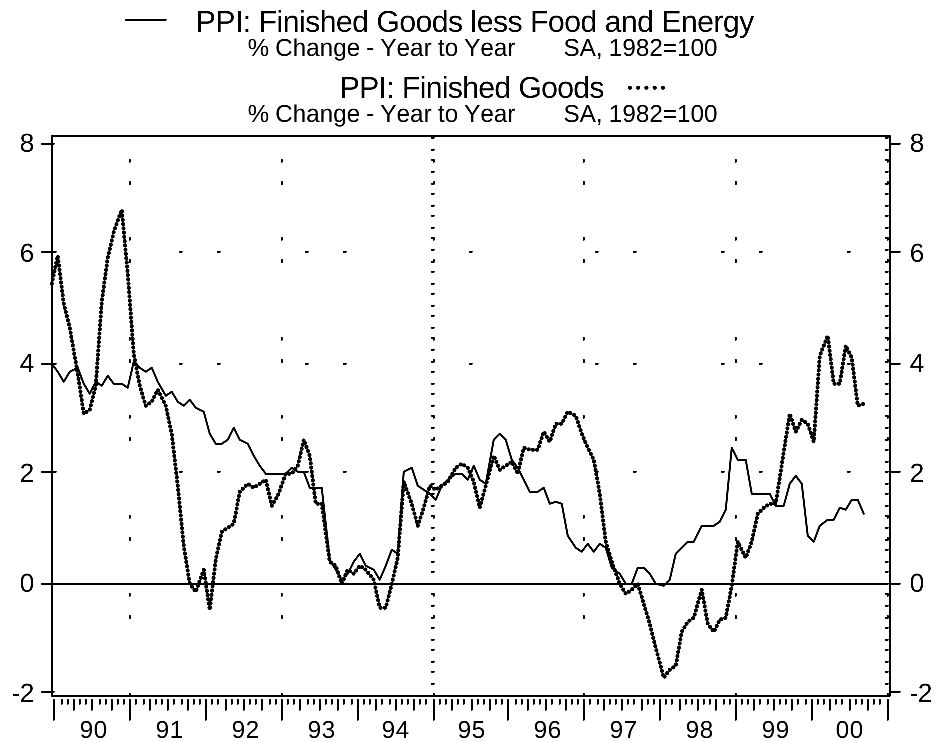


- This chart shows both total (all component) CPI inflation and core (ex-food and energy) CPI inflation during the decade of the 1990s on a year-over-year basis.

- 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 has for the most part continued to post modest gains on a year-over-year basis but recent figures indicate that core inflation is no longer falling.

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

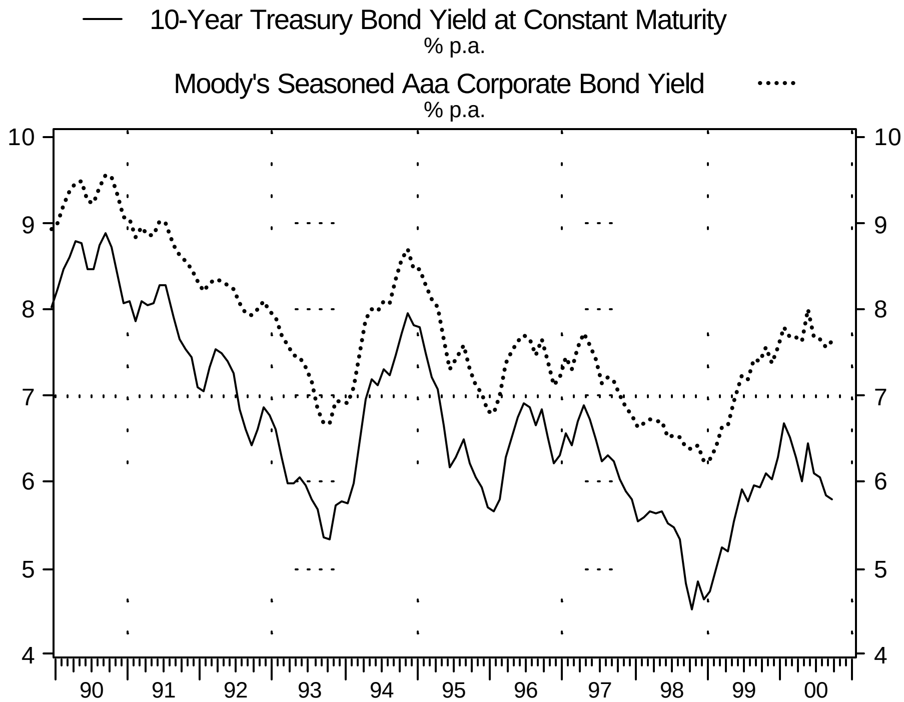


- This graph shows producer prices. Both the total finished good (all components) measure of producer prices and the core (ex-food and energy) measure of finished good producer prices are shown on a year-over-year basis.

- Recently, increases in energy prices have boosted the total PPI. Removing the volatile food and energy components, however, shows 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).

- September figures indicated that energy prices pushed up the total figure whereas the "core" number edged down on a year-over-year basis.

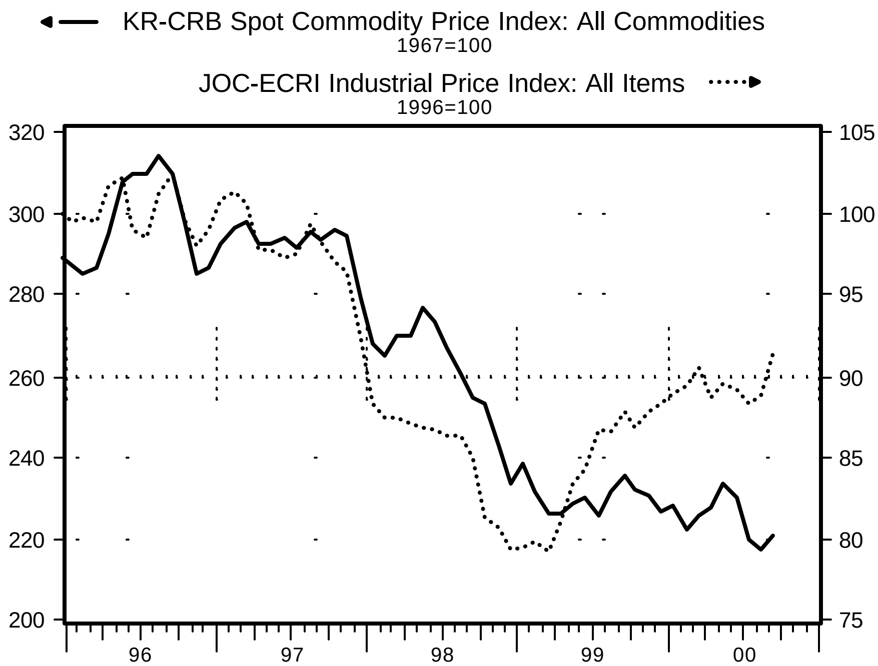
VI. Forward-Looking Market Price Indicators



- 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.

- 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.)

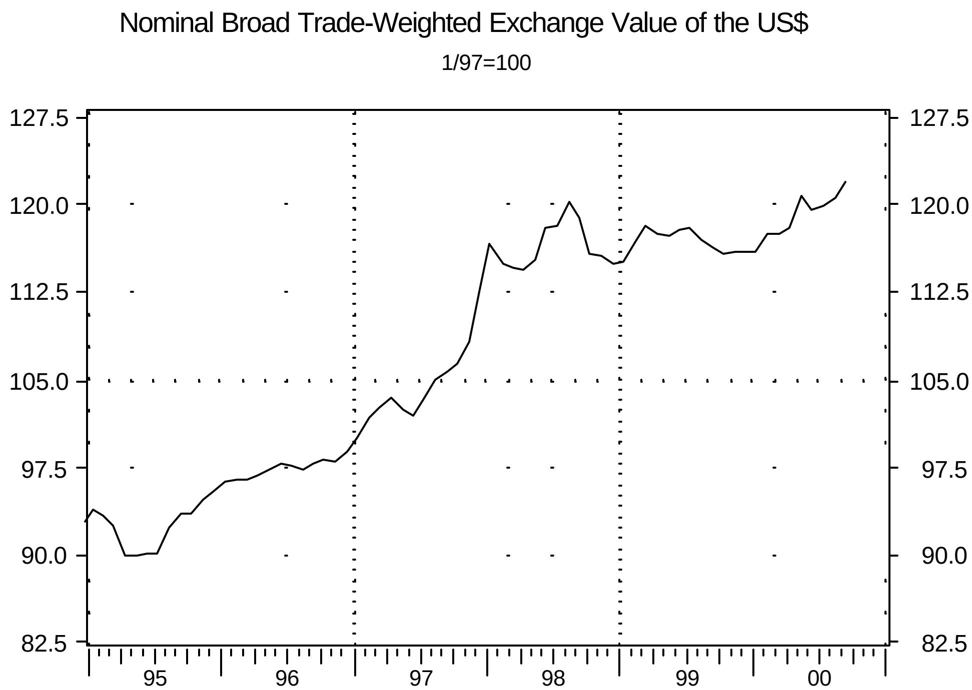


- This chart shows two commonly used broad commodity price indices (the Knight-Ridder-Commodity Research Bureau spot index and the Journal of Commerce -- Economic Cycle Research Institute industrial price index).

- The JOC index contains industrial commodity prices <u>including energy prices</u>. It has fallen for several years but increased in the last year or so. This increase is importantly related to energy price increases. Nonetheless, 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.

- The commodity price index <u>without energy</u> shows no signs 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, but recently has stabilized at a firm level.

- Recently, the dollar has strengthened against the Euro, but remains soft against the Japanese yen.

- Last month, at the initiative of the European Central Bank, the monetary authorities of the U.S. and Japan joined with the European Central Bank in concerted intervention in foreign exchange markets in an effort to boost the Euro.

VII. 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