hold its own, but not much more. The economy will add about 1.5 million jobs, but this will only be enough to produce a small reduction in the unemployment rate. Virtually all of the added employment will be in the services sector.

In the financial markets, we expect the Federal Reserve to hold short-term interest rates stable until well into next year. Rates are currently at a 40-year low, and we do not expect any further Fed easing beyond their cut in early November. We think rates a year from now will be a little above current levels.

Risks

All things considered, this is a relatively sanguine outlook. It is, however, by no means a sure thing. It could be thrown off track by a variety of developments. Some risks are non-economic. Further terrorist events in the U.S. would be a setback. The course of events in Iraq is a great imponderable, and its economic consequences are nearly impossible to predict. A quick resolution would probably be a positive; a quagmire would eventually be a negative.

Economic risks are very much present as well. Over the past two years, we have been reminded with emphasis that equity markets can go down as well as up. By some measures, equity values are still very high, especially if corporations continue to find profit increases elusive. So far, declines in their market holdings have not affected households' willingness to spend. If the market were to fall further, damaging effects on spending would become increasingly more likely.

A related concern is the housing market. Some observers think the rise in housing prices over the past few years is producing a bubble akin to that in technology stocks prior to 2000. While about half of American households own stocks, in many cases the ownership is indirect, via pension funds or 401k plans. But two-thirds of households own homes, and in most cases it is their largest asset. If there is a bubble, and if it bursts, the wound could be deep.

A third underlying concern is the very large U.S. trade deficit, which has been rising steadily for over a decade. This is the normal pattern during a strong expansion like that of the 1990s, as increasing income leads to rising purchase of imports. Usually, however, recession yields a reversal. During the expansion in the 1980s, for example, the deficit rose to almost 3 percent of GDP. But when the economy weakened after 1990, the deficit came down almost to the point of balance in 1992. By contrast, during the recent recession, the deficit has continued to grow. In the third quarter of this year it amounted to 5.2 percent of GDP. The mirror image of the trade deficit is an equal level of borrowing from abroad. At some point this imbalance must be corrected. The questions are when and how? One element will probably be a decline in the value of the dollar. If this unfolds abruptly, all bets are off. In the short run, depreciation could be stimulative, making U.S. goods more competitive on world markets. But it would also be inflationary, probably pushing the Federal Reserve toward higher rates.

Each of the problems just discussed represents risks that things will change. A final risk is that things will simply continue as they are with consumption alone pushing the economy slowly uphill. Even without troubles abroad or in the market, this would be a risky imbalance.

But we think that investment will take a little pressure off consumption and that with a little luck the U.S. economy will rack up another adequate, but not great, performance in 2003. ◄

Andreas Hauskrecht

Visiting Assistant Professor of Business Economics and Public Policy, Kelley School of Business, Indiana University, Bloomington

World economic growth for 2002 is estimated at 2.2 percent, measured in terms of real Gross Domestic Product (GDP), compared to growth rates of 4.7 percent in 2000 and 2.2 percent in 2001. The International Monetary Fund in Washington forecasts world economic growth for 2003 at a disappointing 2.8 percent and points to evidence for a probably even lower growth rate.

The world still lacks a power engine, a growth locomotive to help pull other regions out of economic struggles. The recovery in the U.S. and Europe is delayed and more modest than originally hoped. Japan is still stuck with a combination of deflation and a very low growth rate of GDP with the imminent risk of falling back into recession. Moreover, Latin America is on the brink of an economic collapse. Gleams of hope are the prospects for Southeast Asia and, to a smaller extent, for Middle and Eastern Europe and Russia (see **Table 1**).

Table 1
Growth Comparisons for Selected Countries

Country	GDP		Inflation (Consumer Price Index)		Current Account (Percent of GDP)		Unemployment	
	2002	2003	2002	2003	2002	2003	2002	2003
United States	2.2	3.25	1.5	2.3	-4.6	-4.7	5.9	6.3
Canada	3.4	3.4	1.8	2.1	1.7	1.9	7.6	6.7
Japan	-0.5	1.0	-1.0	-0.6	3.0	2.9	5.5	5.6
France	1.2	2.3	1.8	1.4	1.9	1.4	9.0	8.9
Germany	0.5	2.0	1.4	1.1	1.9	2.1	8.3	8.3
Italy	0.7	2.3	2.4	1.8	0.2	0.2	9.3	8.9
Euro Area	0.9	2.3	2.1	1.6	1.1	1.0	8.4	8.2
United Kingdom	1.7	2.4	1.9	2.1	-2.1	-2.3	5.2	5.3
Mexico	1.5	4.0	4.8	3.7	-4.5	-4.1	-	-
Brazil	1.5	3.0	6.5	4.3	-3.8	-3.6	-	-
China	7.5	7.2	-0.4	1.5	1.5	1.0	-	-
India	5.0	5.7	4.5	5.1	0.1	0	-	-
South Korea	6.3	5.9	2.7	3.3	2.1	1.5	0.9	3.0
Taiwan	3.3	4.4	0.4	1.6	5.8	5.9	5.0	4.9

Europe

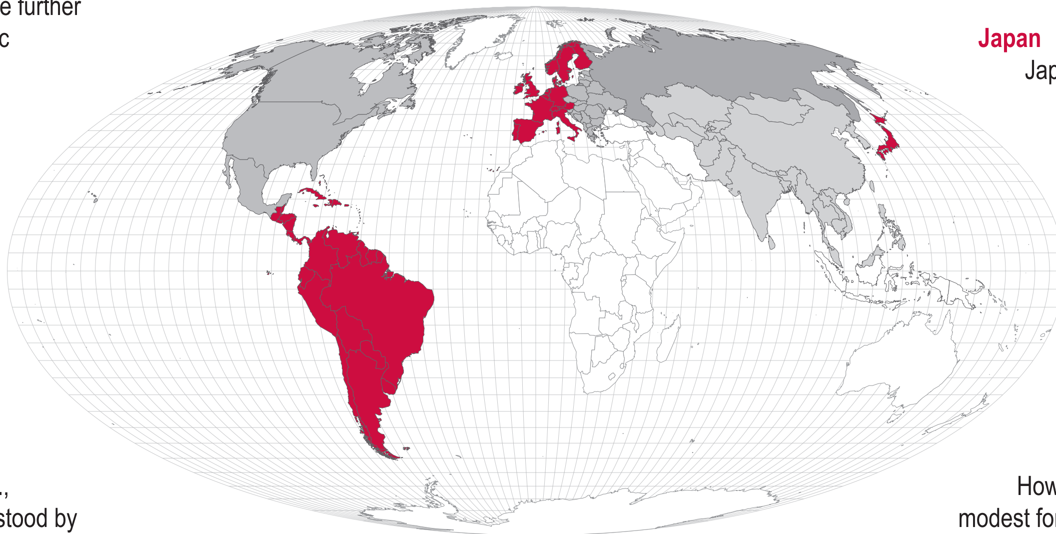
Despite already modest forecasts for the growth rate of real GDP, the core European countries performed even worse than predicted. Germany's growth rate of real GDP in 2001 was a diminutive 0.5 percent. France, Italy, and the United Kingdom all showed growth rates of GDP below 2.0 percent. The picture for 2003 looks only slightly brighter with an expected economic growth rate of 2.3 percent for the European Union.

The explanation for this gloomy outlook is multifaceted. With low domestic demand, Europe's economic prospects depend largely on dynamic export growth. The dramatic stock market price decline further weakened domestic consumption and investment. Universal banks and life insurers keep huge unrealized losses from large equity holdings in their balance sheets that depress lending. In contrast to the U.S., and not well understood by economists, productivity growth in Europe is declining and tarnishes growth perspectives. Considering the rapid aging of European society, far-reaching reforms of the social insurance schemes and the labor markets are urgently needed. While current interest rate levels are appropriate for Euro-member countries with inflation rates above 3.0 percent (such as Ireland and Spain), they are clearly too high for Germany, Italy, and France. Furthermore, the strict rules of the stabilization pact do not allow the needed fiscal stimulus.

North America

The best guess for the U.S. economy is a continued but modest economic recovery and a growth of real GDP slightly above 3.0 percent. Productivity growth rates are encouraging signals for a continuing self-sustained growth path.

NAFTA members are closely integrated through trade. Canada and Mexico are strongly dependent on U.S. demand for their exports. Real GDP growth for Mexico and Canada in 2003 is expected to be considerably above the world average with around 4.0 percent and 3.4 percent, respectively.



Latin America

The outlook for most countries in Latin America is murky. The Argentine full-blown debt default sent shock waves to Uruguay, Paraguay, and Bolivia. Whether the former will be able to avoid a financial collapse in 2003, despite a generous International Monetary Fund loan in 2002, is an open question. While Venezuela suffers considerable political and economic uncertainty, Brazil—by far the biggest economy of the continent—is at risk of defaulting on its debt.

Russia and Eastern Europe

Russia and most Middle and Eastern European countries are doing well and look rather optimistically toward 2003 with expected growth rates of about 4.0 percent. Still, these economies are too small to have a profound effect on world economic growth.

Asia

The picture for emerging economies in 2003 looks very diverse. Asia recovered surprisingly fast and well from the recession; real GDP growth for 2003 is estimated at 6.1 percent. Highlights are China and India with forecasted growth rates of 7.2 percent and 5.7 percent, respectively.

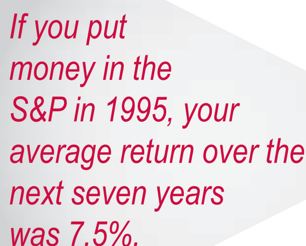
Japan

Japan seems unable to come out of its economic calamity. Real GDP growth is estimated to be at -0.5 percent in 2002 while a meek increase of 1.0 percent is predicted for 2003. However, even this modest forecast might be overly optimistic. Export growth is jeopardized by a stronger yen against the U.S. dollar and the euro. With a government debt of roughly 150 percent of GDP, not much scope for a financial stimuli package is left. Essentially, Japan has not redressed the real causes of the economic disaster; that is cleaning up the balances of banks and enterprises, thereby tackling the non-performing debt problem and allowing insolvent economic entities to go bust. The dramatic decline of stock prices aggravated the situation because banks held large portfolios of equities. Political power struggles block any attempt for a fundamental change.

The Risks

A possible war against Iraq presents a large risk in this forecast. Another risk is the projected U.S. Current Account deficit of almost $500 billion, which is around 4.7 percent of GDP. A reversal of capital flows could cause a rapid and dramatic devaluation of the U.S. dollar against other key currencies, such as the euro and the yen. This would badly distort world trade and harm world economic growth. However, the dynamic productivity growth rate in the U.S. is a hint that it might be continuously attractive to invest here.

The risk of a Brazilian default is acute. With an overall debt of almost $300 billion—a little more than 60 percent of GDP—it is hard to understand how stern the situation really is. It is the debt structure more than the actual level of debt that causes concern. After the last monetary reform in 1994, the Brazilian government tried to minimize the financing cost of government debt by indexing sovereign bonds either against the U.S. dollar or the short-term domestic interest rate. Consequently, any devaluation of the domestic currency (the real) or an increase of the domestic interest rate to avoid a further slipping of the currency increases the debt burden. Brazil seems to be caught in a vicious cycle. Only if the new government is able to reverse the devaluation trend of the real and to lower real interest rates will Brazil have a realistic chance to avoid a fall-back into monetary chaos and economic contraction. The contagious shock waves from such an event would be devastating for the whole continent. ◄



Financial Forecast

Robert S. Neal

Associate Professor of Finance, Kelley School of Business, Indiana University-Purdue University, Indianapolis

William L. Sartoris

Professor of Finance and Director, Investment Banking Academy, Kelley School of Business, Indiana University, Bloomington

The financial outlook for 2003 is cautiously optimistic. We think the market has reached its lows and is now poised to return to the positive column. As we all know too well, since peaking in March of 2000, the performance of the equity markets has been abysmal. The Dow Jones 30 Industrials has fallen 24 percent, the S&P 500 has declined 41 percent, and the Nasdaq Composite has plummeted a stunning 73 percent. As investment professionals who advocate a long-term investment strategy, we have suffered the decline with everyone else. In fact, our 401k plans have been reduced to 301k's!

From a historical perspective, the behavior of the markets over the last seven years has been highly unusual. From 1995 to 2000, the S&P 500 increased an average of 21 percent per year, well above the long run growth rate of roughly 11 percent. These growth rates, of course, are not sustainable. Many have characterized this period as a "bubble" and indeed, after the fact, the description seems appropriate. However, suppose that as a long-term investor you had put your money in the S&P in 1995 and not paid any attention to the markets. Your average return over the seven-year period would be 7.5 percent per year. That's a bit lower than the historical average, but still a decent overall return.

As students of financial markets, we know that stock prices are influenced by three fundamental factors: interest rates, earnings, and attitudes toward risk. Our outlook toward interest rates is generally favorable for the next year. While interest rates are at historically low levels, the market does not expect a large increase over the next year. The Federal Funds rate—the interest rate set by the Federal Reserve for very short-term borrowing—is currently 1.75 percent, an extremely low interest rate. Does this mean that interest rates will rise in the near term? In fact, the opposite is expected to occur. The interest rate on short-term Treasury Bills is now about 1.5 percent. The only way for the Treasury Bill rate to be below the Federal Funds rate is for investors to expect the Fed to announce additional rate cuts in the near future.

A different logic applies to long-term interest rates. The ten-year rate is currently about 4 percent, also at the bottom of its historical range. Do we expect this rate to rise? Yes, but forecasting long-term rates is a bit like forecasting next year's Super Bowl Champion—a very imprecise process. Long-term interest rates are driven by expectations of future inflation and expectations of future growth. On the inflation side, recent data suggest little evidence of price pressures. Over the past 12 months, the Consumer Price Index has risen 1.5 percent and the Producer Price Index has fallen 1.2 percent. Both of these measures, however, tend to overstate the true inflation rate because they don't adequately reflect technological improvements. The second factor, expectations of future growth in the economy, influences the slope of the yield curve. As the expected future growth rises, the yield curve becomes steeper. If corporate earnings reflect future growth, then an anticipated increase in earnings may contribute to a rise in long-term rates.

The outlook for corporate earnings is generally positive. After terrible earnings momentum in 2001, the decline has finally stopped. In the first quarter of 2002, S&P 500 earnings fell 12 percent from the previous year. By the second quarter, however, positive growth had returned and reached 6 percent during the third quarter, compared to the previous year. Earnings for the fourth quarter of 2002 are expected to rise 15 percent from year earlier levels. Overall, 2002 earnings should show a growth of roughly 2 percent. The outlook for 2003 is much more positive. According to estimates from First Call and industry analysts, 2003 earnings will rise 15 percent, with growth rates increasing as the year progresses.

While low interest rates and a return to normal earnings growth would be a welcome sign to investors, an important factor