

CRS Report for Congress

Received through the CRS Web

Current Economic Conditions and Selected Forecasts

Updated June 26, 2003

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Summary

The recession that began in March 2001 has not yet been declared over.¹ However, it is important to recognize that U.S. real growth has been positive for 18 months (6 consecutive quarters). The economy has now exceeded its previous high at the end of the 1991 - 2001 expansion.

Yet the rebound in growth has not translated into higher employment. Employment has continued to contract. The unemployment rate has remained high.

Moreover, the most recent data suggests that the economy continues to go through a “rough patch”. Growth remained positive in the first quarter 2003, but subdued for the second quarter in a row. Real GDP rose by 1.4%, the same pace as in the fourth quarter, on an annualized quarter-quarter basis, seasonally adjusted. Employment losses picked up in the first quarter and the civilian unemployment rate, after declining to 5.7% in January, rose to 6.1% in May, a rate last observed during May-June, 1994. Measured inflation increased in the first quarter and decreased during April and May, a pattern due in large part to energy prices.

While quarterly growth typically has its ups and downs, the recent weakness in household spending, limited pick up in business investment and continuing employment contraction has raised concerns.² Recent data offer limited guidance because it is difficult to separate immediately arising issues from the underlying trends. Key questions to keep in mind are to what extent do recent slow growth and employment contraction reflect: (1) continuing adjustment to imbalances in the business sector, particularly in the telecommunications industries; and/or (2) normal recovery trends in the aftermath of a recession ?

Despite these concerns, most economists expect the economy to pick up throughout the year, with the second half growing at an annualized pace at or above 3.5%. The unemployment rate is expected to show little change for the time being until businesses are sufficiently confident of conditions ahead so that they increase hiring. Inflation is expected to slow as oil prices decelerate. Fiscal and monetary policies were both eased in 2001 and 2002 and additional fiscal easing is now in place for 2003. The external deficit is large and expected to remain so.

¹ The recession has not been declared over yet by the National Bureau of Economic Research (NBER), which is the nonprofit, nonpartisan organization that dates the starting and ending points of U.S. business cycle. The NBER declared March 2001 to be the start of the recession. Typically, the NBER dates the end of a recession with a lag in order to make sure of trends and to take major data revisions into account. In the present situation, the absence of a recovery in employment is also a factor which the NBER is weighing heavily in its assessment.

² Even during the fast-growing years of the 1990s, a quarter of rapid growth often followed a quarter of slow growth.

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Current Economic Conditions and Selected Forecasts

Current Economic Conditions

While the recession that began in March 2001 has not yet been declared over, it should be recognized that U.S. real growth has been positive for 18 months (6 consecutive quarters).³ Since hitting its low point in the third quarter 2001, the level of real GDP has rebounded by 4.0%. The economy has now gone beyond its previous high at the end of the 1991 - 2001 expansion. In comparison to the previous business cycle, the level of GDP is higher now than it was at the same time in the previous recovery.

Yet despite the recovery in growth, legitimate concerns remain. The rebound in growth has not translated into an upswing in employment. Employment has continued to contract and the unemployment rate has remained high. Since the recession began in March 2001, employment has fallen by around 2.3 million people. The civilian unemployment rate rose to a high of 6.1% in May 2003 from a low of 3.8% (April 2000) during the 1991-2001 expansion. So far in 2003 the rate has tended to rise. While it fell below 6.0% for the first 3 months of the year, in April it returned to that rate and, as noted, in May rose to 6.1%.

Moreover, despite the positive recovery of real growth in the past 18 months, the past two quarters have been subpar. The most recent data suggests that the economy continues to go through a “rough patch”:

- Growth remained positive in the first quarter 2003, but subdued for the second quarter in a row: real GDP rose by 1.4%, the same pace as in the fourth quarter, on an annualized quarter-quarter basis, seasonally adjusted. Although the first quarter growth was the same as in the fourth quarter, consumption was slightly higher. The narrowing of the inflation-adjusted international trade deficit also boosted growth in the first quarter, after subtracting from growth in the fourth. (In national accounting terms, a narrowing of the deficit adds to growth and a widening subtracts from growth.)

³ The recession has not been declared over yet by the National Bureau of Economic Research (NBER), which is the nonprofit, nonpartisan organization that dates the starting and ending points of U.S. business cycle. The NBER declared March 2001 to be the start of the recession. Typically, the NBER dates the end of a recession with a lag in order to make sure of trends and to take major data revisions into account. In the present situation, the absence of a recovery in employment is also a factor which the NBER is weighing heavily in its assessment.

- Employment losses picked up in the first five months. Employment losses during the final 5 months of 2002 were about 250,000 vs. losses of 600,000 during the first 5 months of 2003. The civilian unemployment rate stood at 6.1% in May, a rate last observed in the May-July period of 1994.
- Measured inflation presents a mixed picture. The broadest measure of inflation for the economy, the GDP price index, accelerated from +1.8% in the 4th quarter 2002 to +2.4% in the 1st quarter 2003. The Consumer Price Index (CPI) rose sharply during the first quarter of 2003. However, the CPI fell in April and was unchanged in May. This pattern has been heavily influenced by sharp movements in the price of energy. Undoubtedly, a similar pattern will show up in the second quarter GDP indexes. Nevertheless, some economists fear that the U.S. may experience a period of deflation which will have a negative effect on growth and employment.

The most recent data are difficult to interpret. The key questions are: to what extent does relatively slow growth reflect continuing adjustment in the business sector, particularly in the telecommunications industries; and/or normal cyclical adjustment in the aftermath of a contraction? Alternatively, a weak first quarter may simply reflect the typical ups and downs of quarterly growth. Growth is not an even process. Even during the fast-growing years of the 1990s, a quarter of rapid growth often followed a quarter of slow growth.

Beginning in January 2001, Federal Reserve policy has shifted to one of ease. Since then, the Federal Open Market Committee (FOMC) of the federal reserve System has lowered the federal funds target rate by 550 basis points (5.5 percentage points). On January 3 and 31, March 20, April 18, May 15, June 27, and August 21, 2001, in the face of a falling rate of GDP growth and limited inflationary pressures, the target rate for federal funds was reduced to 3.50%. On September 17, in the wake of the terrorist attacks on the U.S., the target rate was reduced to 3.0%. On both October 2 and November 6 it was reduced 1/2% and on December 11, 1/4%. Additional easing took place on November 6, 2002, when the target rate was reduced to 1.25% from 1.75%. More recently, the federal funds target rate was reduced by 25 basis points to 1% following the meeting of June 24-25. The FOMC decision was related to continuing growth disappointment and the need to add further support to economic activity from monetary policy. Inflationary pressures remain subdued, and concerns have turned to disinflation.

Recent Macroeconomic Developments

GDP. To understand the most recent macroeconomic developments, it is important to understand the context over the medium-run. The growth rate of GDP since 1991 is shown in **Table 1**. Its most notable feature is that the growth rate of GDP averaged more than 4% per year during the second half of the recent expansion. GDP growth began to slacken during the second half of 2000 and actually contracted during the first 3 quarters of 2001 at an annual rate of 0.8%. This trend was reversed during the fourth quarter, when GDP grew positively, at an annual rate of 2.7%. The economy continued to expand during the 4 quarters of 2002, when real GDP grew at annual rates of 5.0%, 1.3%, 4.0%, and 1.4%, respectively. In 2003, real GDP increased by an annualized rate of 1.4% in the first quarter.

The growth in GDP since the fourth quarter 2001 has not yet translated into a comparable pick up in production in part because of the inventory cycle. However, this should not be worrisome. As **Table 1** illustrates, GDP rose far less than Final Sales in 2001 because inventory liquidation was on-going over the course of 2001. Inventory liquidation is normally a good sign, although in accounting terms, it subtracts from GDP. When inventories are liquidated, additional sales will come from new production and this will assist the recovery. We saw the process at work in 2002, when inventories were built up again after being drawn-down in 2001. GDP rose by 2.9% (4th-quarter-4th quarter), but the annualized growth of final sales rose by 2.5%. The difference between the two was the rise in inventories. Inventories were liquidated again in the first quarter 2003 as production could not keep up with the demand for goods and final sales rose at an annual rate of 2.3%.

Table 1. The Growth Rate of Real GDP v. Final Sales (%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
GDP Year Over Year	-0.5	3.0	2.7	4.0	2.7	3.6	4.4	4.3	4.1	3.8	0.3	2.4
4thQ Over 4thQ	0.9	4.0	2.5	4.1	2.3	4.1	4.3	4.8	4.3	2.3	0.1	2.9
Final Sales Year Over Year	-0.2	2.8	2.6	3.4	3.1	3.6	4.0	4.2	4.3	3.7	1.5	1.8
4thQ Over 4thQ	0.2	4.2	2.6	3.2	2.9	3.9	4.0	4.7	4.2	2.6	1.6	2.5

Source: U.S. Department of Commerce.

The Recession. On November 26, 2001, the National Bureau of Economic Research (NBER), the agency that dates the American business cycle, announced that the longest economic expansion in American history ended in March 2001. The U.S. recession is now in its 25th month. The final estimate of its duration may be shorter because the NBER usually dates the end of a recession after the fact to make sure of the data. However, for the time being, the NBER is withholding judgment because

key indicators are diverging. Counting the present recession, the United States has experienced 10 recessions since World War II. The average length of the nine previous recessions was 11 months. The longest recession lasted 16 months, the shortest 6 months.

The growth rate of Gross Domestic Product (GDP) has been slow relative to the pace of the second half of the 1990s. In 2001, it was barely positive, as the economy contracted during the first 3 quarters and rebound modestly in the fourth quarter at a 2.7% annual rate. For the year as a whole, real GDP increased by 0.1% as measured on a fourth quarter-fourth quarter basis and by 0.3% on an annual (or year-year) basis.⁴ Positive growth continued throughout 2002. Quarterly growth was, respectively, at annual rates of 5.0%, 1.3%, 4.0%, and 1.4%. Growth reported so far in 2003 was 1.4% in the first quarter.

Labor Markets. The civilian unemployment rate fell from its cyclical high in June 1992 (7.8%) to a low of 3.8% in April 2000, as shown in **Table 2**. At 3.8%, the unemployment rate was at a 30-year low. With a weakening of growth and a contraction followed by a weak recovery, the unemployment rate rose to a high of 6.1% in May 2003. Over the past 18 months, it has moved in a narrow band between 5.6% and 6.1%.

Since the recession began in March 2001, payroll employment has fallen by approximately 2.3 million. It is important to understand that this is a net concept. Jobs have continued to be created during this period, but job creation has not been sufficient to offset the loss in jobs elsewhere. On balance, this has translated into a net decrease in employment. Even during the recession, the U.S. economy has remained dynamic, even though this is not readily apparent from the aggregate figures.

More recently, job growth was positive in January, but the estimated 353,000 (revised) decline in February's payroll employment more than offset January's improvement. In March, April and May, payroll employment dropped cumulatively by an additional 453,000. In the aftermath of a contraction, labor markets typically improve with a lag after growth picks up because employers are reluctant to hire until they see that economic recovery is firmly in place.

⁴ There are several ways to measure the rate of growth in GDP for a particular year and they can be quite different. Economists generally prefer measurement of the change in GDP from fourth quarter to fourth quarter in order to emphasize the point of growth at which the economy ended the year. In contrast, popular coverage often features "annual GDP," which compares the average of the four quarters of GDP for a particular year to a similar average for the previous year. Because it is an average, annual GDP in fact measures the midpoint of growth for the year. The year-year comparison is therefore a comparison of growth midpoints for a given year.

Table 2. Civilian Unemployment Rate, 1991 - 2003
(in percentages)
Seasonally Adjusted

	J	F	M	A	M	J	J	A	S	O	N	D
1991	6.4	6.6	6.8	6.7	6.9	6.9	6.8	6.9	6.9	7.0	7.0	7.3
1992	7.3	7.4	7.4	7.4	7.6	7.8	7.7	7.6	7.6	7.3	7.4	7.4
1993	7.3	7.1	7.0	7.1	7.1	7.0	6.9	6.8	6.7	6.8	6.6	6.5
1994	6.6	6.6	6.5	6.4	6.1	6.1	6.1	6.0	5.9	5.8	5.6	5.5
1995	5.6	5.4	5.4	5.8	5.6	5.6	5.7	5.7	5.6	5.5	5.6	5.6
1996	5.6	5.5	5.5	5.6	5.6	5.3	5.5	5.1	5.2	5.2	5.4	5.4
1997	5.3	5.2	5.2	5.1	4.9	5.0	4.9	4.8	4.9	4.7	4.6	4.7
1998	4.6	4.6	4.7	4.3	4.4	4.5	4.5	4.5	4.6	4.5	4.4	4.4
1999	4.3	4.4	4.2	4.3	4.2	4.3	4.3	4.2	4.2	4.1	4.1	4.0
2000	4.0	4.1	4.0	3.8	4.1	4.0	4.1	4.1	4.0	3.9	4.0	3.9
2001	4.1	4.2	4.2	4.4	4.4	4.6	4.6	4.9	5.0	5.4	5.6	5.8
2002	5.6	5.6	5.7	5.9	5.8	5.8	5.8	5.8	5.7	5.8	5.9	6.0
2003	5.7	5.8	5.8	6.0	6.1							

Source: U.S. Department of Labor.

Inflation. The U.S. inflation performance has been remarkable over the past 10 years. The inflation rate decelerated throughout most of the expansion in the 1990s, as **Tables 3** and **4** illustrate. Toward the end of the expansion in 2000, the inflation rate accelerated, but the pick up was not noticeably different from earlier years of the cycle.

The deceleration in inflation over the 1990s occurred even as the pace of growth accelerated. In the postwar experience, it is unusual to have the rates of growth and inflation moving in the opposite direction, particularly when the unemployment rate was sustained at a relatively low level close to 4.0% in what was generally considered to be an economy at or above full employment.

During the 1991- 2001 expansion, the inflation rate increased more slowly on average than at any time since the early 1960s. At the same time, growth was stronger and the unemployment rate lower than experience would have predicted. Inflationary pressures slowed further with the recession. The exception is the acceleration in the Consumer Price Index (CPI) on a 12 month basis, but the pick up reflected the sharp increase in energy prices. Higher energy prices will be tough for consumers and businesses for awhile, but they are not expected to be permanent.

With the start of the recession in March 2001, inflation decelerated. The increase in consumer prices (the Consumer Price Index or CPI) slowed on a year-year basis from 2.8% in 2001 to 1.6% in 2002. The rate of increase in the GDP deflators, the broadest measures of inflation in the economy, decelerated from 2.3% in 2000 to 2.0% in 2001 and 1.3% last year. The exception to the deceleration story is the CPI

measured on a December - December basis. It rose by 2.4% during 2002, versus an increase of 1.6% in 2001. Despite acceleration in 2002, the rate of increase remained below the pace during most of the 1990s expansion. The acceleration continued through March 2003 (an increase of 3.0% as measured from March 2002 to March 2003). However, the CPI fell absolutely in April and was unchanged in May. While this pattern reflects, in large measure, the behavior of energy prices, some economists fear that it portends the on-set of deflation. This, they translate into falling GDP and rising unemployment.

Table 3. Rate of Change in the Consumer Price Index (CPI)
(in percentages)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Dec. over Dec.	3.1	2.9	2.7	2.7	2.5	3.3	1.7	1.6	2.7	3.4	1.6	2.4
Excluding food and energy	4.4	3.3	3.3	2.6	3.0	2.6	2.2	2.4	1.9	2.6	2.7	1.9
Year Over Year	4.2	3.0	3.0	2.6	2.8	3.0	2.3	1.6	2.2	3.4	2.8	1.6
Excluding food and energy	4.9	3.7	3.3	2.8	3.0	2.7	2.4	2.3	2.1	2.4	2.6	2.4

Source: U.S. Department of Labor.

Table 4. Rate of Change in the GDP Deflators
(in percentages)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Implicit Price Deflator	4.2	3.1	2.3	2.4	2.1	2.1	1.9	1.8	1.1	1.6	2.3	2.0	1.3
Chain Type Price Index	4.2	3.1	2.3	2.4	2.1	2.1	1.9	1.8	1.1	1.6	2.3	2.0	1.3

Source: U.S. Department of Commerce.

With the favorable inflation performance of the economy, economists think that several forces keeping a lid on inflation may be at work:

- In the short-run, the acceleration in productivity improvement is regarded by some economists as an important factor in the slowdown in inflationary pressure at the same time growth picked up during the 1991-2001 expansion. Since 1995, nonfarm business productivity has increased on average by 2.6% annually.⁵ In 2002, productivity rose by a 4.8% rate, fourth quarter - fourth quarter. To put recent developments into perspective, the average annual rate of increase since 1995 is double the average annual rate from 1973 to 1995 (2.6% versus 1.3%). In concrete terms, this important change means that the same amount of labor will produce higher output.

⁵ Nonfarm business productivity is the measurement of output per hour.

Over time, a change of this nature will mean substantially stronger growth in per-capita income and a higher standard of living.

- Unit labor costs have been decelerating or falling. With more output produced for each hour worked, firms have their employee cost per unit of output reduced. The growth rate of per unit labor costs has been falling in the past 2 years, as shown in **Table 5**.⁶ This reflects both the pick-up in productivity growth and slowdown in basic labor costs during the recession. Employee cost trends are also measured in the Employment Cost Index (ECI). The ECI for private industry accelerated from 1995 through most of 2001 and early 2002, but began to decelerate in the course of 2002 as a result of weakened labor market pressures. In the first quarter of 2003, however, it accelerated from the third and fourth quarters due to increases in both the (1) wage and salary and (2) benefits components.
- Technological advances have led to declining prices for many goods that use certain information technology components as inputs.

Table 5. Rate of Change in Labor Costs
(in percentages)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Unit Labor Costs	0.4	1.5	1.1	1.5	0.7	1.1	2.4	1.4	4.9	-0.5	-1.0	2.1
Employment Cost Index	3.5	3.6	3.1	2.6	3.1	3.4	3.5	3.4	4.4	4.2	3.2	3.8

Source: U.S. Department of Labor.

Note: Unit labor costs are for nonfarm business, 4th quarter-4th quarter. The Employment Cost Index is for private industry, December - December. For 2003, it is the annualized rate for the 1st quarter.

The U.S. Foreign Trade Deficit. The U.S. foreign trade deficit (net imports), as shown in **Table 6**, recorded a continued and dramatic fall from 1988 through 1991.⁷ In each of these years the trade deficit declined as export growth exceeded import growth. During 1992 the trade deficit began to grow as a fraction

⁶ On a year over year basis, the rise in per unit labor costs, 1990 - 2002, was respectively, 4.3%, 3.6%, 1.6%, 1.7%, 0.8%, 1.2%, 0.5%, 0.9%, 2.7%, 2.0%, 3.9%, 1.6% and -1.9%.

⁷ The foreign trade deficit figure analyzed above is different from the headline trade deficit reported in the press and another trade deficit ratio often used by economists, although they are all related and can be reconciled. In this report, the "trade deficit" refers to exports and imports from the U.S. national accounts, which are the basis for the GDP figures. The underlying data for the figures cited above are released quarterly and annually and are on an inflation-adjusted basis ("real"). In contrast, foreign trade figures frequently quoted in the press are different because they released monthly rather than quarterly, not adjusted for inflation and are defined slightly differently otherwise. These figures are usually not compared to GDP. To make matters even more confusing, economists often refer by convention to the quarterly trade figures known as the current account. The current account position includes components not in the figures above and is not adjusted for inflation. For 2002, the current account deficit was approximately 4.8% of nominal GDP.

of GDP and is now running at a rate in excess of its previous high in 1987. During the first quarter of 2003, it reached 5.1% of GDP (nominal basis). The increase in the U.S. foreign trade deficit during 1992–2002 reminds us that the United States still receives a substantial net inflow of capital from abroad.

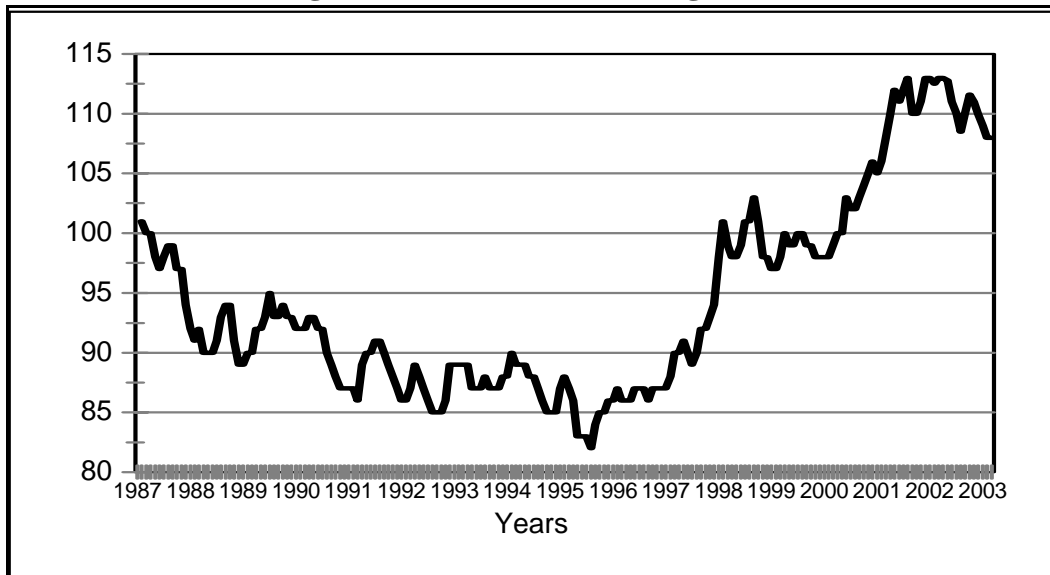
**Table 6. U.S. Foreign Trade Deficit
(as a percent of GDP)**

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Trade Deficit	1.8	1.2	0.8	0.2	0.3	0.8	1.2	1.0	1.1	1.4	2.6	3.6	4.3	4.4	5.2

Source: Department of Commerce.

Note: Percentages measure the real trade deficit divided by real GDP.

Figure 1. Real Dollar Exchange Rate



Source: Board of Governors of the Federal Reserve System

The U.S. Dollar. Figure 1 records the movement in the foreign exchange value of the dollar measured against a trade-weighted index of the currencies of many U.S. trade partners over the past 15 years. After hitting a low in the second quarter 1995, the dollar rose in real or inflation-adjusted terms (that is, it appreciated) by over 34% to its peak in February 2002. Since then, it has depreciated by more than 9% on an inflation-adjusted basis, and is now around its April 2000 level. Even after the depreciation, the dollar remains well above its 1995 low (23%). The dollar has depreciated by about the same percentage on a nominal basis (that is, not adjusted for inflation).

The dollar has shown more movement against the major world currencies than the broad trade-weighted index described above suggests.⁸ Since its high in February 2002, the dollar has depreciated by approximately 18% against an index consisting of the major currencies that circulate, adjusted for inflation. The dollar has moved differently against other trade partners whose currencies are not substantially traded. Until recently, it had appreciated.

The dollar has depreciated considerably in recent months. In the Federal Reserve's weighted currency index, the euro area is slightly more heavily weighted in U.S. trade than Canada. The dollar has depreciated considerably against both the currencies of both trade partners. Since the end of March, the dollar has declined by 8.2% against the euro and by over 9% against the Canadian dollar.

Posture of Fiscal and Monetary Policy

The course of GDP growth can respond significantly to changes in fiscal and monetary policy.

Fiscal Policy. The posture of fiscal policy depends on how it is measured. A generally accepted method is to examine the ratio of the structural or full employment budget deficit to full employment GDP. When that is done, as shown in **Table 7**, fiscal policy during 2002 was expansionary as the full employment surplus fell from 0.8% to a deficit of 1.5% of potential GNP. An alternative, although inferior measure, is the ratio of the actual budget deficit to actual GDP. When examined, fiscal policy in 2002 was also expansionary as the actual surplus fell from 1.3% to a deficit of 1.5% of actual GDP.

Monetary Policy. Traditionally, the posture of monetary policy has been judged either by the growth of the monetary aggregates or by movements in interest rates.⁹ In fact, neither is an unambiguous indicator. The monetary aggregates, for example, give a confused picture. All three M's grew more slowly over 2002 compared to 2001. However, the growth of M1 and M2 has accelerated during the first 4 months of 2003. Not so for M3. It is unclear what this implies for the future growth of GDP.

⁸ In **Figure 1**, the dollar is measured against an index of the currencies of many of the major trade partners of the United States weighted according to the proportion of trade. This is referred to as the "broad dollar index". The Board of Governors also publishes the exchange rate of the dollar with the currencies of smaller groups of countries or individual countries.

⁹ For a more comprehensive discussion of monetary policy, see CRS Report RL30354, *Monetary Policy: Current Policy and Conditions*, by Gail Makinen.

Table 7. Alternative Measures of Fiscal Policy
(\$ in billions per fiscal year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Standardized Budget Deficit	\$121	\$147	\$185	\$185	\$141	\$144	\$99	\$73	\$37	\$ 3	\$+99	\$+80	\$153
Full Employment GDP	5,706	6,088	6,403	6,713	7,030	7,376	7,740	8,137	8,528	8,945	9,442	9,995	10,428
Ratio	0.021	0.024	0.029	0.028	0.021	0.020	0.013	0.009	0.004	0.000	+0.011	+0.008	0.015
Actual Budget Deficit	\$221	\$269	\$290	\$255	\$203	\$164	\$107	\$22	\$+69	\$+126	\$+236	\$+127	\$158
Actual GDP	5,738	5,928	6,222	6,561	6,949	7,323	7,700	8,194	8,655	9,141	9,715	10,032	10,337
Ratio	0.039	0.045	0.047	0.039	0.029	0.022	0.014	0.003	+0.008	+0.014	+0.024	+0.013	0.015

Source: Congressional Budget Office (January 2003)

The positive growth in aggregate reserves over 2001-2003 to-date is in response to the aggressive easing of monetary policy by the Federal Reserve as it attempts to accelerate the growth in aggregate demand. The continued rapid growth of the monetary base reflects in part the growth in reserves. However, it mainly reflects the growth in paper currency in circulation since about 90% of the base is accounted for by currency (the great portion of which does not circulate in the United States). Thus, it is not clear how much information on the future condition of the economy can be read by looking at the growth rate of the monetary aggregates.

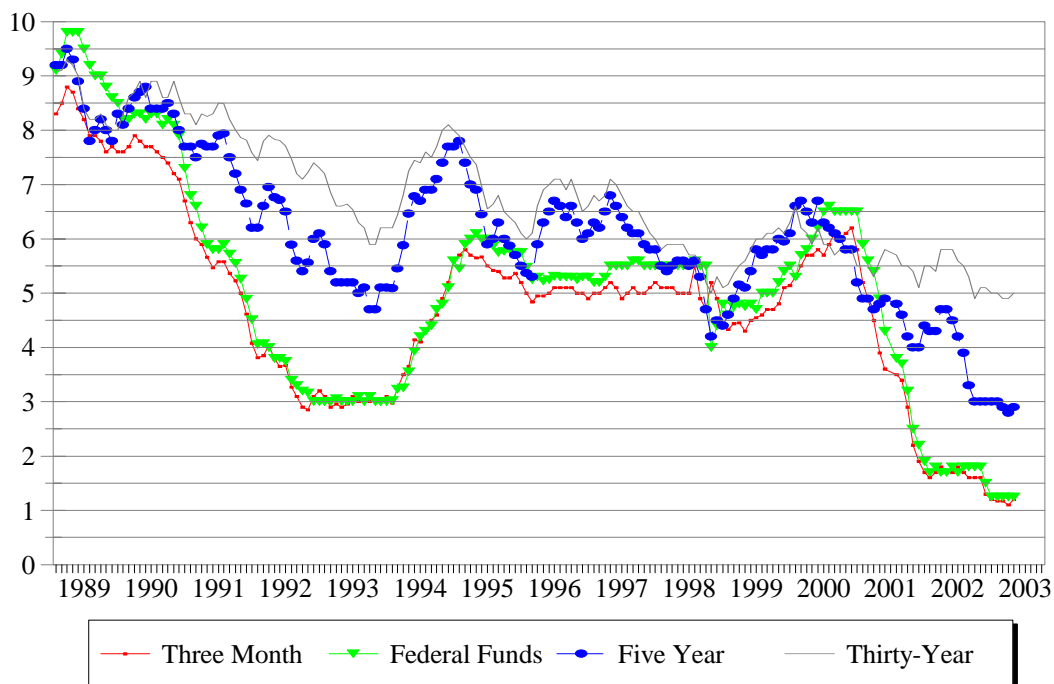
Table 8. The Growth Rates of the Monetary Aggregates
(annualized rates of change)

Time Period	Aggregate Reserves	Monetary Base	M1	M2	M3
88:12-89:12	0.8%	4.2%	0.8%	5.4%	4.0%
89:12-90:12	3.1	9.5	4.0	3.8	1.6
90:12-91:12	9.0	8.3	8.7	3.0	1.3
91:12-92:12	19.6	10.5	14.3	1.6	0.3
92:12-93:12	11.3	10.5	10.3	1.6	1.4
93:12-94:12	- 1.8	8.2	1.8	0.4	1.7
94:12-95:12	-5.0	3.9	-2.0	4.1	6.0
95:12-96:12	-11.2	4.0	-4.1	4.7	7.3
96:12-97:12	-6.6	6.1	-0.7	5.7	9.1
97:12-98:12	-3.5	7.0	2.2	8.8	11.0
98:12-99:12	-7.6	15.3	2.3	6.0	8.3
99:12-00:12	-7.3	-1.5	-3.0	6.2	8.6
00:12-01:12	6.7	8.7	8.3	10.5	12.9
01:12-02:12	2.8	7.2	3.2	6.5	6.5
02:12-03:05	4.6	7.2	9.8	8.8	4.7

Source: Board of Governors of the Federal Reserve System.

The growth in the reserves of depository institutions results to a large degree from decisions to move the key federal funds' interest rate (shown in **Figure 2**), the principal tool of monetary policy. These moves have been motivated primarily by a desire to bring the economy to full employment and then keep it growing at a rate sufficient to maintain full employment. From time to time, other factors may influence the movement of this rate. For example, the turmoil in both domestic and international financial markets cause the rate to be reduced 1/4% on September 29, October 15, and November 17, 1998 at which point it stood at 4.75%. In three equal moves of 1/4% during June, August, and November 1999, the rate was returned to its pre-crisis level of 5.5%. On both February 2 and March 21, 2000, in the face of mounting evidence that the economy was growing at an unsustainable rate, the federal funds rate was raised an additional 1/4%, and on May 16 it was raised 1/2%, bringing the rate to 6.5%. In six equal cuts of 1/2% (January 3 and 31, March 20, April 18, May 15 and June 27), and a seventh cut of 1/4% (August 21), the rate was reduced to 3.50%. In response to the 9/11 terrorist attacks, the rate was reduced to 3.0% on September 17 and in a further move toward easing, it was reduced to 2.5% on October 2, to 2.0% on November 6, and to 1.75% on December 11. For most of 2002, the FOMC did not make additional cuts in its federal funds target rate because it wanted to wait and see how strong economic activity would be following the dramatic cuts in 2001. Toward the end of the year (November 6, 2002), the target was reduced to 1.25% in the face of a softening in demand growth. For most of the first half of 2003, assessment of the underlying strength of the economy was obscured by temporary dampening effects related to the geopolitical tensions earlier in the year. With these effects diminishing, it became apparent that sustained growth had not yet resulted. On June 25, 2003, the target federal funds rate was lowered to 1% in order to provide further support to the economy.

Figure 2. Yield on Selected U.S. Treasury Securities and Federal Funds (%)



Source: Board of Governors of the Federal Reserve System.

As **Figure 2** shows, movements in short-term interest rates mimic closely movements in the federal funds rate. This is not as true for longer-term rates. Their rise and fall as well as the magnitude of their shifts is often different from the timing and magnitude of shifts in the federal funds rate. This is due in part to the fact that they respond to the longer run outlook for inflation, the financing requirements necessitated by the budget deficit, both current and prospective, and the international flow of capital.

Summary of Current Developments

The NBER decided on November 26 2001 that the longest economic expansion in U.S. history was over and that the United States had been in a recession since March 2001. This decision was unprecedented in the sense that in March the U.S. economy—according to the data then available—was still expanding. We now know that GDP was contracting, a contraction that would run 3 quarters. The unemployment rate reached a low of 3.8% in April 2000. It began to rise and in May 2003 reached a high of 6.1%, even as positive GDP growth resumed. Since the recession began, employment has declined by approximately 2.3 million. On the positive side, the rate of inflation slowed, although some of the decline can be attributed to the sharp fall in oil prices. To combat the economic slump, both fiscal and monetary policies have become expansionary. In eleven separate moves during 2001, the target for the federal funds rate was reduced to 1.75% on December 11, from a high of 6.5% on January 3. On November 6, 2002, the rate was reduced to 1.25% in the face of evidence suggesting that demand growth had softened. Signs of revival are beginning to show. GDP grew during each of the past 6 quarters. However, signals are mixed. Growth has been 1.4% (annual rate) for two quarters in a row (4th quarter 2002 and 1st quarter 2003). Based on incomplete data for the second quarter, there are a few signs of improvement, but most activity remains subdued.

Sources of GDP Growth

Table 9 records the sources of growth in GDP over the 1991-2001 expansion. These data record two interesting developments. First, investment spending played an important role in that expansion. And among the categories of investment, outlays for personal computers were important. This bodes well for the longer run growth in productivity. Second, purchases by all levels of government played only a small role in that expansion.

Table 9. Sources of GDP Growth: 1992 through 2002

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real GDP Growth*	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	**	100.0%	100.0%
Consumption	59.3	86.2	51.5	63.3	71.1	80.0	105.1		65.1	72.0
Investment	46.7	1.2	42.4	45.5	44.4	30.3	21.6		50.4	-28.6
Govt. Purchases	0.8	-6.8	12.0	10.2	10.1	16.3	7.3		23.6	2.6
Net Exports	-6.97	19.4	-5.9	-19.0	-25.6	-26.4	-34.0		-39.1	54.1

Source: Department of Commerce.

* Computed using real GDP at 1996 chained dollars on a 4th quarter over 4th quarter basis. For 2003, data for first quarter.

** When the small change in GDP is compared with the large change in components, the resulting percentages are so large as to be meaningless.

Economic Forecasts, 2002-2003

The forecasts in **Table 10** come from three sources. OMB and CBO are well known. BC stands for the Blue Chip Economic Indicators, a firm that collects the forecasts from about 50 forecasters in finance, business, and universities. BC Con represents the consensus or average forecasts of this group. BC T-10 is the average of the high ten among these forecasts, while BC B-10 is the average of the low ten forecasts.

The overall view taken by the forecasts summarized in **Table 10** is that a somewhat higher rate of GDP growth will occur during 2003, with a strong pick-up coming in the second half of the year. The rate of GDP growth, according to the consensus forecast, will be insufficient to have much of an effect on the unemployment rate. The inflation rate for the entire economy (as measured by the GDP price index) is expected to remain below 2.0%. Inflation as measured by the fixed market basket of the Consumer Price Index for all Urban Consumers is forecast to accelerate by over half a percentage point to slightly below 2.5%. Both short-term and long-term interest rates are expected to be at or slightly below their 2002 levels.

The Chairman of the Board of Governors of the Federal Reserve presented the economic projections of the Federal Reserve Board of Governors and Federal Reserve District Bank Presidents for 2003 in testimony before the Senate Banking Committee on February 11, 2003 and the House Financial Services Committee on February 12, 2003. The Federal Reserve projections for 2003 are that from the fourth quarter 2002 to the fourth quarter 2003, real GDP will grow between 3.25% and 3.50% and that prices¹⁰ will increase about 1.25% to 1.50%. The civilian

¹⁰ In its Monetary Report to Congress, the Board of Governors of the Federal Reserve System features in its projections a measure of inflation known as the Personal Consumption Expenditure (PCE) chain-type price index. This price index attempts to measure inflation with regard to consumer spending.

unemployment rate is projected to be between 5.75% and 6.0% during the fourth quarter of the year.

Table 10. Economic Forecasts 2003 - 2004

	2002		2003				2002*	2003	2004
	3*	4*	1*	2	3	4			
Nominal GDP^a									
OMB	5.1	3.1	4.4	NA	NA	NA	3.6	4.2	5.2
CBO	5.1	3.1	4.4	NA	NA	NA	3.6	4.2	5.4
BC T-10	5.1	3.1	4.4	5.0	6.8	6.8	3.6	4.4	6.1
BC Con.	5.1	3.1	4.4	3.5	4.9	5.2	3.6	4.1	5.3
BC B-10	5.1	3.1	4.4	2.2	3.0	3.4	3.6	3.7	4.4
Real GDP^a									
OMB	4.0	1.4	1.9	NA	NA	NA	2.4	2.9	3.6
CBO	4.0	1.4	1.9	NA	NA	NA	2.4	2.5	3.6
BC T-10	4.0	1.4	1.9	2.8	4.8	4.7	2.4	2.6	4.1
BC Con.	4.0	1.4	1.9	2.0	3.5	3.7	2.4	2.4	3.6
BC B-10	4.0	1.4	1.9	1.4	2.3	2.6	2.4	2.1	3.0
Unemployment^b									
OMB	5.7	5.9	5.8	NA	NA	5.6	5.8	5.7	5.5
CBO	5.7	5.9	5.8	NA	NA	NA	5.8	5.9	5.7
BC T-10	5.7	5.9	5.8	6.1	6.2	6.3	5.8	6.1	6.1
BC Con.	5.7	5.9	5.8	6.0	6.1	6.0	5.8	6.0	5.7
BC B-10	5.7	5.9	5.8	6.0	5.8	5.7	5.8	5.8	5.4
GDP Price Index (chain-weighted)^a									
OMB	1.0	1.6	2.5	NA	NA	NA	1.1	1.3	1.5
CBO	1.0	1.7	2.5	NA	NA	NA	1.1	1.6	1.7
BC T-10	1.0	1.7	2.5	2.2	2.0	2.1	1.1	1.9	2.1
BC Con.	1.0	1.7	2.5	1.5	1.4	1.6	1.1	1.7	1.7
BC B-10	1.0	1.7	2.5	0.8	0.7	0.8	1.1	1.4	1.1
CPI-U^a									
OMB	2.2	2.0	3.8	NA	NA	NA	1.6	2.2	2.1
CBO	2.2	2.0	3.8	NA	NA	NA	1.6	2.3	2.2
BC T-10	2.2	2.0	3.8	2.3	2.4	2.6	1.6	2.7	2.6
BC Con.	2.2	2.0	3.8	1.1	1.5	1.8	1.6	2.3	1.9
BC-10	2.2	2.0	3.8	-0.2	0.5	1.0	1.6	1.9	1.1
T-BILL Interest Rate (3 month)^b									
OMB	1.7	1.3	1.2	NA	NA	NA	1.6	1.6	3.4
CBO	1.7	1.3	1.2	NA	NA	NA	1.6	1.4	3.5
BC T-10	1.7	1.3	1.2	1.2	1.3	1.4	1.6	1.3	2.6
BC Con.	1.7	1.3	1.2	1.1	1.1	1.2	1.6	1.1	1.9
BC B-10	1.7	1.3	1.2	1.0	0.9	0.9	1.6	1.0	1.2

	2002		2003				2002*	2003	2004
	3*	4*	1*	2	3	4			
10-year Treasury Note^b									
OMB	4.3	4.0	3.9	NA	NA	NA	4.6	4.2	5
CBO	4.3	4.0	3.9	NA	NA	NA	4.6	4.4	5.2
BC T-10	4.3	4.0	3.9	4.0	4.2	4.5	4.6	4.2	5.3
BC Con.	4.3	4.0	3.9	3.7	3.8	4.0	4.6	3.9	4.5
BC B-10	4.3	4.0	3.9	3.5	3.4	3.5	4.6	3.6	3.8

Sources: Blue Chip Economic Indicators, June 10, 2003. Congressional Budget Office, January, 2003; and, the Office of Management and Budget, February, 2003.

* Actual data, subject to revisions. The annual data for nominal GDP, real GDP, the GDP price index and the CPI are on a year over year basis; and the unemployment and interest rate data are either quarterly or annual averages. Some of the 2003 first quarter data is actual, but subject to revision.

^a Annualized quarterly rates of change.

^b Quarterly averages.

Promotion of Economic Growth

Over the longer run, the economic well-being of a nation depends on the growth of potential output or GDP per capita. Crucial to this growth is the fraction of a nation's resources devoted to capital formation. The ability to add to the capital stock through investment depends on a nation's saving rate.

Saving comes from several sources. In the private sector individuals (households) and businesses are responsible for saving. The former save when all of their after tax income is not used for consumption. Businesses save through retained earnings and capital consumption allowances. The public sector can also be a source of national saving and this occurs when government revenues are larger than expenditures. Budget surpluses, then, can be viewed as a source of national saving.

Table 11 shows the sources of saving for the United States during the past 40 years. There are several things to note about these data. First, except for the decade of the 1990s, the gross private sector savings rate has averaged a remarkably stable 17%-19% of GDP, with most of the saving being done by businesses. More significantly, however, the private sector saving rate net of depreciation, representing saving available for additions to capital, declined considerably in the 1990s. Thus, even without a federal budget deficit, the United States would have had a "saving problem."

Second, over this 40-year period, the saving done by the public sector, as a whole, has declined. There is, however, diversity as to the contribution made by the level of government. The large negative contribution made by the federal government during the 1980s reflects the widely publicized budget deficit. Even though state and local governments have been running budget surpluses, they have not been large enough to offset the federal deficits. This has been reversed beginning in 1993. The improved budget position of the federal government has been adding to national saving.

Third, the data show that for 20 of these 40 years, the United States exported a small fraction of its savings to the rest of the world (i.e., was a net exporter of capital). This changed during the 1980s when the United States started to import the savings of the rest of the world.

The United States has been able to sustain its growth and standard of living since the 1980s because we have been able so far to attract sufficient capital (saving) from international investors. Without these saving, the United States has a “financing gap” in view of its domestic saving shortfall relative to its demand for investment capital. In the absence of sufficient capital, U.S. interest rates will have to rise in order to restore balance between investment and a now smaller amount of saving. Higher interest rates will choke off investment and dampen U.S. growth¹¹.

Should efforts to correct the international trade deficit prove fruitful, the net inflow of foreign saving will diminish or perhaps on net cease (that is, stabilize). Should this occur without a significant improvement in either the private sector saving rate or the negative saving rate of the public sector, the rate of new investment will fall to a very low level in the United States and with it the means for improving the well-being of future generations of Americans.

A sudden increase in the national saving rate is, however, not without some possible adverse consequences. In the short run, a sudden increase in the saving rate means decreased consumption and/or lower public sector net spending, both of which depress aggregate demand. Moreover, in either case, the demand for some types of output would fall to be replaced by an increased demand for other types of output. As a result, some industries and firms would have to contract while others expand. Resources would have to transit from declining to growing industries. These short-run dislocations should be borne in mind if a higher national saving rate becomes the object of public policy.

¹¹ See also CRS Report RL30534, *America’s Growing Current Account Deficit: Its Causes and What It Means for the Economy*, by Marc Labonte and Gale Makinen; and CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Cures*, by Craig Elwell.

Table 11. U.S. Saving By Sector
(as percent of GDP)

Year	Private Sector				Public Sector				Net Private & Pub. ^a	Net ^b Foreign
	Pers.	Bus.	Total	Net of Deprec.	Fed.	State & Local	Total	Net of Deprec.		
1960-9	5.7	11.4	17.1	9.6	2.2	1.7	4.0	1.3	10.9	-0.6
1970-9	6.8	11.6	18.4	9.8	-0.5	1.8	1.3	-1.2	8.6	-0.2
1980-9	6.7	12.6	19.2	9.0	-2.2	1.4	-0.8	-3.0	6.0	1.5
1990-9	4.3	12.5	16.9	6.8	-1.0	1.3	-0.3	-2.0	4.8	1.4
1984	7.8	13.2	21.0	11.0	-3.1	1.7	-1.4	-3.7	7.3	2.2
1985	6.7	13.1	19.8	9.8	-3.0	1.6	-1.4	-3.7	6.1	2.6
1986	6.0	12.1	18.1	8.0	-3.1	1.5	-1.6	-3.8	4.2	3.2
1987	5.3	12.3	17.7	7.6	-1.9	1.3	-0.6	-2.9	4.7	3.2
1988	5.7	12.7	18.5	8.4	-1.5	1.4	-0.1	-2.4	6.0	2.2
1989	5.5	11.9	17.4	7.3	-1.2	1.4	0.2	-2.0	5.3	1.6
1990	5.8	11.8	17.5	7.5	-1.8	1.1	-0.7	-2.9	4.6	1.2
1991	6.2	12.1	18.4	8.2	-2.4	1.0	-1.4	-3.7	4.5	-0.2
1992	6.5	12.1	18.4	8.3	-3.5	1.0	-2.5	-4.8	3.5	0.6
1993	5.3	12.1	17.5	7.5	-2.9	1.1	-1.8	-4.1	3.4	1.1
1994	4.5	12.3	17.0	6.9	-1.9	1.2	-0.6	-2.9	4.0	1.5
1995	4.1	12.8	17.1	7.1	-1.5	1.3	-0.1	-2.4	4.7	1.3
1996	3.5	13.0	16.5	6.5	-0.7	1.4	0.8	-1.5	5.0	1.4
1997	3.0	13.1	16.2	6.1	0.4	1.5	1.9	-0.3	5.8	1.5
1998	3.4	12.2	15.6	5.6	1.5	1.6	3.1	1.0	6.6	2.3
1999	1.9	12.7	14.6	4.4	2.2	1.6	3.8	1.6	6.0	3.4
2000	1.8	11.9	13.7	3.6	3.1	1.4	4.5	2.3	5.9	4.4
2001	1.7	12.2	13.9	2.9	1.7	0.9	2.6	0.4	3.3	3.8
2002*	2.8	12.5	15.3	4.2	-0.8	0.7	-0.1	-2.2	2.0	4.5

Source: U.S. Department of Commerce.

^a Equal to the sum of private sector saving net of depreciation and total public sector saving net of depreciation.

^b Negative sign indicates the export of saving from the United States. Positive sign indicates the import of saving from abroad.

* Data for the first three quarters of the year.