Outlook for 2004

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Every October, a group of faculty at the Kelley School of Business gathers to discuss the economic outlook for the nation and the state. The discussion begins with the latest forecast generated from the U.S. model developed at the Center for Econometric Model Research (CEMR) at Indiana University. A consensus is then generated around adjustments to the model forecast. The CEMR model of Indiana is used to translate the economic forecast for the U.S. into a forecast for Indiana.

The results of these deliberations are presented at many venues throughout Indiana where the faculty from the Kelley School are joined by a local panelist who discusses the outlook for that part of the state. The following articles summarize the views of the Outlook Panel. They also discuss some potential problems facing us, including a ballooning federal deficit, massive bilateral trade imbalances, and issues of corporate governance and reporting.

Bill Witte gives the details of the national economic forecast, showing that recent strength in consumer spending and housing will be augmented in 2004 by an upturn in business spending on plants and equipment, along with a rise in exports. Andreas Hauskrecht presents the international outlook and explains why large accumulations of dollar reserves overseas raise the risk of dollar depreciation. John Boquist and Bill Sartoris trace recent financial developments, exploring why the outlook for 2004 is positive but not exuberant. Gil Viets examines the important issues of corporate governance and reporting that remain a concern for economic performance. Jeff Fisher takes a close look at the housing industry, which has been such a source of economic strength this year, and finds further grounds for optimism for 2004. Jerry Conover and Jim Smith draw on the international and national forecasts to present their outlook for the Indiana economy in the coming year. And a cadre of economists from universities around the state provide their views and forecasts for their metropolitan economies. ◄

The U.S. Economy

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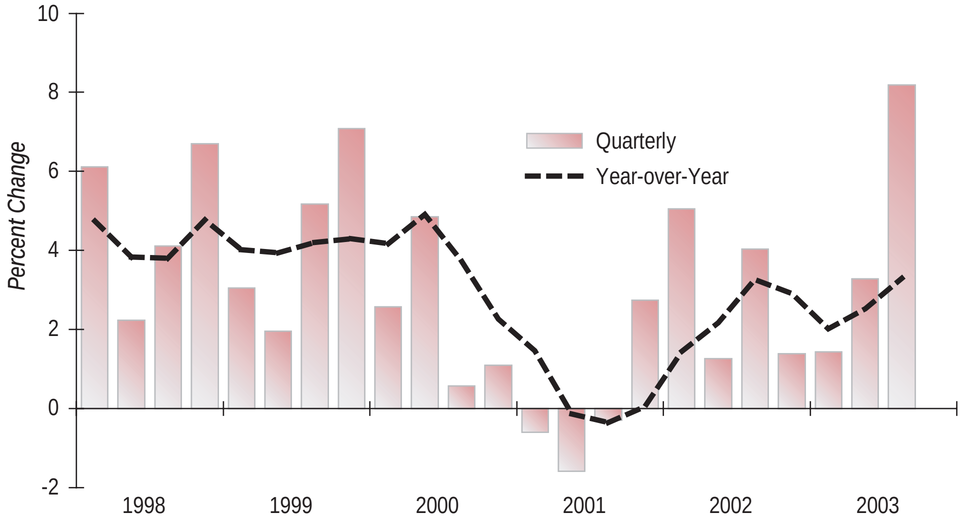
The U.S. economy during 2003 has been an exercise in cognitive dissonance. By most measures, the economy has performed quite well (and quite close to the outlook we presented a year ago). Yet the “man on the street” by most reports believes that things are not going well. In this national overview, I will first look at the good news from last year and dissect the fly in the ointment. Then I will outline our relatively optimistic view of what we can expect in 2004, along with some things that could cause problems during the next year.

Overall, output growth for 2003 will probably come in at about 3 percent, with growth accelerating in the second half of the year. Figure 1 shows the past six years of real output growth. At the same time, inflation has remained low (about 2 percent for consumer prices), and interest rates dropped at mid-year to levels not seen in over four decades. Household income, driven by rising labor productivity with a boost from the federal tax cut, has registered solid growth. Households have used this income (and funds from mortgage refinancing) to purchase nearly seventeen million new cars and trucks and push housing construction to an all-time high. Since the spring, clear signs of a sustained recovery in business investment exist, especially in the high-tech area. Even the stock market has had an up year.

The U.S. economy has been an exercise in cognitive dissonance—a psychological phenomenon that refers to the discomfort felt at a discrepancy between what one already knows or believes and new information or interpretation.

During the past summer, the National Bureau of Economic Research—a Boston-based group of economists who arbitrate the beginnings and ends of recessions—declared that the “official” end of the recession occurred in November 2001. This means

Figure 1
Real Output: Annual Rate of Change



we are now two full years into the recovery period. Indeed, in terms of output, we are beyond recovery and into a new period of expansion.

Yet there is a continuing string of anecdotal evidence that Americans are apprehensive about the economic outlook. Central to this concern is the labor market. **Figure 2** shows why. During the late 1990s, the economy was adding almost three million jobs each year. For the past two and a half years, job losses have averaged over a million each year. As of September 2003, total employment was nearly 2.6 million below its peak in early 2001. As a result, unemployment has risen steadily to above 6 percent. This is not high by historical standards, but it is far removed from the below 4 percent levels reached prior to the recession.

The situation in the manufacturing sector, an especially important part of the Indiana economy, is even grimmer. Nationally, the sector accounts for all of the job losses and then some. Since July of 2000, employment in manufacturing has declined month after month without a break. Over that period the decline has totaled almost 16 percent. Moreover, much of this contraction represents permanent structural change and not a cyclical phenomenon. In some cases, jobs are being lost to lower cost areas abroad; in others, they are being eliminated by the tide of advancing productivity that permits firms to produce more goods with fewer workers.

Although the labor market situation is troubling, we think that most of the bad news is behind us and are optimistic about the outlook for 2004. While we don't expect to see numbers matching the 8.2 percent growth registered in the third quarter of 2003, we do expect output growth next year to approach 4 percent. This growth should also be more broadly based than during the past two years when household spending on consumption and housing was keeping the economy afloat. Next year, economic growth should have significant help from business investment in new plant and equipment, and probably also from some inventory rebuilding.

Another sector that should experience definite improvement is international trade. Since the beginning of 1997, the U.S. net export deficit (in inflation-adjusted dollars) has quintupled to over $500 billion (more than 5 percent of GDP). This has been partly a reflection of

- A voracious demand by American consumers and businesses for foreign goods
- A strong dollar
- Slow growth (or no growth) abroad, reducing demand for our exports

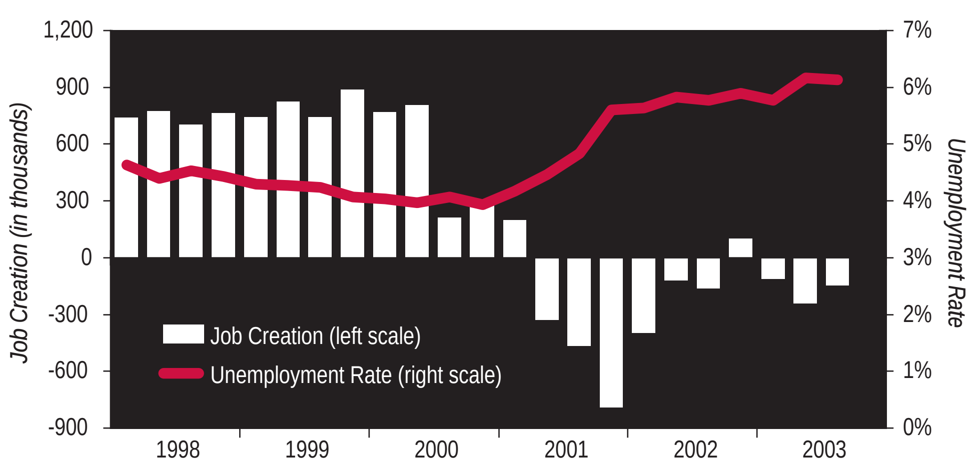
But now two of these factors seem to be changing. The dollar has been falling in the foreign exchange market since 2002, by over 15 percent against other major currencies. More importantly, economies in the rest of the world are looking better than in quite a while.

The continuing expansion we foresee should finally begin to produce improvement in the labor market. We think the economy could generate close to two million new jobs in 2004. This would be sufficient to pull the unemployment rate down to the mid 5 percent range by the end the year.

Our scenario should also make life interesting for the Federal Reserve. The Fed is committed to holding short-term interest rates at their very low current levels for "a considerable period." If our outlook is correct, this considerable period will end sometime after mid-year. By the end of the year, two or three upward movements in short-term rates cannot be ruled out.

One area where things are not likely to show any marked improvement is the federal budget. During the last two years, the deficit

Figure 2
Changes to the Labor Market



has risen at a very rapid pace, as spending (on defense and other things) has increased and tax cuts have held down revenues. A growing economy should yield some expansion of revenue, but only enough for the deficit to stabilize.

Any economic forecast can be upset by unforeseen occurrences. The shift of monetary policy away from its very accommodative stance of the past three years could present difficulties for the expansion. There is a lot of leverage in the U.S. economy, which makes increasing interest rates certain to cause at least a little anguish.

However, the greatest risk during the next year probably lies in the international arena. The situation in Iraq is currently unsettling. If it were to worsen, the impact on the economy would be hard to predict. But it is unlikely that it would be good, especially if the fallout entailed higher oil prices.

But the period since September 11 has shown the enormous resilience of the U.S. economy in the face of external threats. And it is well to remember that since 1982 the U.S. economy has had less than two years of contraction and nearly twenty years of expansion. All signs point to 2004 being added to the expansion side of the ledger. ◀

The International Economy

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Economic growth in the world is likely to come in at 3.2 percent for 2003, measured in terms of real Gross Domestic Product (GDP), compared to growth rates of 2.4 percent in 2001 and 3.0 percent in 2002. The International Monetary Fund in Washington (IMF, *World Economic Outlook*, Fall 2003) forecasts world economic growth for 2004 at 4.1 percent, with a rather high degree of confidence that the worldwide upturn will continue.

The forecast predicts an economic upswing for essentially all world regions, with the significant exception of Japan. As in the last few years, the world depends notably on the U.S. as the economic powerhouse that helps other regions pull out of their economic struggles. The economic growth path in the U.S. is expected to be robust, while recovery in Europe is further delayed and more modest than originally hoped.

Like last year, China and India are expected to show very robust economic growth in 2004; however, their combined GDP adds up to a relatively modest 16 percent of U.S. GDP, clearly not enough to displace the U.S. as the world economic growth locomotive (see Table 1).

Table 1
Growth Comparisons for Selected Countries

Country	GDP		Inflation (Consumer Price Index)		Current Account (Percent of GDP)		Unemployment	
	2003	2004	2003	2004	2003	2004	2003	2004
World Output	3.2	4.1						
United States	2.6	3.5-4.0	1.8	1.3	-5.1	-4.7	6.0	5.5
Canada	1.9	3.0	2.8	1.7	1.6	1.6	7.9	7.7
Mexico	1.5	3.5	4.6	3.4	-2.2	-2.7	3.8	3.3
Brazil	1.5	3.0	15.0	6.2	-0.8	-1.5	-	-
Euro area	0.5	1.9	2.0	1.6	0.8	0.8	9.1	9.2
France	0.5	2.0	1.9	1.7	1.2	1.6	9.5	9.7
Germany	0.0	1.5	1.0	0.6	2.4	2.1	9.5	9.8
Italy	0.4	1.4	2.8	2.0	-1.1	-0.9	9.0	9.0
United Kingdom	1.7	2.4	2.8	2.5	-1.0	-0.9	5.2	5.2
Russia	6.0	5.0	14.4	12.9	8.4	5.2	7.9	7.7
Japan	2.0	1.4	-0.3	-0.6	2.9	2.9	5.5	5.4
China	7.5	7.5	0.8	1.5	1.4	1.3	10.2	9.9
India	5.6	5.9	4.0	4.8	0.6	0.3	9.1	9.0
South Korea	2.5	4.7	3.3	3.0	1.6	1.8	3.4	3.3
Taiwan	2.7	3.8	0.1	0.8	8.5	8.8	5.3	5.0

Europe

Europe had another disappointing year with real GDP growth around 0.5 percent—well below expectations. Germany even experienced another (albeit short) recession. In 2003, German GDP remained flat. France, with an expected real GDP growth of 0.5 percent, and Italy, with 0.4 percent growth, performed only marginally better.

The outlook for 2004 looks slightly brighter with an expected real GDP growth rate of 1.9 percent for the entire euro area. Although on a modest level, the United Kingdom outperformed continental Europe in 2003 with a GDP growth of 1.9 percent and will enjoy a somewhat higher growth rate of around 2.4 percent in 2004.

Clearly, the disappointing German performance pulled down the rest of Europe. The shrinking of the construction sector that exploded during post-unification years alone contributed to a decrease of GDP growth of around 0.3 percent. Although the European Central Bank has further eased monetary policy in 2003, real interest rates in Germany are not particularly low, given the very low inflation of 1 percent. The so-called stabilization pact (ironically a German invention) restricts the use of fiscal policy to stimulate domestic demand. Financial institutions groan under a huge burden of nonperforming loans, a bit similar to the situation in Japan. Consequently, banks are more careful with new lending.

Considering the rapid aging of European society, far-reaching reforms, with the overall aim to reduce nonwage labor costs, of the social insurance schemes and the labor markets are urgently needed. The latter is imperative for the big European countries, such as France, Germany, Italy, and Spain. Several countries have recently introduced or proposed substantial reforms.