Current Economic Developments

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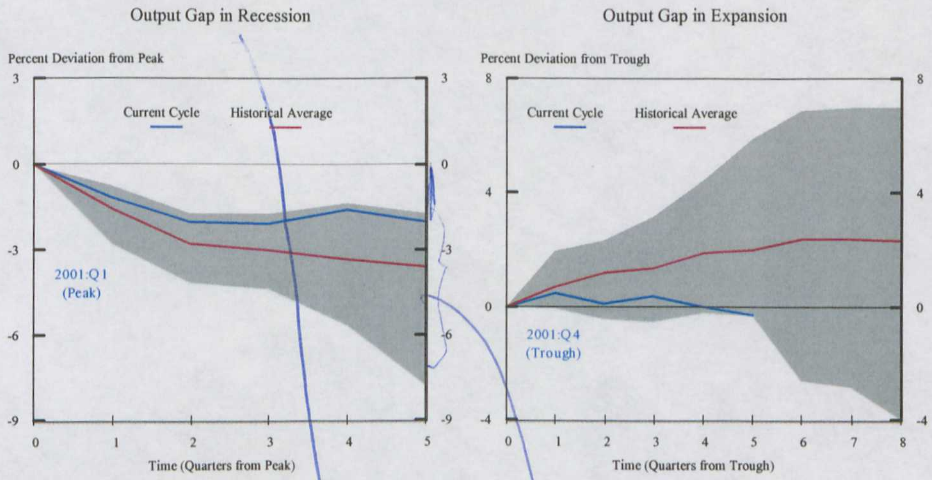
Summary

- After a relatively weak recession, a relatively weak recovery
- So far financial markets and sentiment are more optimistic than are data for the real economy
- Excess capacity and slowing inflation are issues
- Fiscal and monetary stimulus are in place -- but are they sufficient?
- When will we see investment spending pick-up?
- What is the role of productivity growth in all this?

The recent recession was unusually mild, but the ongoing recovery is proving to be much weaker than usual as well



Source: Bureau of Economic Analysis.
Note: Gray shading indicates historical range.

since trough - reduction in output gap -

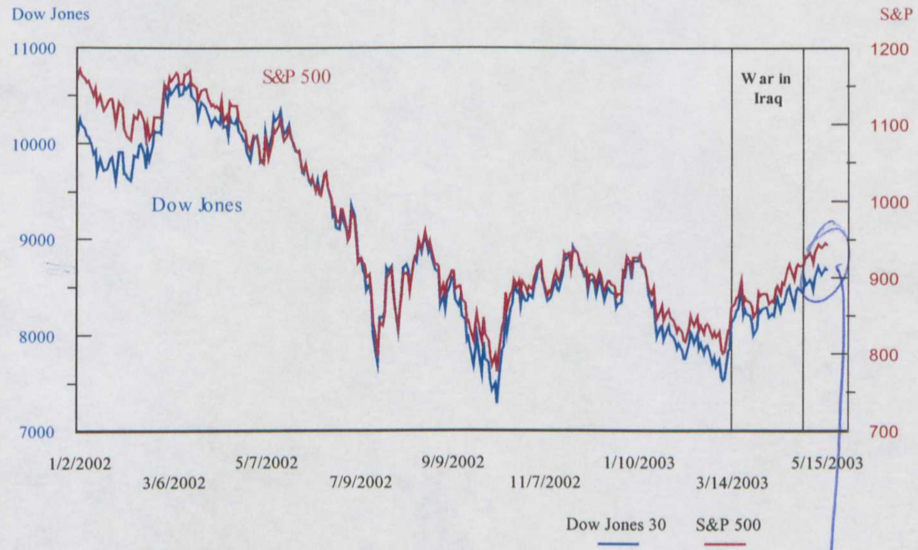
output gap: CBO - potential ~ 3+%

change } range of cumulative deviation from full capacity output

Δ in output gap from peak to trough - reduction in utilization of economy by 2½%

normally declines well over 3%

The successful war in Iraq has contributed to a rally in financial markets that has raised stock prices to their highest levels in almost a year



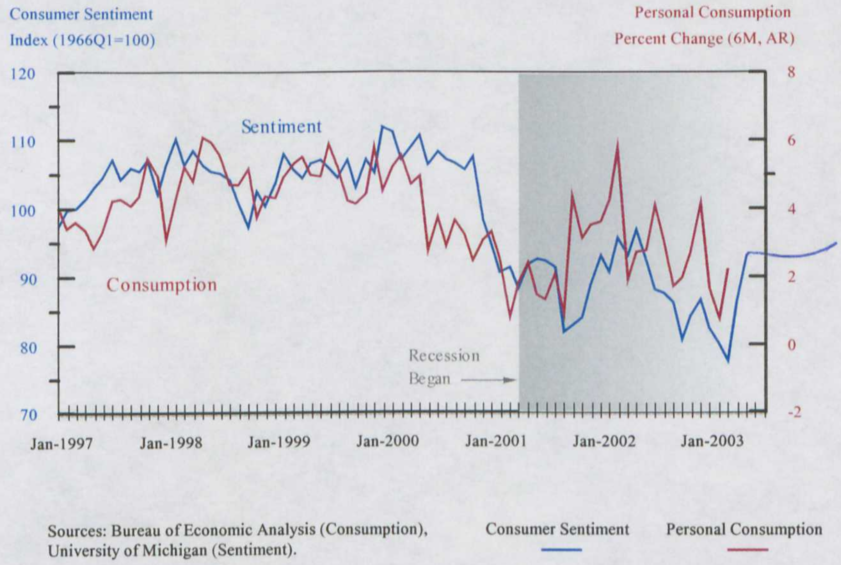
Source: Bloomberg.

latest trend

8683 Dow @ 10:30

S&P 935

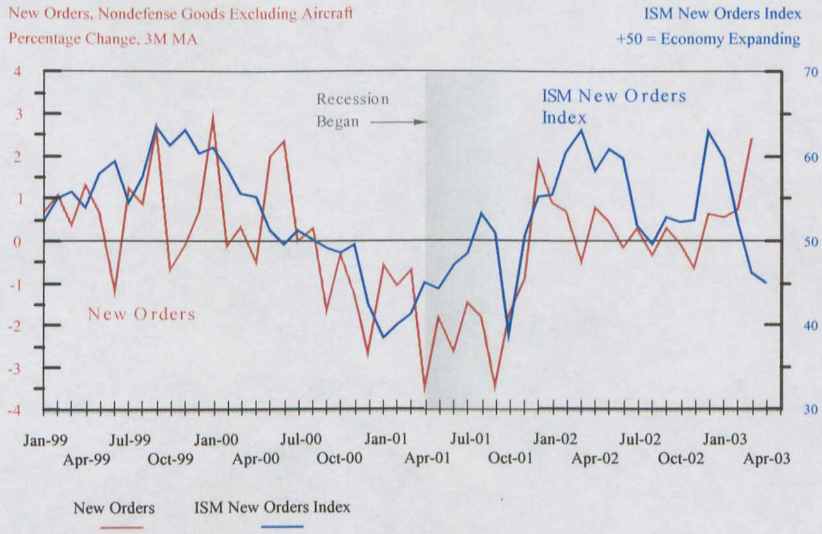
Consumer sentiment also rebounded in April and May, raising hope that consumer spending may be firming, but sentiment remains relatively low



Sources: Bureau of Economic Analysis (Consumption), University of Michigan (Sentiment).

may ↑
all
expectations
current ↓
slightly

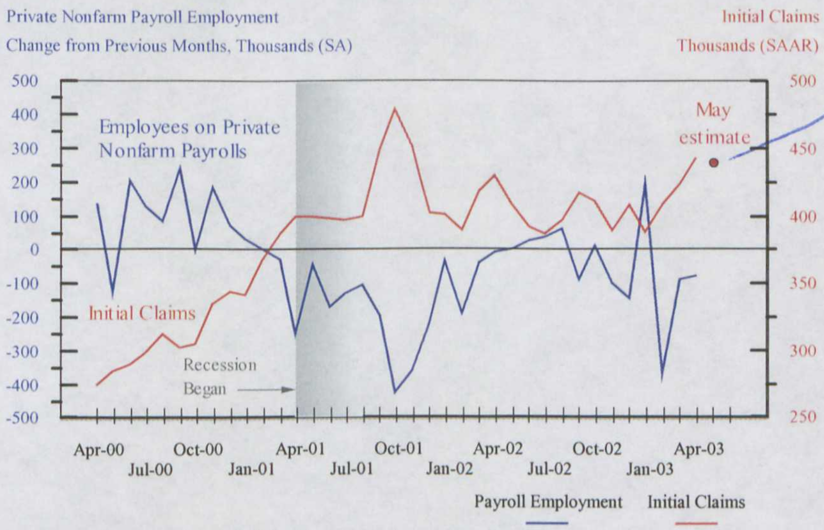
New orders for capital goods looked promising in March but the ISM report in April showed new orders contracting as factories still struggle to recover



Sources: Bureau of the Census, Institute for Supply Management.

IP declining
last 2 mos
March/april
-.5

The wobbly recovery faltered as employment fell again recently and new unemployment claims headed back up

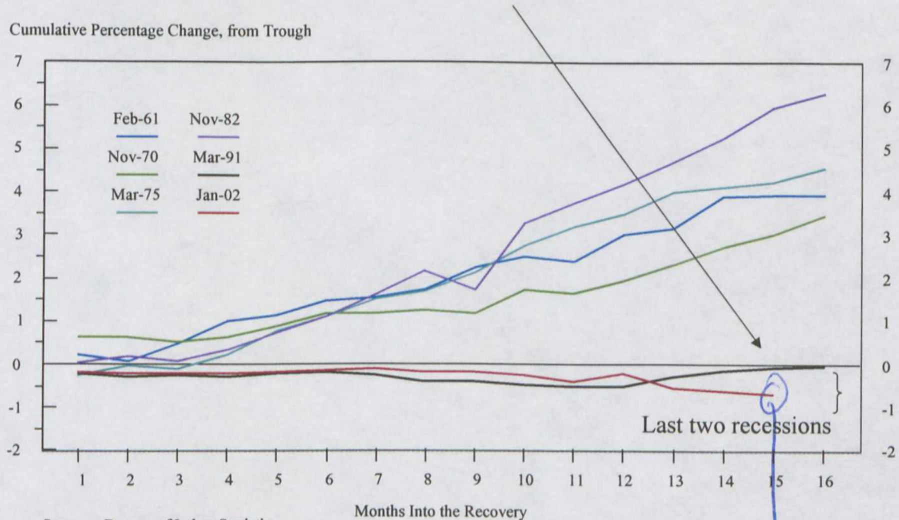


Sources: Bureau of Labor Statistics (Payroll Employment).
Department of Labor (Initial Claims).

433, today

4 week moving av.

The current recovery continues to look "jobless" compared with past recoveries -- even compared with the 1990-91 recession

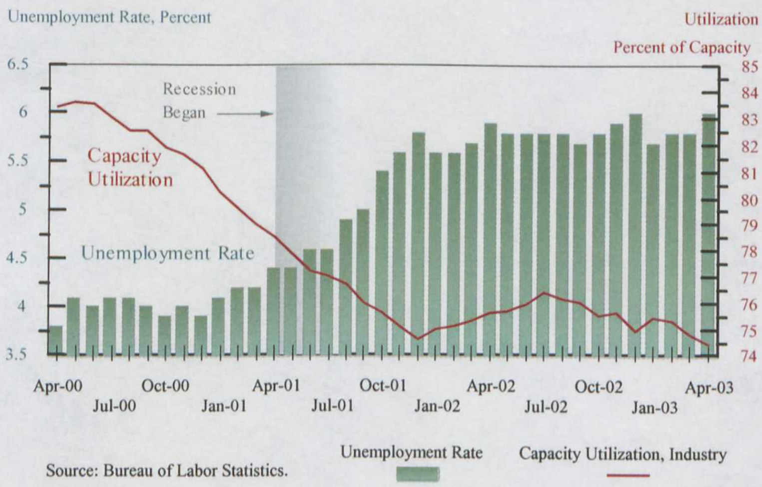


Sources: Bureau of Labor Statistics
Board of Governors.
Bureau of Economic Analysis.

down roughly 700 th jobs also since 1/02

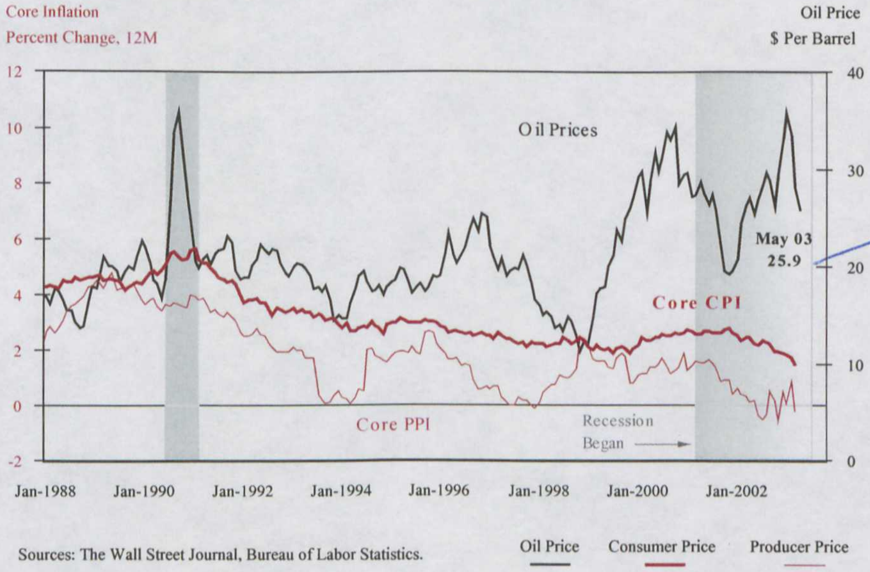
3/4 million

Weakening in labor markets comes at an inopportune time with stubbornly high levels of underutilized resources in labor and capital markets



Source: Bureau of Labor Statistics.

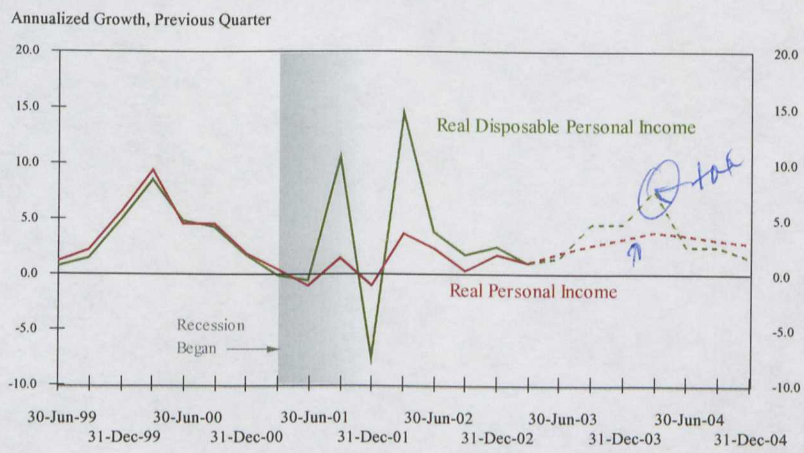
Oil prices fell and inflation remains low, but weakness in early 2003 is contributing to greater disinflation in core consumer prices



Sources: The Wall Street Journal, Bureau of Labor Statistics.

upto
$29
WTI
stubborn

Additional fiscal stimulus from expected tax cuts boosts forecasts of income, but 2001-02 tax cuts have had only a modest effect on growth

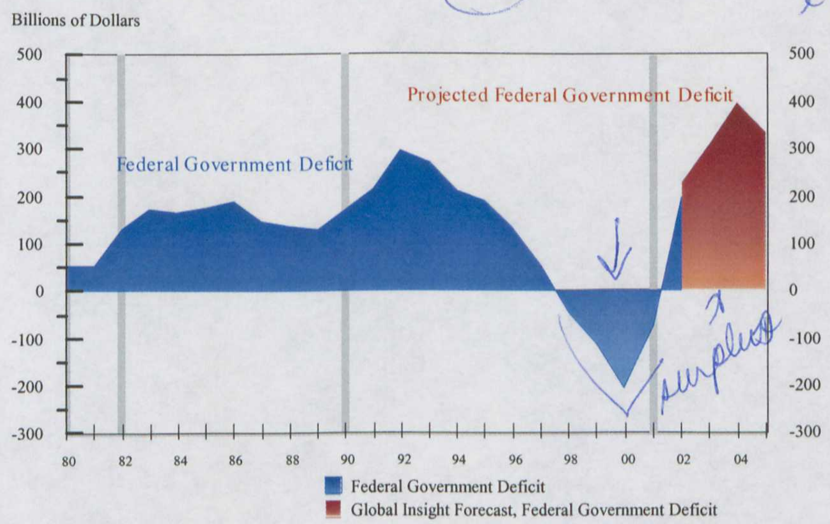


Source: Global Insight.

expected tax cuts -
DRI forecast
1/2 Pres. proposal

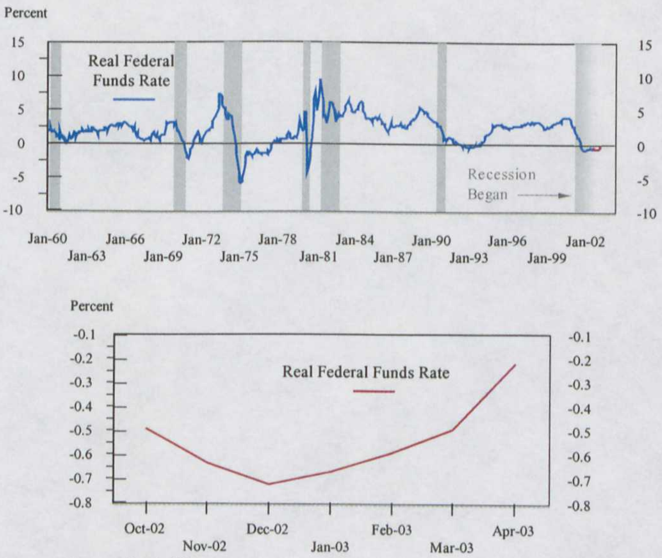
The magnitude of expected fiscal stimulus is restrained by forecasts of high budget deficits and offsetting contraction in S&L government budgets

e100B



Sources: Bureau of Economic Analysis.
Global Insight (Forecasts)..

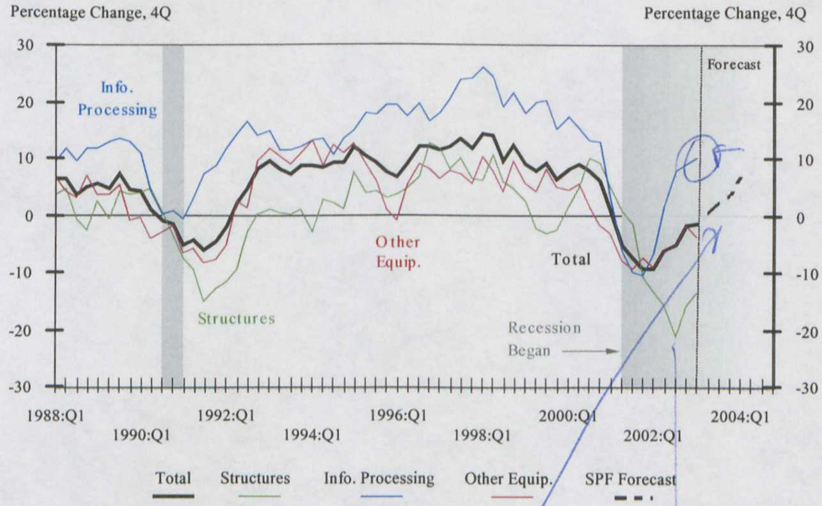
Monetary policy remains stimulative with the real federal funds rate below zero, but declining inflation has raised the real rate in recent months



Sources: Board of Governors.
Bureau of Labor Statistics (Core CPI).

- & productivity

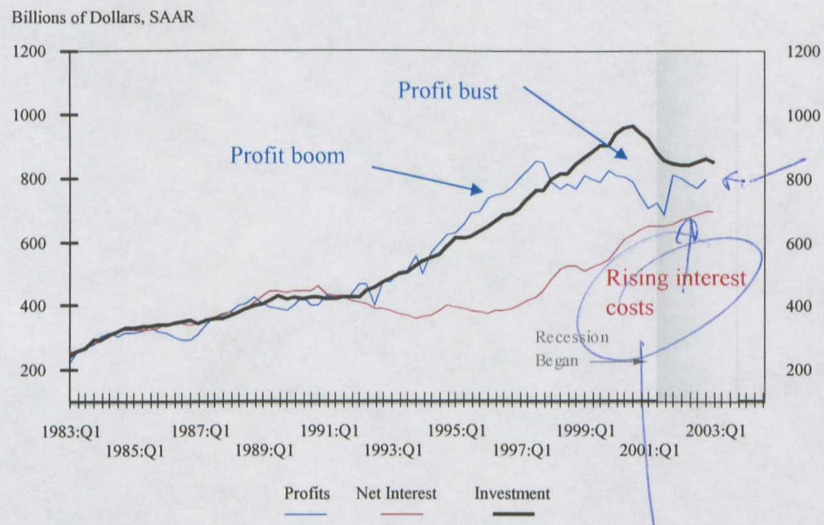
Prospects for robust recovery depend importantly on investment.
Information processing is growing, but other investment is still weak, and the long-run trend is quite uncertain after the 1990s boom



Sources: Bureau of Economic Analysis, Survey of Professional Forecasters.

4Qtr %Δ's
1Q+r ind. dropped
B&S -4.2
E&S - 4.4
InfoP - +10.8

The investment recovery still faces "headwinds" from sagging profits growth, rising interest costs, and reduced credit ratings. Risk premia are lower but still high

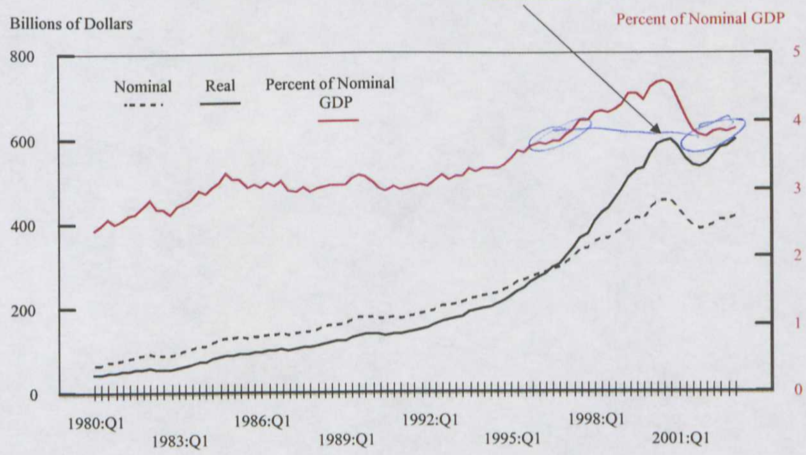


Source: Bureau of Economic Analysis.

IVA & CC adjs not after tax

+ refinancing issue more debt switch to cap mkts

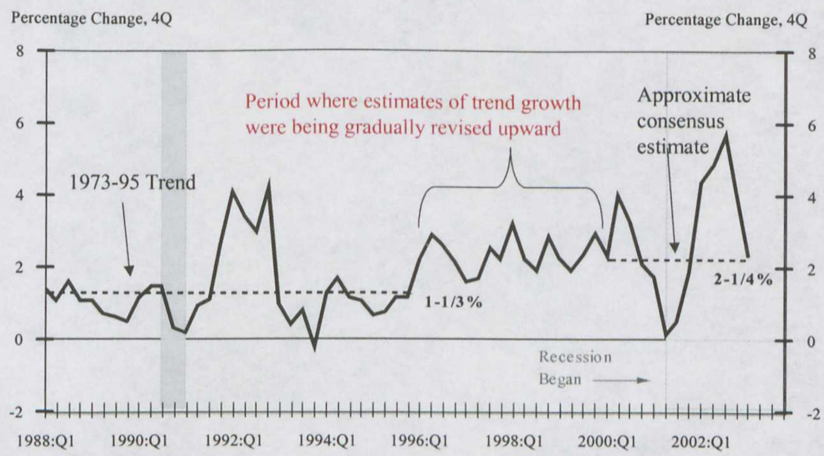
Although nominal spending on high tech investment is still relatively weak, investment in real (price-adjusted) terms has recovered to its peak level in 2000. Higher real tech investment contributes to real output and productivity growth.



Source: Bureau of Economic Analysis.

reflects on potential for growth as well

Productivity growth has been remarkably strong during this business cycle but identifying trend vs. cycle is still difficult



Source: Bureau of Labor Statistics.

One area of optimism here

Views on Trend Labor Productivity

- **The Optimists**
  - Emergence of "New Economy," IT Revolution in mid 1990s boosts growth to historic rates of **3%** or more
- **The Pessimists**
  - Not much changed, growth still much less than **2%**
- **Centrists**
  - Best estimate is in between, around **2-1/4%**
  - Most analysts were slow to raise estimates (late 90s)
  - But they never got caught up in euphoric overestimates

Productivity Growth this Business Cycle

- **Relatively strong**
  - Smaller decline during recession – than usual
  - Greater, more persistent rebound as recovery unfolds

4 Qtr. growth rate ~~[illegible]~~ 2.4

1.6 Q1

- **Why is it so strong?**
  - Is trend growth substantially higher now?
  - Or is the cyclical response different this time?
    - Productivity may be restraining employment more than usual
- **Is it sustainable?**
  - To what extent will robust productivity growth "support" the current recovery?

real wage growth

incomes – possibly productivity

Understanding Resurgent Productivity

- **How much is tied to investment growth?**
  - Capital deepening helped during the boom….
  - ….but outlook for investment is less certain now
- **How much is due to IT innovations?**
  - Innovative process improvements, workforce practices?
  - Is IT capital more productive than other capital?
- **How much depends on falling IT prices?**
  - What is expected rate of ongoing technical change?
- **If IT and productivity are linked:**
  - Will productivity growth remain high in the future?
  - Or is this a gradual rise in the *level* of productivity?

- more questions than answers