Outlook for 2003

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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. ◄

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