

Outlook for 2003

After the longest economic expansion in U.S. history, the economy slipped into recession in March 2001. Fortunately, it turned out to be fairly short and fairly mild. We estimate that the recession ended in the first quarter of 2002. That makes it less than a year in length. The peak to trough decline in real Gross Domestic Product (GDP) was only 0.6 percent. Both in depth and duration, this was a minor recession.

The recovery now under way has also been modest. Real economic growth has averaged 3.0 percent over the last four calendar quarters, a solid performance but not spectacular. The questions we face as we look to 2003 are many. Will the economy continue to grow? Will the recovery accelerate? Will inflation remain in check? What are the domestic and international risks we face?

The articles that follow address these questions and others. Bill Witte gives us an overview of the national economy and the major domestic issues we face. Andreas Hauskrecht provides background on the international economy, a key factor in the prospects for the U.S. economy. Robert Neal and Bill Sartoris examine the financial markets and give some clues on where interest rates and equity prices might be heading. Jeffrey Fisher analyzes the housing market, which has been a bright spot in the economy through the last few troubled years. Finally, Morton Marcus compares how Indiana and the U.S. have reacted to the recession. ◀

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The U.S. Economy

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The performance of the U.S. economy during the past year is something of a paradox. A year ago, in our preview of the prospects for 2002, we forecast that the recession would probably end during the second quarter, with growth for the year of only 1 percent. We thought that inflation would be a little above 2 percent and that unemployment would average 6.3 percent. Each of these estimates has proved to be too pessimistic. In fact, the recession was clearly over by last spring. Output growth during the first three quarters of 2002 has averaged above 3 percent, while inflation (as measured by the consumer price index) has been below 1.5 percent over the past year. The unemployment rate is currently 6.0 percent, and the average for 2002 as a whole will be about 5.8 percent. Productivity growth has been strong. Overall, it was not a bad performance, and certainly better than expected.

The paradox is that it doesn't feel very good. Most people would probably say that the economy has worsened over the past year. Some of the reasons for this disconnect are easy to perceive. One is that the standard of comparison is set by the exuberance of the 1996–99 period, one of the best in U.S. economic history. As is shown in **Figure 1**, year-over-year output growth (real GDP) was consistently above 4 percent over that period, with quarterly spikes that often surpassed a 6 percent rate. By comparison, the 3 percent growth over the past year seems unsatisfactory. The same type of situation prevails in the labor market, as shown in **Figure 2**. Over the four-and-a-half years prior to mid-2000, the U.S. economy added over 3 million jobs per year. By contrast, during the five quarters prior to the middle of this year over 1.7 million jobs were lost. This is the dark side of rapid productivity growth. With rising productivity, fewer workers are needed to produce the same output. In the 1990 recession, it was three full years after the onset of the downturn before employment again reached its level at the cyclical peak. The current recovery may be on a similar trajectory.

Figure 1
Real Output—Annual Rate of Change

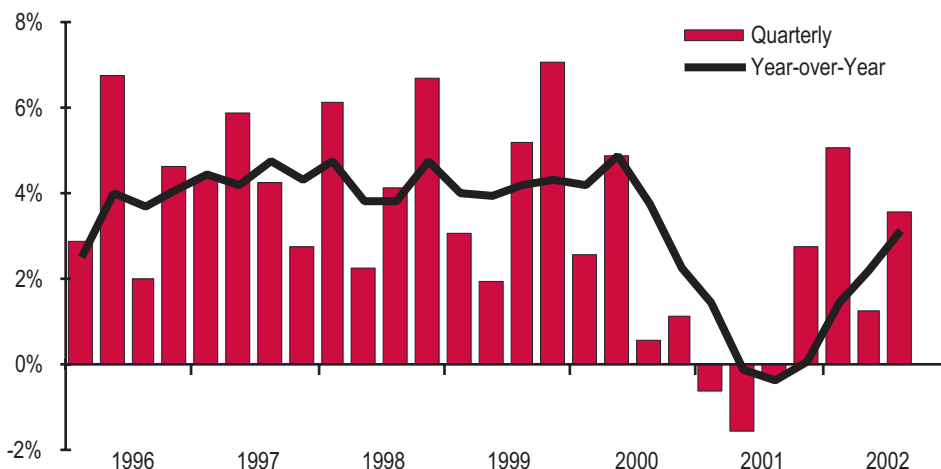
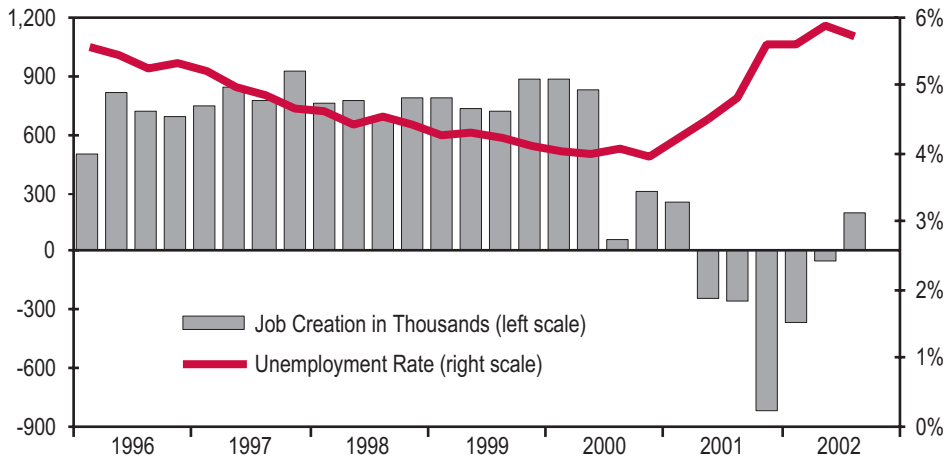


Figure 2
Changes to Labor Market



A second reason why the economic situation seems darker than the raw numbers is a tendency to think in terms of goods markets. Goods account for less than half of the value of total demand and less than a fifth of total employment, but they represent our image of what the economy is really about. During the recession, total output declined for three quarters and by a total of only 0.6 percent. The drop in goods production lasted five quarters and totaled almost 2.7 percent. Total output reached its previous peak in the fourth quarter of last year, only one quarter after the recession trough. Goods production was still below water until this year's third quarter. As shown in **Figure 3**, both investment in equipment and exports are indicative of this pattern. After rapid growth in the 1990s, both sectors plunged during 2001. Through the third quarter of this year both are still 10 percent below their peak levels. In the labor market, employment in goods production started to decline in the second quarter of 2000 (a year earlier than overall employment) and accounts for all of the overall job loss and then some.

Other factors have been reinforcing a bias toward pessimism as well. The steady barrage of news about corporate criminality and malfeasance and the dismal performance of the stock market do nothing to encourage confidence. Deranged snipers and continuous warnings about possible terrorist threats also weigh on the mind.

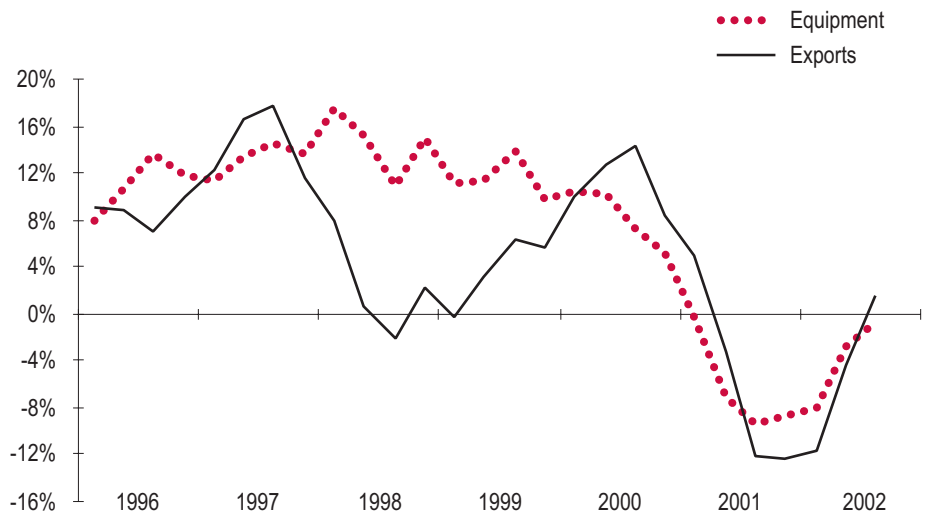
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Clearly, it is not hard to be negative. However, we choose to see the glass as half full rather than half empty. We don't expect great cheers of joy or a booming economy in 2003, but we think the economy will continue to move upward as it has this year. After a relatively slow fourth quarter to end 2002, we expect output to grow at about 3.2 percent during the next year. As was the case this year, consumer spending plus a strong increase in federal government expenditures will lead growth. The positive side of rising productivity is that it raises income levels. After mid-year, business investment will become a positive force as well. Other sectors will contribute less. Construction will do well to maintain its current levels. For housing, it should be said, this would mean holding at a very high level. In the government sector, much of the federal stimulus will be offset by retrenchment from budget-constrained state and local units. Finally, weak economies in much of the rest of the world mean that exports will struggle to keep pace with rising imports, keeping the trade deficit in record territory.

Inflation has been notable the past two years only by its absence, a situation we expect to continue. Consumer prices will rise a little more rapidly than the past year, but still only by a little more than 2 percent.

Good, but not great, output growth combined with a continuing rise in productivity implies that the labor market situation may

Figure 3
Demand for Goods—Annual Rate of Change



The International Economy

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. ◀

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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