Economic Outlook

The national economy began the new year in a "soft spot."

The modest economic recovery stalled in October. In its November 6 meeting, the Federal Open Market Committee (FOMC), acting for the first time in almost a year, reduced its target federal funds rate by 50 basis points to 1.25 percent. The committee noted that although greater productivity growth was supporting economic activity, "incoming economic data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment." In testimony before the Joint Economic Committee on November 13, Fed Chairman Alan Greenspan noted, "the evidence has accumulated that the economy has hit a soft spot." In its December 10 meeting, the FOMC left the target federal funds rate at 1.25 percent. The committee noted that economic activity was supported by accommodative monetary policy and productivity growth, but that "the limited number of incoming economic indicators since the November meeting, taken together, are not inconsistent with the economy working its way through its current soft spot." The January 15 Federal Reserve "Beige Book" reported "subdued growth in economic activity from mid-November through early January, with little change in overall conditions relative to the last survey period." Districts reported "sluggish" growth and "soft" or "subdued" economic activity.

Real gross domestic product (GDP) grew at an annual rate of 0.7 percent in the final quarter of 2002. This followed 4.0 percent growth in the third quarter and continued the irregular pattern of growth during the recovery. This pattern is influenced by the volatility of auto sales (due to dealer incentives). Exhibit 1 presents real GDP growth on both a quarter-to-quarter annualized basis (QA) and a year-over-year basis (Y-o-Y). The erratic nature of the recovery is evident in the ups and downs of the QA series during 2002. The year-over-year series shows that the recovery is real, but modest. The Chicago Fed National Activity Index indicates that the economy is growing below trend.[2]

[2] The Chicago Fed National Activity Index, produced by the Federal Reserve Bank of Chicago, is a weighted average of 85 indicators of national economic activity. It is constructed so that a value of 0 indicates the economy is expanding at its historical trend rate of growth. Values less than 0 indicate below-trend growth and values greater than 0 indicate above-trend growth.

Exhibit 2 presents another picture of the soft state of the economy. The GDP gap is defined as the percentage difference between actual GDP and potential GDP. [3] Also presented are the growth rates of actual GDP and potential GDP. In the late 1990s, the GDP gap was positive, meaning that the economy was producing above its "maximum sustainable level." This suggests that comparing the present situation to the late 1990s may not be a fair comparison. The recession shows up not as the shrinking of the positive gap or even as a negative gap. The recession shows up as a large negative GDP gap and an actual growth rate substantially less than the potential growth rate. The modest recovery is evident by positive actual growth. However, a recovery in which the economy grows slower than its potential does not feel like a recovery. A major reason for this is that the economy is not growing fast enough to generate new employment.

The soft spot is also evident in the Conference Board's index of coincident economic indicators. The coincident index, which describes where the economy is, was flat during the last quarter of 2002. Exhibit 3 shows the performance of the coincident index since January 1999. The index bottomed out in November 2001, suggesting that the recovery may have started then. The index slowly rose throughout 2002 until pausing in September. The four variables used in constructing the index (industrial production, real manufacturing and trade sales, real personal income less transfer payments, and nonagricultural employment) are the same variables used by the National Bureau of Economic Research (NBER) to date the business cycle. The performance of each of these variables is presented in Exhibit 4. Compared to March 2001, industrial production (IP) is down by 2.2 percent and nonagricultural employment (Emp) is down by 1.3 percent. Real personal income less transfers (Income) is up 0.9 percent and real manufacturing and trade sales are up 2.0 percent. The indicators suggest an economy that has stopped falling but is struggling to move forward.

The Conference Board's index of leading economic indicators, which describes where the economy is going, improved throughout the last quarter of 2002.[4] In December, eight of the ten variables used to calculate the leading index were up and two were down. Although the index often gives false signals, it generally turns down before a recession and up before an expansion. In its January 23 news release of the December index, the Conference Board noted "the leading index has improved for three straight months, suggesting a stronger economic recovery in the first half of 2003."

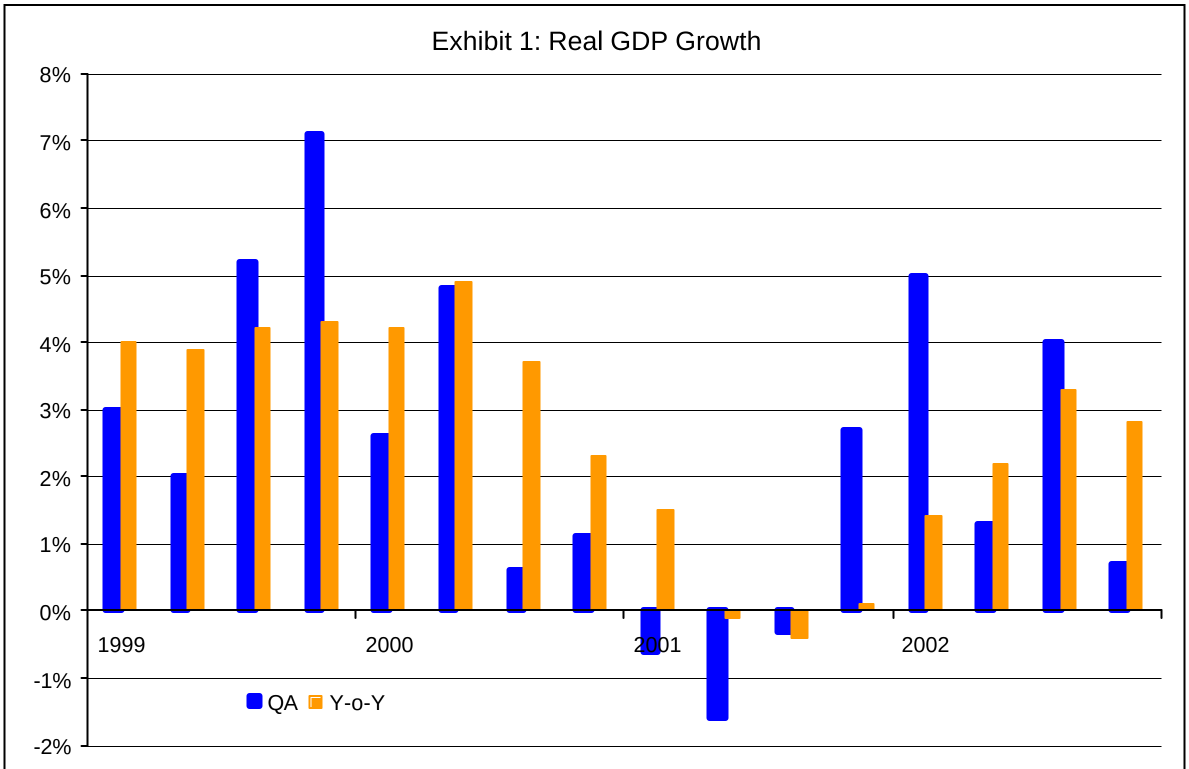
[3] Potential GDP is an estimate of an economy's maximum sustainable level of output. It is not the maximum level of output that can be produced, but is instead the level of GDP attainable when the economy is operating at a high rate of resource use. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

[4] The leading index is a weighted average of 10 economic variables (average manufacturing workweek, jobless claims, new orders for consumer goods, new orders for capital goods, vendor performance, building permits, stock prices, money supply, interest rate spread, and consumer confidence) designed to predict near-term economic conditions.

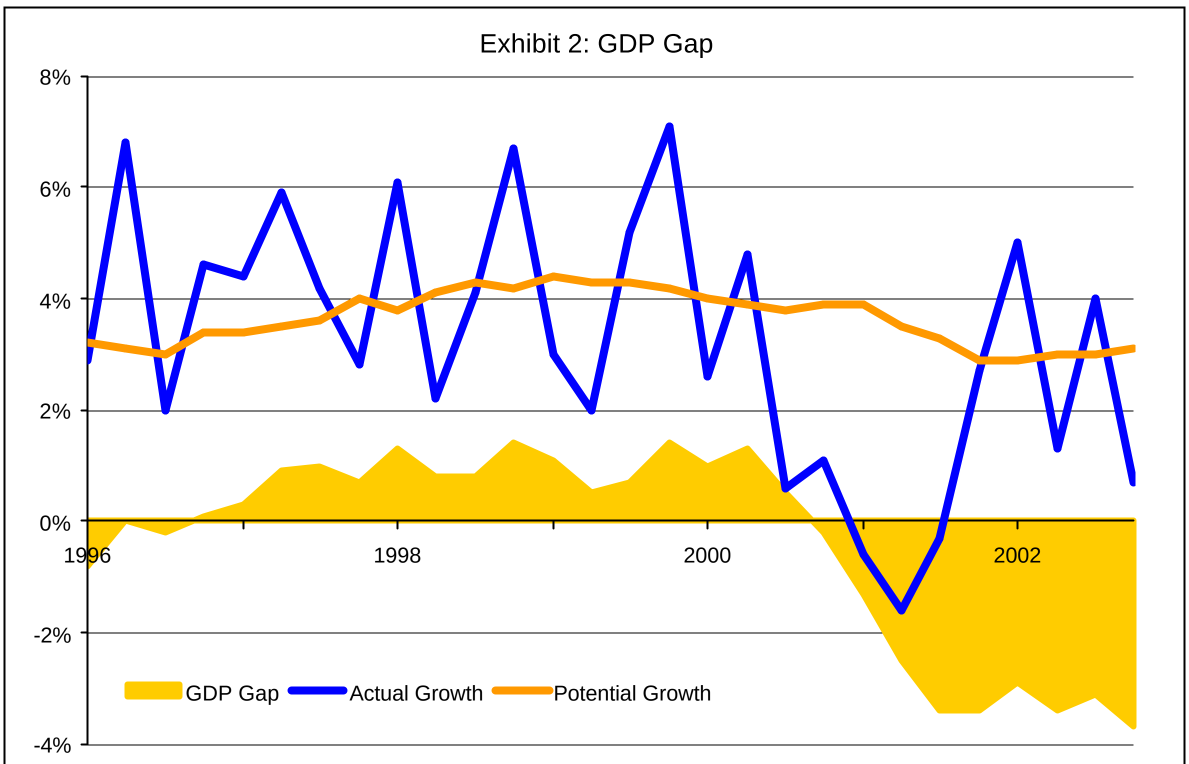
In its January 29 meeting, the FOMC again left the target federal funds rate at 1.25 percent. The committee noted that "oil price premiums and other aspects of geopolitical uncertainty have reportedly fostered continued restraint on spending and hiring by businesses" but "that as those risks lift, as most analysts expect, the accommodative stance of monetary policy, coupled with ongoing growth in productivity, will provide support to an improving economic climate over time."

As is generally the case around turning points in economic cycles, indicators are mixed. The housing market, helped by low mortgage rates, is healthy. Personal income continues to grow. Retail sales are strong, but not outstanding. Purchasing managers indices indicate increases in new orders, which should lead to increased production. Consumer confidence is down. Of course, it has been down for a while, but consumers have continued to spend. One worry is that low consumer confidence will finally lead to lower consumer spending. Industrial production has been flat since summer and capacity utilization is low. The employment situation has been dreary, with output growth insufficient to generate employment growth.

Although the economy began the year in a soft spot, it is not expected to remain there. The economy is forecasted to grow at a faster pace in 2003, but the forecast is subject to a number of risks. The Global Insight January forecast lists the following negative risks: the United States goes to war with Iraq; there is another major terrorist attack; the stock market takes another dive; the housing "bubble" bursts; the U.S. dollar crashes; and there is another financial crisis. One or more these could significantly undermine the economy's nascent recovery. Global Insight also notes two positive risks are: capital spending takes off; and Europe and Japan grow strongly. If either of these were to occur, the economic recovery could be a lot stronger than called for by the baseline forecast.

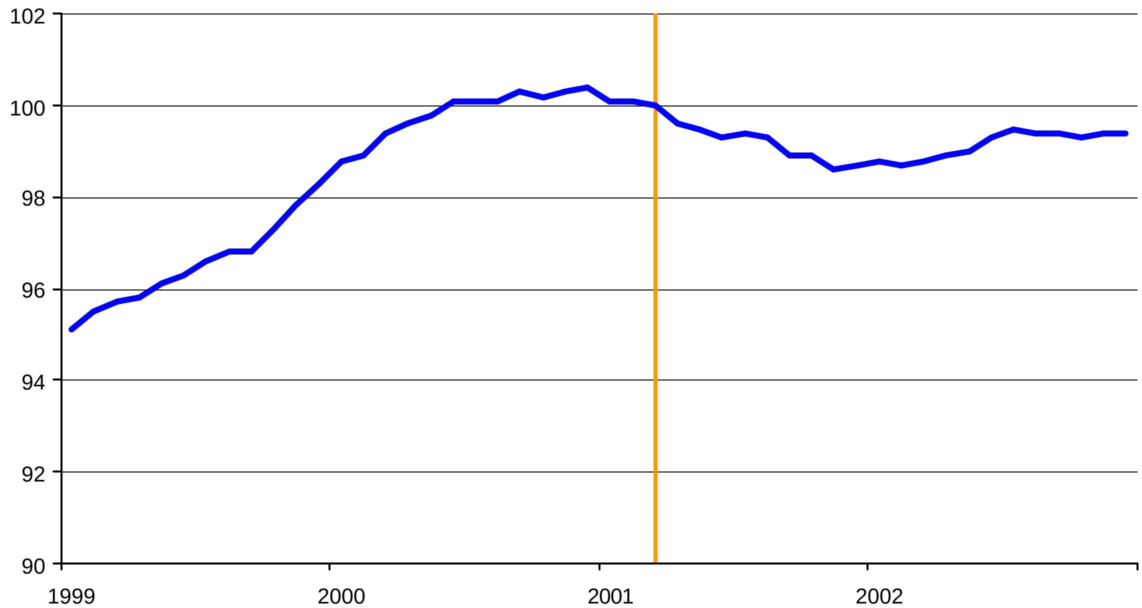


Source: U.S. Bureau of Economic Analysis



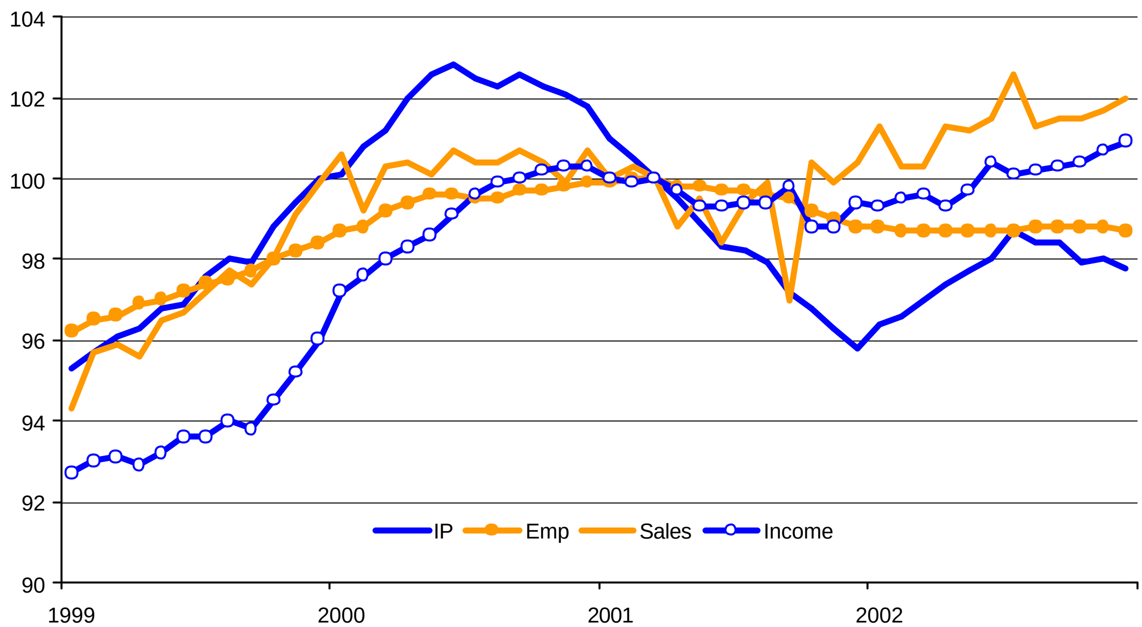
Source: U.S. Bureau of Economic Analysis, Global Insight, and LSC calculations

Exhibit 3: Index of Coincident Economic Indicators (March 2001 = 100)



Source: NBER and LSC calculations

Exhibit 4: Coincident Economic Indicators (March 2001 = 100)



Source: NBER and LSC calculations