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Current Economic Conditions and Selected Forecasts

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Summary

U.S. real GDP growth has been positive for 14 consecutive quarters, and the economy is considered to be in an "expansion" phase. As of the second quarter 2005, real or inflation-adjusted growth was some 12% above its previous high near the end of the 1991-2001 expansion.

Real GDP grew at annualized rates of 3.8% and 3.4%, respectively, during the first two quarters of 2005. These rates were in line with the four quarterly rates of growth during 2004 (which were 4.5%, 3.3%, 4.0%, and 3.8%).

The rebound in payroll employment has not been strong. During August 2005, it was about 3.1 million above the level prevailing at the end of the recession (November 2001), but only about 1.49 million above the peak of the last expansion (March 2001). The unemployment rate rose to a high of 6.3% in June 2003; it has since declined and now (August 2005) stands at an expansion low of 4.9% (down from 5.4% one year ago). The low achieved during the last expansion was 3.8%.

The other elements in the economic picture are mixed:

(1) A pick-up in output at the same time as employment is growing slowly 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.

(2) The inflation rate, measured by the CPI, rose 3.3% during 2004. This was largely driven by rising energy prices as the inflation rate excluding food and energy rose only 2.2%. Over the 12 months ended in August, 2005, the CPI rose3.6% and, for the three months ended in August, it rose at an annual rate of 4.2%. Food and energy prices have played an important role in these rates. Removing these prices from the index, the CPI rose 2.1% for the 12 months ended in August and at an annual rate of 1.4% for the three months ended in August. Nevertheless, the inflation rate is now generating some concern.

The consensus among economists is that GDP will grow between 3.4% and 3.8% this year. The unemployment rate will show little tendency to change. Inflation is expected to be above the rate that prevailed in 2004. Fiscal and monetary policies were both eased beginning in 2001. The easing continued into the first half of 2004. This has had a positive effect on spending. However, on 11 occasions beginning on June 30, 2004, and concluding on September 20, 2005, the Federal Reserve has made a modest effort to tighten monetary policy by increasing the federal funds rate by 1/4%. The cumulative increase has been 2-3/4%. Fiscal policy also tightened modestly. The international trade 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

U.S. economic growth has been positive during each of the past 16 quarters. The National Bureau of Economic Research (NBER) declared that the recession that began in March 2001 had ended in November 2001. As of the second quarter 2005, U.S. real GDP (measured in 2000 dollars) was 12.4% above its recession low point in the third quarter 2001, and had grown about 12% from its previous high near the end of the 1991-2001 expansion.

According to the most recent GDP report, growth in the second quarter of 2005 was at an annual rate of 3.3% (compared with 3.8% in the first quarter), similar in magnitude to the four quarterly rates recorded during 2004 (which were 4.5%, 3.3%, 4.0%, and 3.8%).[1] Growth excluding inventories was above GDP growth in the second quarter, increasing at an annual rate of 5.4%.[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 translated into only a small rise in payroll employment above the level attained at the end of the previous cyclical peak. Since its peak in March 2001, payroll employment has risen by about 1.49 million. An encouraging sign is that employment has grown by about 4.1 million over the past two years. The unemployment rate now stands at an expansion low of 4.9%. It has varied between 4.9% and 5.7% since December 2003. These rates are still above the 3.8% low of the 1990s expansion.

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[1] The estimate of second quarter 2005 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.

Measured inflation appears to be rising. The broadest measure of inflation for the economy, the GDP price index, rose 2.6% during 2004, up from 1.8% in 2003 and 2.0% in 2002. The Consumer Price Index (CPI) followed a somewhat similar path. It rose 2.7% during 2004 vs. 2.3% in 2003 and 1.6% in 2002. For the 12-months ended August 2005, the rate was 3.6%. The movement in both indexes, however, has been heavily influenced by sharp movements in the price of food and energy.

Monetary Policy

The policy of monetary easing that began in January 2001 ended in mid-2004. During this period the Federal Open Market Committee (FOMC) of the Federal Reserve System lowered the federal funds target rate in 13 steps by a cumulative 550 basis points (5.50 percentage points), from 6.5% to1.0% (its lowest level since April 1961). Over the past six months, as inflationary pressures appeared to gather momentum and the unemployment rate declined, the FOMC began to move the federal funds target upward. On each of 10 separate occasions, June 30, August 10, September 21, November 10 and December 14, 2004, and February 2, March 22, May 3, June 30, August 9, and September 20, 2005, the target was advanced by 0.25%. It now stands at 3-3/4%.

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 last expansion (1995-2000). 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%. During 2004, the annualized quarterly rates of growth were 4.3%, 3.6%, 4.0%, and 3.3%. During the first two quarters of 2005, GDP grew at an annual rates of 3.8% and 3.3%, respectively.

Productivity gains have been an important part of the current expansion.[3] Most economists refer to recent trends as reflecting a "productivity-led" recovery. During 2002, 2003, and 2004, productivity rose 5.0%, 4.5%, and 4.0%, respectively. 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.

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[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.

Table 1. The Growth Rate of Real GDP v. Final Sales, 1991-2004

(percent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
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	1.6	2.7	4.2
4thQ-4thQ	1.1	4.1	2.5	4.1	2.0	4.4	4.3	4.5	4.7	2.2	0.2	1.9	4.0	3.8
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	1.2	2.7	3.9
4thQ-4thQ	0.2	4.2	2.6	3.2	2.9	3.9	4.0	4.7	4.2	2.9	1.5	0.8	4.0	3.6

Source: U.S. Department of Commerce.

Labor Markets. The civilian unemployment rate fell from a cyclical high of 7.8% in June 1992 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, reaching an expansion low of 4.9% in August 2005. During the past 20 months the unemployment rate has varied between 4.9% and 5.7%.

Employment is now above its pre-recession peak. Measured from the end of the previous peak in March 2001, payroll employment has risen by approximately 1.49 million. This is unprecedented in any postwar business cycle. Even in the previous business cycle in the early 1990s (which was referred to initially as a "jobless" recovery"), employment had turned substantially upward by this point. Since the upswing began in November 2001, payroll employment has risen by 3.12 million.

Part of the reason for the low rate of job creation in the current expansion may be that employment at the end of the last expansion was substantially above the level many economists believed to be consistent with full employment. Thus, employment levels were expected to adjust downward and the data may be picking up this adjustment.

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 more than 6.2 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 - 2005

(%, 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	5.7	5.6	5.7	5.5	5.6	5.6	5.5	5.4	5.4	5.5	5.4	5.4
2005	5.2	5.4	5.2	5.2	5.1	5.0	5.0	4.9				

Source: 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.

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 - 2004

(%, 4Q - 4Q)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Implicit Price Deflator	2.2	2.3	2.2	2.0	1.9	1.5	1.1	1.6	2.2	2.5	1.7	2.0	2.9
Chain Type Price Index	2.2	2.3	2.2	2.0	1.9	1.5	1.1	1.6	2.2	2.5	1.7	2.0	2.9

Source: U.S. Department of Commerce.

With the start of the recession in March 2001, inflation rate 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 1.7% in 2002, on a fourth quarter-fourth quarter basis. Since then it has been rising, reaching 2.9% during 2004. Over the first half of 2005, it rose at an annual rate of 2.8%.

Table 4. Rate of Change in the Consumer Price Index (CPI), 1992 - 2004

(percent)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
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	3.3
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	2.2
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	2.7
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	1.7

Source: Department of Labor.

The pattern can be found in the CPI. Measured on a December - December basis, it rose by 2.4% during 2002, decelerated to 1.9% during 2003, and then accelerated to 3.3% during 2004. For the 12-month period ended in August, it rose 3.6%, while for the three-months ended in August, it rose at an annual rate of 4.2%. Much of the acceleration can be attributed to energy price increases.

The rate at which Unit Labor Costs have risen has accelerated from 2002 through 2004. During the first half of 2005, the rate of increase moderated somewhat, as shown in **Table 5**. Employee cost trends are also measured in the Employment Cost Index (ECI). The rate at which the ECI for private industry rose accelerated from 1995 through most of 2001, but began to decelerate in the course of 2002 as a result of weakened labor market pressures. The ECI began a very modest rise beginning in 2003, somewhat in line with increases during the late 1990s.

Table 5. Rate of Change in Labor Costs, 1993 - 2005

(in percentages)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Unit Labor Costs	1.6	0.5	2.1	0.7	2.0	2.8	1.6	4.2	0.3	-0.6	0.9	3.3	2.3
Employment Cost Index	3.6	2.6	2.6	3.1	3.4	3.5	3.4	4.4	4.2	3.2	4.0	3.8	3.1

Source: U.S. Department of Labor.

Notes: Unit labor costs are for nonfarm business, 4th quarter-4th quarter. For 2005, it is the annualized rate for the first half year. The Employment Cost Index is for private industry on a December-December basis. For 2005, it is on a June-June 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.[4] 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 1992-2005 reminds us that the United States still receives a substantial net inflow of capital from abroad.

Table 6. U.S. Foreign Trade Deficit, 1988 - 2004

(as a percent of GDP)

1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
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	5.1	5.6

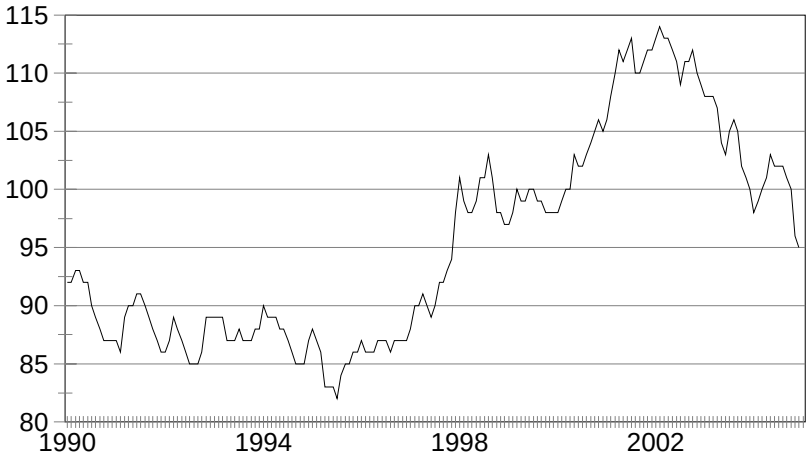
Source: Department of Commerce.

Note: During 2005:1H, the deficit averaged 5.7% 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 over 34% to its peak in February 2002. From then until December 2004, it depreciated by around 17% on an inflation-adjusted basis, with some ups and downs. From December 2004 through mid-September 2005, the dollar has fallen by less than 2%.

[4] 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 2004 the current account deficit was, respectively, approximately 4.1%, 4.6%, and 5.3% of nominal GDP. During 2005:1H, it reached 5.2% of nominal GDP.

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



Source: Board of Governors of the Federal Reserve.

The dollar has shown more movement against the major world currencies than the broad trade-weighted index described above suggests.[5] From its high in February 2002 through April 2005, the dollar has depreciated by nearly 24% against an index consisting of the major currencies that circulate, adjusted for inflation. However, over the period December 2004-mid-September 2005, this index shows that the dollar has risen in value by nearly 5.6%.

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 was expansionary between 2001 and 2003 as a full employment surplus in 2001 fell from 1.1% to a deficit of 2.7% of potential GDP in 2003. The deficit declined to 2.4% of potential GDP in 2004. An alternative, although inferior measure, is the ratio of the actual budget deficit to actual GDP. When examined, fiscal policy was also expansionary since 2000 with the surplus of 2.4% in that year giving way to a deficit of 3.6% in 2003, a net shift of 6% of GDP.

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[5] 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.

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 FY2004, which ended on September 30, was $413 billion.[6] This deficit is more than twice the recorded fiscal deficit in FY2002 and approximately 3.6% of GDP.

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

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Standardized Budget Deficit	$188	$192	$145	$145	$92	$78	$34	$+8	$+116	$+115	$-117	$303	$280
Full Employment GDP	6,398	6,711	7,038	7,390	7,760	8,152	8,535	8,965	9,492	10,077	10,635	11,182	11,758
Ratio	0.029	0.029	0.021	0.020	0.012	0.010	0.004	0.001	+0.012	+0.011	0.011	-0.027	-0.024
Actual Budget Deficit	$290	$255	$203	$164	$108	$22	$+69	$+126	$+236	$+128	$158	$378	$412
Actual GDP	6,241	6,578	6,964	7,325	7,697	8,187	8,626	9,127	9,708	10,060	10,384	10,842	11,553
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	0.036

Source: Congressional Budget Office (January 2005).

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.[7] 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.

The positive growth in aggregate reserves over 2002-2004 support the Federal Reserves view that it is providing important support to the ongoing expansion. 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). Nevertheless, the various measures of money do not provide consistent measures of the thrust of monetary policy.

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[6] Secretary of the Treasury and Director of the Office of Management and Budget, *Budget Results for Fiscal Year 2004*, Oct. 14, 2004. See [http://www.treas.gov/press/].

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

Table 8. The Growth Rates of the Monetary Aggregates

(annualized rates of growth)

Time Period	Aggregate Reserves	Monetary Base	M1	M2	M3
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
03:12 - 04:12	8.8	5.4	5.2	5.7	6.4
04:08 - 05:08	-0.2	3.7	1.0	3.9	6.1

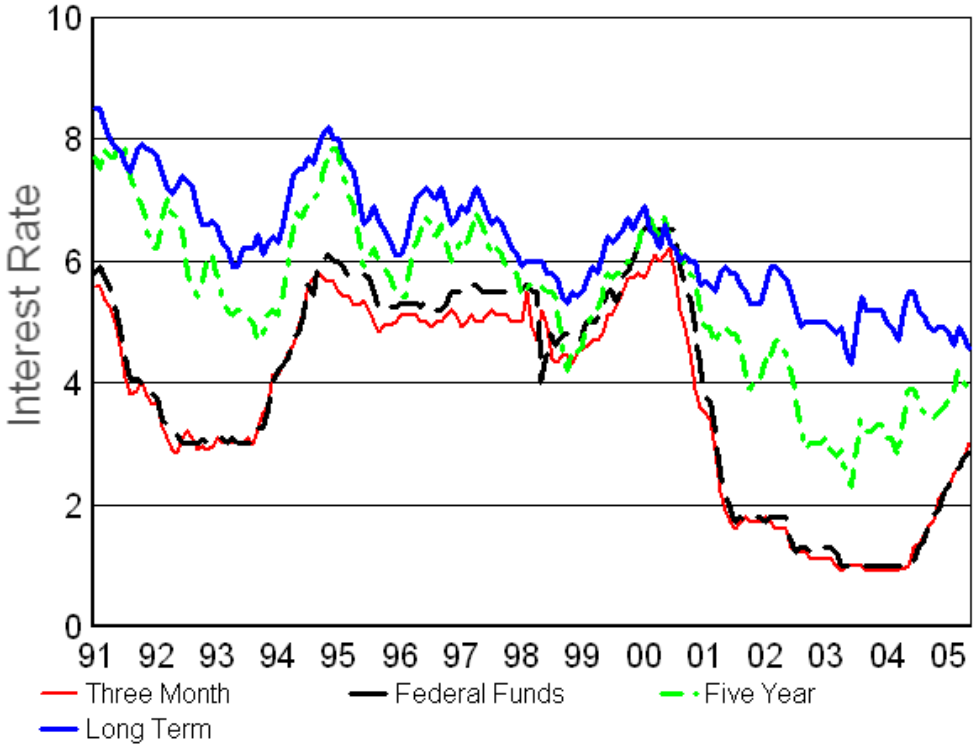
Source: Board of Governors of the Federal Reserve System.

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 raised1/2%, 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. On 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 in equal increments of 0.25% on 11 occasions: June 30, August 10, September 21, November 10, and December 14, 2004, and February 2, March 22, May 3, June 30, August 9, and September 20, 2005. It now stands at 3-3/4%.

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, 2005-2006

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 10 forecasts.

The consensus view taken by the forecasts summarized in **Table 9** is that GDP growth should be about 3.5% during 2005 and 3.3% during 2006 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 range between 2.2% and 3.0%, depending on the price index consulted. Both short-term and long-term interest rates are expected to trend upward, rise both in 2005 and 2006.

In its semi-annual *Monetary Policy Report to the Congress*, dated July 20, 2005, The Board of Governors of the Federal Reserve presented its economic projections for 2005 and 2006. It projected that from the fourth quarter 2004 to the fourth quarter 2005, real GDP will grow 3.5% and that prices[8] will increase from 1.75% to 2.0%. The civilian unemployment rate is projected to be average 5.0% during the fourth quarter of the year. For 2006, real GDP, on a fourth quarter over fourth quarter basis, is projected to grow between 3.25% and 3.5%, prices are expected to rise between 1.75% and 2.0%, and unemployment during the fourth quarter of the year is projected to average between 5.0%.

Table 9. Economic Forecasts 2005 - 2006

	2004		2005				2004[a]	2005	2006
	3[a]	4[a]	1[a]	2[a]	3	4			
Nominal GDP[b]									
OMB	5.3	6.1	7.0	5.8	NA	NA	6.5	6.1	5.6
CBO	5.3	6.1	7.0	5.8	NA	NA	6.5	5.7	5.3
BC T-10	5.3	6.1	7.0	5.8	7.9	6.8	6.5	6.5	6.3
BC Con.	5.3	6.1	7.0	5.8	6.1	5.4	6.5	6.2	5.6
BC B-10	5.3	6.1	7.0	5.8	4.7	4.1	6.5	6.2	4.8
Real GDP[b]									
OMB	4.0	3.3	3.8	3.3	NA	NA	4.4	3.6	3.5
CBO	4.0	3.3	3.8	3.3	NA	NA	4.4	3.8	3.7
BC T-10	4.0	3.3	3.8	3.3	4.4	3.8	4.4	3.7	3.6
BC Con.	4.0	3.3	3.8	3.3	3.6	3.1	4.4	3.5	3.2
BC B-10	4.0	3.3	3.8	3.3	2.8	2.4	4.4	3.4	2.7

[8] In its *Monetary Report to Congress*, the Federal Reserve features in its projections a measure of inflation derived from the Personal Consumption Expenditure (PCE), less food and energy, index found in the GDP accounts. This price index attempts to measure inflation with regard to consumer spending. The PCE covers about 2/3's of GDP.

	2004		2005				2004[a]	2005	2006
	3[a]	4[a]	1[a]	2[a]	3	4			
Unemployment[c]									
OMB	5.4	5.4	5.3	5.1	NA	NA	5.5	5.2	5.1
CBO	5.4	5.4	5.3	5.1	NA	NA	5.5	5.2	5.2
BC T-10	5.4	5.4	5.3	5.1	5.1	5.2	5.5	5.1	5.3
BC Con.	5.4	5.4	5.3	5.1	5.0	5.0	5.5	5.1	5.0
BC B-10	5.4	5.4	5.3	5.1	4.9	4.9	5.5	5.0	4.7
GDP Price Index (chain-weighted)[b]									
OMB	1.5	2.7	3.1	2.4	NA	NA	2.4	1.9	2.0
CBO	1.5	2.7	3.1	2.4	NA	NA	2.4	1.8	1.5
BC T-10	1.5	2.7	3.1	2.4	3.5	3.0	2.4	2.8	2.8
BC Con.	1.5	2.7	3.1	2.4	2.5	2.3	2.4	2.6	2.3
BC B-10	1.5	2.7	3.1	2.4	2.4	1.7	2.4	2.4	2.0
CPI-U[b]									
OMB	1.9	3.4	2.5	4.1	NA	NA	2.7	2.4	2.3
CBO	1.9	3.4	2.5	4.1	NA	NA	2.7	2.4	1.9
BC T-10	1.9	3.4	2.5	4.1	4.7	3.9	2.7	3.4	3.2
BC Con.	1.9	3.4	2.5	4.1	3.4	2.8	2.7	3.1	2.7
BC-10	1.9	3.4	2.5	4.1	2.4	1.8	2.7	2.9	2.2
T-BILL Interest Rate (3 month)[c]									
OMB	1.5	2.0	2.5	2.9	NA	NA	1.4	3.0	3.4
CBO	1.5	2.0	2.5	2.9	NA	NA	1.4	2.8	4.0
BC T-10	1.5	2.0	2.5	2.9	3.7	4.1	1.4	3.4	4.7
BC Con.	1.5	2.0	2.5	2.9	3.5	3.8	1.4	3.2	4.2
BC B-10	1.5	2.0	2.5	2.9	3.3	3.4	1.4	3.0	3.6
10-year Treasury Note[c]									
OMB	4.3	4.2	4.3	4.2	NA	NA	4.3	4.3	4.8
CBO	4.3	4.2	4.3	4.2	NA	NA	4.3	4.8	5.4
BC T-10	4.3	4.2	4.3	4.2	4.5	5.0	4.3	4.4	5.3
BC Con.	4.3	4.2	4.3	4.2	4.3	4.6	4.3	4.3	4.8
BC B-10	4.3	4.2	4.3	4.2	4.1	4.2	4.3	4.2	4.2

Sources: Blue Chip Economic Indicators, September , 2005. Congressional Budget Office, January, 2005; and, the Office of Management and Budget (CEA), June 8, 2005.

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 2005:1H

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP Growth	100.0%	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	122.7	76.8	64.7	64.7
Investment	17.7	34.3	41.5	37.7	26.2	26.9	-187.8	-26.8	22.3	44.2	11.9
Govt. Purchases	4.3	5.2	7.9	8.4	16.3	10.1	80.4	51.0	19.4	9.5	11.5
Net Exports	4.3	-2.9	-6.8	-27.4	-24.1	-24.1	-26.8	-46.9	-18.6	-18.3	11.9

Source: Department of Commerce.

Note: Computed using real GDP at 2000 chained dollars on a year over year basis. Data for 2005 are from first half year.

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 45 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 45-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 and 2002-2004 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 was reversed during the period 1993-2001. The improved budget position of the federal government during this period added to national saving.

Third, the data show that for 20 of these 45 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 began 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 had 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 would have had to rise in order to restore balance between investment and a now smaller amount of saving. Higher interest rates would have choked off investment and dampened U.S. growth[9].

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.

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

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.

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	12.5	13.8	3.2	1.3	1.2	2.5	0.5	3.7	3.7
2002	1.5	13.3	14.8	4.4	-1.6	0.9	-0.7	-2.7	1.7	4.4
2003	1.0	13.9	14.9	4.6	-2.5	1.1	-1.4	-3.3	1.2	4.6
2004	0.9	14.9	14.9	4.9	-2.4	1.3	-1.1	-3.1	1.8	5.4

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.