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Current Economic Conditions and Selected Forecasts

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Summary

U.S. real GDP has been positive for 12 consecutive quarters, and the economy is considered to be in an “expansion” phase. As of the third quarter 2004, real or inflation-adjusted growth was nearly 10% above its previous high near the end of the 1991-2001 expansion.

Real growth at 3.7% in the third quarter of 2004 was somewhat above the 3.3% rate achieved in the second quarter, but below the 4.5% rate achieved in the first quarter (all at annualized quarterly rates). All are down from the 7.4% rate achieved in 2003:3Q. Even during the 1990s expansion, the pace of growth was rarely over 7%.

Yet the rebound in growth has not translated into higher payroll employment, and many call this a “jobless recovery.” Payroll employment, despite recent gains, is only 1,146,000 above the level prevailing at the end of the recession (November 2001). The unemployment rate rose to a high of 6.3% in June 2003; it has since declined and now (October) stands at 5.5%. During the first 10 months of 2004 it has varied between 5.4% and 5.7%. These are well above rates in the second half of the 1990s.

There are however positive elements of the economic picture:

(1) A pick-up in output at the same time as employment is declining means that productivity (or output per worker) is increasing. As we saw in the 1990s, productivity growth is the key to raising our standard of living and is not necessarily associated with weak labor markets over time. We eventually experienced *both* rapid productivity and strong employment growth as the recovery broadened and deepened throughout the decade. In the short run while adjustment is taking place, however, there is a human toll from the continuing payroll employment losses.

(2) The inflation rate, measured by the CPI, accelerated over the first half of 2004, rising at an annual rate of 4.9%. However, this was largely driven by rising energy prices. Over the past three months (June-September), the inflation rate was only 0.6% (annualized quarterly rate).

While most economists did not expect the sizzling 2003:3Q pace to be sustained, they anticipate that growth will settle down to around 4% over the next year, still above what is considered to be the long-run potential rate of growth. However, the unemployment rate is expected to show only a modest change as long as businesses are able to improve profitability through increased productivity. Inflation is expected to remain low while considerable slack remains in the economy. Fiscal and monetary policies have both been eased since 2001 and the easing has continued into this year. They are having a positive effect on spending. However, on June 30, August 10, September 21, and November 10, the Federal Reserve made a modest shift to tighten monetary policy. The external deficit is large and expected to remain so. This report will be updated monthly.

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Current Economic Conditions and Selected Forecasts

Current Economic Conditions

Overview

The U.S. economy is once again in an expansionary phase because it has more than recovered its recession-related losses in real GDP. This situation was formally recognized on July 17 by the National Bureau of Economic Research (NBER), which declared that the recession starting in March 2001 had ended in November 2001. As of the third quarter 2004, U.S. real GDP (measured in 2000 dollars) was 10.25% above its recession low point in the third quarter 2001, and had grown 9.9% beyond its previous high near the end of the 1991-2001 expansion. U.S. real growth has now been positive for 12 consecutive quarters.

According to the most recent GDP report, growth in the third quarter of 2004 was at an annual rate of 3.7%, up from the 3.3% recorded in the second quarter, but down from the 4.5% rate during 2004:1Q and the 7.4% rate during 2003:3Q.¹ Growth excluding inventories was more buoyant in the third quarter increasing at an annual rate of 4.2%.² Contributions to GDP came mainly from consumption and investment in equipment and software.

Yet, despite the recovery in growth and other positive signs, concerns remain. The rebound has not yet translated into payroll employment rising above the level attained at the end of the previous cyclical peak. Employment has contracted on balance and the unemployment rate has risen and remained high relative to the level reached in the late 1990s, even as growth picked up. Since its peak in March 2001, payroll employment has fallen by 490,000. An encouraging sign is that employment has grown by about 2.2 million since August 2003. The unemployment rate has

¹ The estimate of third quarter 2004 GDP growth is from the first (or “advance”) estimate.

² The accounting framework that governs the calculation of GDP isn’t always straightforward. In the GDP accounting rules, inventories subtract from growth if they are drawn down more in a particular quarter. However, in some circumstances, the drop in inventories might point to stronger growth ahead. For example, if domestic demand (defined as GDP other than inventories) accelerates at the same time inventories are drawn down, the standard interpretation is that growth will probably be higher in the near future. The reason why a pick-up is anticipated would be at least technical: with demand on the rise, inventories will not be sufficient after a while and new production will eventually be required to keep up with demand. New production increases GDP, according to the accounting framework. A pick-up may also signal underlying acceleration in the economy. quarter data. A similar signal was evident in the third quarter estimate.

varied between 5.4% and 5.7% since December 2003, which is well above the 3.8% low of the 1990s expansion.

Measured inflation appears to be moderating. The broadest measure of inflation for the economy, the GDP price index, rose from a 1.1% rate in 2003:2Q to 3.2% during 2004:2Q and then declined to 1.3% during 2004:3Q (all at annualized rates). The Consumer Price Index (CPI) followed a similar path. Its annualized rate of growth accelerated from 0.7% during 2003:4Q to 4.8% during 2004:2Q and, then, to 1.9% during 2004:3Q. The CPI, however, has been heavily influenced by sharp movements in the price of food and energy.

The most recent data are difficult to interpret. The key questions are: To what extent does the recent improvement in several key indicators point to the long-awaited strengthening of the economy? How will this translate in the labor markets? Will employment pick up strongly with a lag, as it did in the 1990s? To what extent will a drag on growth continue from adjustment in the business sector, particularly in the telecommunications industries, but also in transportation-related industries affected by security concerns?

Monetary Policy

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 in 13 steps by a cumulative 550 basis points (5.50 percentage points), from 6.5% to, most recently, 1.0% on June 25, 2003 its lowest level since April 1961. The June FOMC decision was related to continuing growth disappointment and the need to add further support to economic activity from monetary policy. However, over the past year inflationary pressures have moved upward. To forestall additional upward pressures, the Fed, beginning June 30, 2004, moved the federal funds target upward by 0.25%. Subsequent moves of 0.25% on August 10, September 21 and November 10, carried the target to 2.0%.

Details

GDP. To understand the most recent macroeconomic developments, it may be important to understand aspects of the previous business cycle. The growth rate of GDP since 1991 is shown in **Table 1**. Its most notable feature is that after a weak start, 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 2000:3Q, 2001:1Q, and 2001:3Q. This pattern was reversed beginning with 2001:4Q when GDP grew positively, at an annual rate of 1.6%. Since that time, it has experienced positive growth in each subsequent quarter. In 2003, real GDP grew at an annualized rate of 1.9% in the first quarter, 4.1% in the second, 7.4% in the third quarter, and 4.2% in the fourth quarter. During the first three quarters of 2004, GDP grew, respectively, 4.5%, 3.3%, and 3.7%.

Productivity gains have been an important part of the current expansion.³ Most economists refer to recent trends as reflecting a “productivity-led” recovery. In 2002, productivity rose by 5.0%; and quarterly growth during 2003 and the first three quarters of 2004 has been, respectively, 3.7%, 6.7%, 9.0%, 3.1%, 3.7%, 3.9% and 1.9% (at annualized quarterly rates). To put these numbers into perspective, the underlying productivity trend from 1973 to 1995 was for 1.4% annual growth; and the “step-up” in productivity from 1995 to 2000 was to a 2.5% annual rate of productivity growth. In the previous expansion, strong productivity gains were not part of the initial recovery phase after March 1991 and did not show up in the aggregate data until 1995.

The second jobless recovery? Many people are referring to the present expansion as a “jobless recovery” and parallels have been made to the “jobless recovery” after the 1990-1991 recession. How do the two compare?

Payroll employment gains in the present cycle are far smaller than in 1991-1992. Payroll employment was 1.146 million higher in October 2004 than at the end of the recession in November 2001 (35 months ago). By this point in the previous recovery, payroll employment had increased by 4.123 million.

Furthermore, between the start of the recession and now (from March 2001 to October 2004), payroll employment has declined by 490,000. At the same point in the 1991 expansion (43 months out), employment had increased by 2.9 million.

Table 1. The Growth Rate of Real GDP v. Final Sales, 1991-2003
(percent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP Year-Year	-0.2	3.3	2.7	4.0	2.5	3.7	4.5	4.2	4.5	3.7	0.8	1.9	3.0
4thQ-4thQ	1.1	4.1	2.5	4.1	2.0	4.4	4.3	4.5	4.7	2.2	0.2	2.3	4.4
Final Sales Year-Year	-0.2	3.0	2.6	3.4	3.0	3.7	4.0	4.2	4.5	3.8	1.6	1.4	3.1
4thQ-4thQ	0.2	4.2	2.6	3.2	2.9	3.9	4.0	4.7	4.2	2.9	1.5	1.2	4.5

Source: U.S. Department of Commerce.

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 initially by a modest recovery, the unemployment rate reversed course and rose, reaching a high of 6.3% in June 2003. Since then it has declined,

³ Productivity is measured by output per hour of all persons. In the current situation, change in both the numerator and denominator of this ratio have been contributing to higher productivity: output (the numerator) has been rising and hours (denominator) have been declining.

reaching an expansion low of 5.4% in August . It rose to 5.5% in October. During the past 11 months has varied between 5.4% and 5.7%.

Employment remains below its pre-recession peak, however. Measured from the end of the recession in November 2001, payroll employment has risen by approximately 1.146 million. This is unprecedented in any postwar business cycle. Even in the previous business cycle in the early 1990's (which was also referred to initially as a "jobless" recovery"), employment had turned substantially upward by this point. (See Box, above.)

To analyze labor market conditions, it is important to understand that employment is a net concept that reflects considerable "churning" in the labor markets, measured as the flows of gross job gains and gross job losses. At any given time, the U.S. economy is creating and destroying jobs — although this is usually not readily apparent from the aggregate net figure.⁴ In this sense, the U.S. is considered the most "dynamic" labor market in the world.

In the present situation, jobs have continued to be created, but job creation has not been sufficient to offset job loss elsewhere. This description raises questions about the underlying components (i.e., the gross flows): do net job losses reflect that (1) gross job losses have been so large that they have offset "normal" gross job gains; (2) while gross job losses have been small, they have nevertheless been larger than weak gross job gains; or (3) weakness in both components has been driving the new number, as gross job losses have been large and gross job gains small?

The argument has been made that gross job creation has been weaker in this recovery than in the early 1990s recovery.⁵ This argument appears to have been confirmed by the new data series on Business Employment Dynamics released by the Bureau of Labor Statistics. In the current expansion, gross job losses appear to have returned to pre-recession levels, but gross job gains have not recovered at all. More specifically, as of December 2002 (the latest data available), gross job creation has continued to decelerate since the recession and is taking place at only 1995 levels. On balance, this has translated into a net decrease in employment.⁶ Intuitively, the

⁴ For example, according to the Bureau of Labor Statistics (BLS), while net employment was only 0.1% lower in Dec. 2002 than in Sept. 2002 (quarterly rate), this small change reflected considerable churning in the labor market: 7.2% of the jobs in Dec. were newly created since Sept., while 7.3% of the jobs in Sept. no longer existed in Dec. because they had disappeared. BLS comments: "These gross job gains and job losses statistics demonstrate that a sizable number of jobs appear and disappear in the relatively short time frame of one quarter." See Bureau of Labor Statistics, *New Quarterly Data on Business Employment Dynamics from BLS*, Sept. 30, 2003, pp. 2-3.

⁵ See Erica L. Groshen and Simon Potter, "Has Structural Change Contributed to a Jobless Recovery?" *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, vol.1, no. 8, Aug. 2003, available at [<http://www.newyorkfed.org>].

⁶ Bureau of Labor Statistics, *New Quarterly Data on Business Employment Dynamics from BLS*, Sept. 30, 2003. The new BLS series is useful for investigation of trends in gross jobs flows — an area in which there has been little data because of the difficulties in following (continued...)

weakness on the gross job creation side is appealing: following a contraction, labor markets typically improve with a lag after growth picks up because employers are reluctant to hire until they see that an economic recovery is firmly in place. However, some economists argue that recent trends reflect structural changes in the economy.⁷

Divergence in payroll and household surveys ? An interesting and perhaps important feature of the present economic recovery is the divergence between the two main measures of employment. It is well known that the payroll survey remains far below prerecession levels despite the rise in GDP growth so far in this expansion and an improvement in employment since August. Less well-known is the fact that the other main measure of employment (the household survey of the Bureau of Labor Statistics) indicates that employment has increased by 3.5 million since the expansion began. Does the difference between the two measures of employment reflect statistical problems ? Experts do not know. Some economists also note that self-employment trends are more accurately captured by the household survey (the payroll survey does not measure self-employment) and that household employment trends have often been reliable forward indicators of coming improvement in payroll employment in the aftermath of a recession.

Table 2. Civilian Unemployment Rate, 1991 - 2004
(%, 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	5.8	5.9	5.8	6.0	6.1	6.3	6.2	6.1	6.1	6.0	5.9	5.7
2004	5.6	5.6	5.7	5.6	5.6	5.6	5.5	5.4	5.4	5.5		

Source: Department of Labor.

⁶ (...continued)

jobs over time. There are some limitations to the series. The data starts at Sept. 1992, after the recession (July 1990 - March 1991). As a consequence, a full comparison to the recent recession and early recovery phase is not possible. In addition, the new BLS series is not collected from the same survey as the payroll employment data and so they are not precisely comparable.

⁷ Groshen and Potter, *op. cit.*

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.

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. Moreover, the deceleration in inflation over the 1990s occurred even as the pace of growth accelerated. In the postwar experience, this combination of developments is unusual. The rates of growth and inflation have not typically moved 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.

Table 3. Rate of Change in the GDP Deflators, 1992 - 2003
(%, 4Q-4Q)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Implicit Price Deflator	2.2	2.3	2.2	2.0	1.9	1.5	1.1	1.6	2.2	2.5	1.5	1.7
Chain Type Price Index	2.2	2.3	2.2	2.0	1.9	1.5	1.1	1.6	2.2	2.5	1.5	1.7

Source: U.S. Department of Commerce.

With the start of the recession in March 2001, inflation decelerated, excluding energy prices. 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 deflator, the broadest measures of inflation in the economy, decelerated from 2.2% in 2000 to 1.5% in 2002, on a fourth quarter-fourth quarter basis.

Table 4. Rate of Change in the Consumer Price Index (CPI), 1992 - 2003
(percent)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Dec. over Dec.	2.9	2.7	2.7	2.5	3.3	1.7	1.6	2.7	3.4	1.6	2.4	1.9
Excluding food and energy	3.3	3.3	2.6	3.0	2.6	2.2	2.4	1.9	2.6	2.7	1.9	1.1
Year Over Year	3.0	3.0	2.6	2.8	3.0	2.3	1.6	2.2	3.4	2.8	1.6	2.3
Excluding food and energy	3.7	3.3	2.8	3.0	2.7	2.4	2.3	2.1	2.4	2.6	2.4	1.4

Source: Department of Labor.

The exception to the deceleration story is the CPI measured on a December - December basis. It rose by 2.4% during 2002 and 1.9% during 2003, versus an increase of 1.6% in 2001. Despite this acceleration, the rate of increase remained below the pace during most of the 1990s expansion and the price of all items excluding food and energy decelerated.

The rate of inflation measured by the CPI showed great variability over 2003. On an annualized basis the rate for the four quarters of the year were 5.2%, -0.7%, 3.1%, and 0%. This volatility reflects, in large measure, the behavior of energy prices. “Core inflation” (i.e., inflation excluding food and energy prices) showed little movement over the four quarters, rising, respectively, 0.8%, 1.0%, 1.5%, and 1.1%. A similar pattern has occurred in the first nine months of 2004. The overall index rose at an annual rate of 3.5% whereas the index less food and energy rose only 2.3% (for the 12-months ended in September the CPI rose 2.5%).

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. In 2002 and 2003, productivity rose respectively 4.3% and 5.6% (fourth quarter over 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. 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 over the past two years, as shown in **Table 5**. With more output produced for each hour worked without a comparable rise in labor costs, firms have their employee cost per unit of output reduced. Recent trends reflect the pick-up in productivity growth and slowdown in basic labor costs during the recession plus continuing labor market weakness in the recovery-expansion phase to-date. 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 the first half of 2002, but began to decelerate in the course of 2002 as a result of weakened labor market pressures. Its rise in 2003 may reflect the fact that the increase in productivity is being reflected in employee compensation.
- 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, 1993 - 2004
(in percentages)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Unit Labor Costs	1.6	0.5	2.1	0.7	2.0	2.8	1.6	4.2	0.3	-0.6	-0.2	0.3
Employment Cost Index	3.6	2.6	2.6	3.1	3.4	3.5	3.4	4.4	4.2	3.2	4.2	3.7

Source: U.S. Department of Labor.

Note: Unit labor costs are for nonfarm business, 4th quarter-4th quarter. For 2004, it is the annualized rate for the first three quarters of the year. The Employment Cost Index is for private industry, December - December: for 2004 it is on a September-September basis.

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 1992.⁸ In these years, the trade deficit declined as export growth exceeded import growth. During 1993 the trade deficit began to grow as a fraction of GDP and is now running at a rate in excess of its previous high in 1987. The increase in the U.S. foreign trade deficit during 1992 - 2004 reminds us that the United States still receives a substantial net inflow of capital from abroad.

Table 6. U.S. Foreign Trade Deficit, 1988 - 2003
(as a percent of GDP)

1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.8	1.2	0.8	0.2	0.2	0.7	1.0	0.9	1.0	1.2	2.2	3.1	3.9	4.0	4.7	4.9

Source: Department of Commerce.

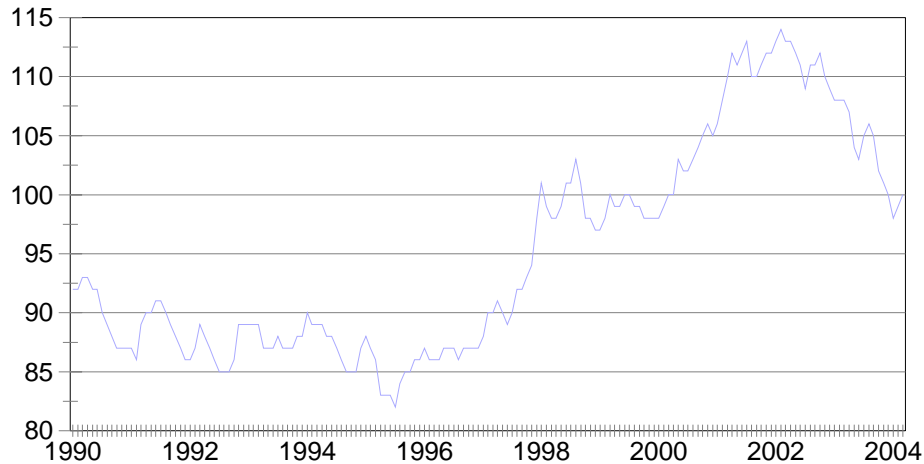
Note: During the first three quarters of 2004, the trade deficit averaged 5.3% of GDP.

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

⁸ 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, 2003, and the first half of 2004 the current account deficit was, respectively, approximately 4.6%, 4.8%, and 5.4% of nominal GDP.

over 34% to its peak in February 2002. From then until January 2004, it has depreciated on balance by around 13% on an inflation-adjusted basis, with some ups and downs. By September, the dollar had risen by about 3.4%.

**Figure 1. Real Dollar Exchange Rate
(Broad Dollar Index)**



Source: The Board of Governors of The Federal Reserve System.

The dollar has shown more movement against the major world currencies than the broad trade-weighted index described above suggests.⁹ From its high in February 2002 until September 2004, the dollar has depreciated by nearly 21% against an index consisting of the major currencies that circulate, adjusted for inflation. The fall in the exchange value of the dollar has been most noticeable against the British pound, the Canadian dollar, and the Euro.

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 has been expansionary since 2002 as a full employment surplus in 2001 fell

⁹ 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.

from 1.1% to a deficit of 2.8% of potential GNP in 2003. An alternative, although inferior measure, is the ratio of the actual budget deficit to actual GDP. When examined, fiscal policy was also expansionary with the surplus of 2.4% in 2000 giving way to a deficit of 3.5% in 2003, a net shift of nearly 6% of GDP.

In their annual joint statement, the Secretary of the Treasury and the Director of the Office of Management and Budget announced that the total fiscal deficit for FY2003, which ended on September 30, was \$374 billion.¹⁰ This deficit is more than twice the recorded fiscal deficit in FY2002 and around 3.5% of 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.¹¹ The three monetary aggregates, as shown in **Table 8**, have not responded uniformly to the easing of monetary policy. The rate of growth of M1 in 2003 exceeded 2002. The reverse was true for M2 and M3.

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

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Standardized Budget Deficit	\$186	\$188	\$142	\$147	\$96	\$83	\$32	+\$12	+\$108	+\$106	\$146	\$313
Full Employment GDP	6,402	6,713	7,033	7,381	7,750	8,151	8,545	8,962	9,464	10,038	10,519	11,052
Ratio	0.029	0.028	0.020	0.020	0.012	0.010	0.004	0.001	+0.011	+0.011	0.014	-0.028
Actual Budget Deficit	\$290	\$255	\$203	\$164	\$107	\$22	+\$69	+\$126	+\$236	+\$127	\$158	\$374
Actual GDP	6,222	6,561	6,949	7,323	7,700	8,194	8,655	9,141	9,715	10,032	10,337	10,856
Ratio	0.047	0.039	0.029	0.022	0.014	0.003	+0.008	+0.014	+0.024	+0.013	0.015	0.035

Source: Congressional Budget Office (January 2004).

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, four of the quantity measures of monetary policy have recorded a rising rate of growth.

¹⁰ Secretary of the Treasury and Director of the Office of Management and Budget, *Budget Results for Fiscal Year 2003*, Oct. 20, 2003. See [<http://www.treas.gov/press/>].

¹¹ For a more comprehensive discussion of monetary policy, see CRS Report RL30354, *Monetary Policy: Current Policy and Conditions*, by Gail Makinen and Marc Labonte.

Table 8. The Growth Rates of the Monetary Aggregate
(annualized rates of growth)

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	6.4	6.5
02:12-03:12	6.9	5.7	6.2	4.6	3.3
03:10 - 04:10	6.1	5.5	4.6	4.5	4.8

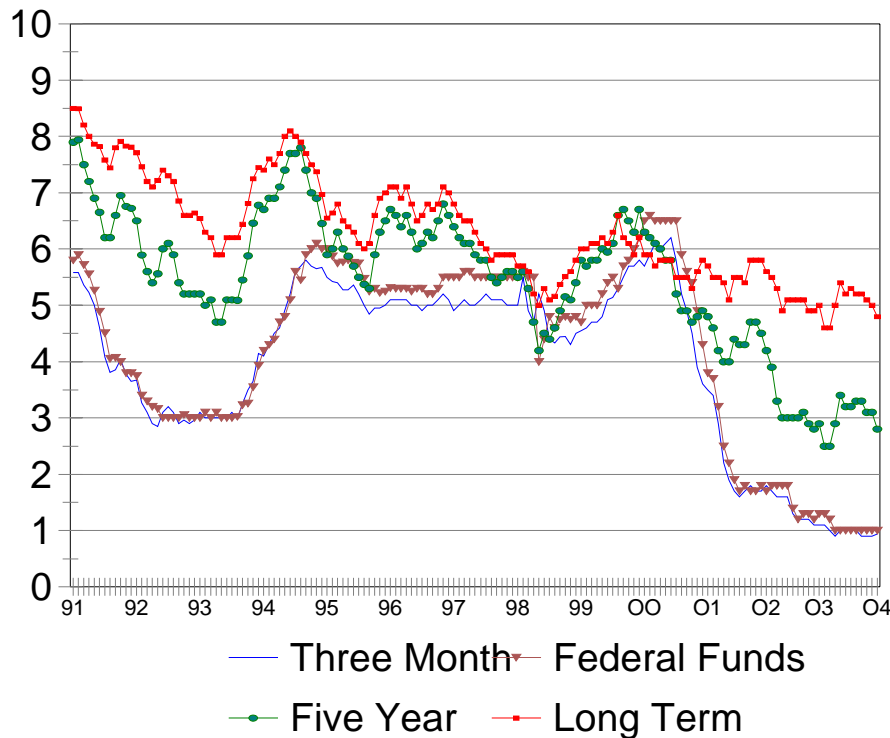
Source: Board of Governors of the Federal Reserve System.

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 September 11, 2001, 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. Nevertheless, the rate was reduced to 1.0% on June 25, 2003. In the face of the strength of the current expansion and its possible effect on inflation, the target rate was raised three times in 2004: 1.25% on June 30, 1.5% on August 10, and 1.75% on September 21.

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.

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



Source: Board of Governors of the Federal Reserve System.

Economic Forecasts, 2004-2005

The forecasts in **Table 9** 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 consensus view taken by the forecasts summarized in **Table 9** is that GDP growth should exceed 4% which is near to what is generally considered the rate of U.S. potential growth. This rate of GDP growth, according to the consensus, however, will be insufficient to have other than a modest effect on the unemployment rate. The consensus anticipates that the unemployment rate will begin to come down only gradually. The inflation rate for the entire economy is expected to remain below 2.0%. Both short-term and long-term interest rates are expected to rise in 2004 above their 2003 averages.

The chairman of the Board of Governors of the Federal Reserve presented the economic projections of the Federal Reserve Board and Federal Reserve District Bank Presidents for 2004 in testimony before the Senate Committee on Banking, Housing, and Urban Affairs on July 20, 2004, and the House Financial Services Committee on July 21, 2004. The Federal Reserve projections for 2004 are that from the fourth quarter 2003 to the fourth quarter 2004, real GDP will grow between 4.5% and 4.75% and that prices¹² will increase about 1.75% to 2.0%. The civilian unemployment rate is projected to be between 5.25% and 5.5% during the fourth quarter of the year. For 2005, real GDP, on a fourth quarter over fourth quarter basis, is projected to grow between 3.5% and 4.0%, prices are expected to rise between 1.5% and 2.0%, and unemployment during the fourth quarter of the year is projected to average between 5.0% and 5.25%.

¹² 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.

Table 9. Economic Forecasts 2004 - 2005

	2003		2004				2003 ^a	2004	2005
	3 ^a	4 ^a	1 ^a	2 ^a	3 ^a	4			
Nominal GDP ^b									
OMB	8.8	5.7	7.4	6.6	5.1	NA	4.8	6.7	5.7
CBO	8.8	5.7	7.4	6.6	5.1	NA	4.8	6.8	6.1
BC T-10	8.8	5.7	7.4	6.6	5.1	7.6	4.8	6.7	6.2
BC Con.	8.8	5.7	7.4	6.6	5.1	5.6	4.8	6.6	5.5
BC B-10	8.8	5.7	7.4	6.6	5.1	3.8	4.8	6.5	4.7
Real GDP ^b									
OMB	7.4	4.2	4.5	3.3	3.7	NA	3.0	4.7	3.7
CBO	7.4	4.2	4.5	3.3	3.7	NA	3.0	4.5	4.1
BC T-10	7.4	4.2	4.5	3.3	3.7	4.3	3.0	4.4	4.0
BC Con.	7.4	4.2	4.5	3.3	3.7	3.6	3.0	4.4	3.5
BC B-10	7.4	4.2	4.5	3.3	3.7	2.8	3.0	4.3	3.0
Unemployment ^c									
OMB	6.1	5.9	5.6	5.6	5.4	NA	6.0	5.5	5.3
CBO	6.1	5.9	5.6	5.6	5.4	NA	6.0	5.6	5.2
BC T-10	6.1	5.9	5.6	5.6	5.4	5.5	6.0	5.5	5.5
BC Con.	6.1	5.9	5.6	5.6	5.4	5.4	6.0	5.5	5.3
BC B-10	6.1	5.9	5.6	5.6	5.4	5.3	6.0	5.5	5.0
GDP Price Index (chain-weighted) ^b									
OMB	1.4	1.6	2.8	3.2	1.3	NA	1.8	1.9	1.9
CBO	1.4	1.6	2.8	3.2	1.3	NA	1.8	2.2	1.8
BC T-10	1.4	1.6	2.8	3.2	1.3	2.6	1.8	2.3	2.4
BC Con.	1.4	1.6	2.8	3.2	1.3	1.9	1.8	2.1	1.9
BC B-10	1.4	1.6	2.8	3.2	1.3	1.2	1.8	2.1	1.4
CPI-U ^b									
OMB	2.4	0.7	3.5	4.8	1.8	NA	2.3	2.5	2.3
CBO	2.4	0.7	3.5	4.8	1.8	NA	2.3	2.6	2.0
BC T-10	2.4	0.7	3.5	4.8	1.8	3.2	2.3	2.7	2.9
BC Con.	2.4	0.7	3.5	4.8	1.8	2.5	2.3	2.6	2.4
BC-10	2.4	0.7	3.5	4.8	1.8	1.8	2.3	2.6	1.9
T-BILL Interest Rate (3 month) ^c									
OMB	1.0	0.9	0.9	1.1	1.5	NA	1.0	1.3	2.6

	2003		2004				2003 ^a	2004	2005
	3 ^a	4 ^a	1 ^a	2 ^a	3 ^a	4			
CBO	1.0	0.9	0.9	1.1	1.5	NA	1.0	1.3	2.6
BC T-10	1.0	0.9	0.9	1.1	1.5	2.2	1.0	1.5	3.3
BC Con.	1.0	0.9	0.9	1.1	1.5	1.9	1.0	1.4	2.8
BC B-10	1.0	0.9	0.9	1.1	1.5	1.7	1.0	1.3	2.3
10-year Treasury Note ^c									
OMB	4.3	4.3	4.0	4.6	4.3	NA	4.0	4.5	5.1
CBO	4.3	4.3	4.0	4.6	4.3	NA	4.0	4.6	5.4
BC T-10	4.3	4.3	4.0	4.6	4.3	4.6	4.0	4.4	5.4
BC Con.	4.3	4.3	4.0	4.6	4.3	4.3	4.0	4.3	4.8
BC B-10	4.3	4.3	4.0	4.6	4.3	4.1	4.0	4.2	4.3

Sources: Blue Chip Economic Indicators, October, 2004. Congressional Budget Office, September, 2004; and, the Office of Management and Budget, July 2004.

a. 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.

b. Quarterly rates of change are annualized.

c. Quarterly averages.

Special Topics

Accounting for GDP Growth

Table 10 records contributions to growth in GDP from 1995 to 2004. These data record two interesting developments. First, investment spending played an important role in the 1991-2001 expansion. Its contribution to GDP growth was unusually large during most of that period. 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. The relative contribution of consumption did not change significantly during this period, although it continued to be the largest single contributor to GDP growth.

Table 10. Accounting for GDP Growth: 1995 through 2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP Growth ^a	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Consumption	73.6	63.5	57.4	81.2	81.6	87.2	234.2	118.4	76.0	63.2
Investment	17.7	34.3	41.5	37.7	26.2	26.9	-187.8	-21.0	22.2	50.1
Govt. Purchases	4.3	5.2	7.9	8.4	16.3	10.1	80.4	43.1	16.9	9.7
Net Exports	4.3	-2.9	-6.8	-27.4	-24.1	-24.1	-26.8	-40.6	-15.2	-22.9

Source: Department of Commerce.

a. Computed using real GDP at 2000 chained dollars on a year over year basis. For 2004, data for first three quarters.

Promotion of Economic Growth: The Importance of Saving

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. The drop in the household (personal) savings rate has been the major factor in the decline in the private sector saving rate. 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. growth¹³.

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 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.

¹³ 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 & Public ^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	3.8	12.3	16.1	6.4	-1.1	1.3	0.2	-2.0	4.5	1.3
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	5.2	11.6	16.8	7.3	-1.8	1.2	-0.6	-2.8	4.4	1.2
1991	5.4	12.0	17.4	7.6	-2.4	1.0	-1.4	-3.6	4.0	-0.2
1992	5.8	11.8	17.6	8.0	-3.5	1.1	-2.4	-4.7	3.3	0.6
1993	4.3	11.9	16.2	6.8	-2.9	1.1	-1.8	-4.1	2.8	1.1
1994	3.5	12.0	15.5	6.0	-1.9	1.3	-0.6	-2.9	3.1	1.5
1995	3.4	12.7	16.1	6.7	-1.6	1.3	-0.3	-2.5	4.1	1.2
1996	2.9	12.9	15.8	6.2	-0.8	1.4	0.6	-1.5	4.8	1.3
1997	2.6	13.1	15.7	6.1	0.3	1.6	1.9	-0.2	5.9	1.3
1998	3.2	12.0	15.2	5.5	1.4	1.7	3.1	1.0	6.5	2.1
1999	1.7	12.6	14.3	4.5	2.0	1.6	3.6	1.7	6.2	3.0
2000	1.7	11.9	13.6	3.5	2.8	1.6	4.4	2.4	5.9	4.0
2001	1.3	12.4	13.7	3.2	1.4	1.3	2.7	0.7	3.9	3.7
2002	1.7	13.2	14.9	4.7	-1.4	1.1	-0.3	-2.3	2.4	4.4
2003	1.5	13.7	15.2	5.3	-2.9	1.2	-1.7	-3.8	1.5	4.7

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.