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

Andreas Hauskrecht

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

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.

Russia and Eastern Europe

Russia and most Middle and East European countries are continuing to do well and the outlook is rather optimistic into 2004. Yet the positive effect of a strong world market for crude oil might slowly peter out, revealing how well they (Russia, in particular) have used the oil windfall products to prepare their economies for rougher climates.

Latin America

Latin America had, as so often in the past, another murky year. Cynics might say 2004 can only get better. Although starting from a very low level, Argentina is on an upward path, and Brazil is expected to grow by a respectable 3 percent next year. The significant decrease in its refinancing costs in international financial markets and lower domestic interest rates are a good basis for further robust economic growth.

Asia

The SARS virus negatively impacted several Asian economies this year. The forecast for 2004 is generally optimistic with expected growth rates of 4.7 percent in South Korea and 3.8 percent in Taiwan. The leaders in the region are again China and India, with forecasted growth rates of 7.5 percent and 5.9 percent, respectively. China continues to attract foreign capital and passed the U.S. in 2003 as a major recipient of foreign direct investment. However, more and more voices are warning about a possible Chinese bubble and the dramatic consequences for Asia if this bubble ever bursts. Supporting this pessimistic view are the obvious similarities with former Asian bubble countries:

- Nonperforming loans in the state-owned banking sector are estimated as high as 60 percent of Chinese GDP.
- Several sectors show clear signs of overproduction with extremely low profit margins.
- The real estate market is booming.
- The reliability of officially published data is questionable.

Japan

Japan enjoyed an unexpectedly strong economic upswing in 2003 with a real GDP growth of 2 percent. Yet Japan is still miles away from a sustainable growth path of its nominal GDP because deflation is expected to accelerate in 2004, and real GDP growth is expected to be around 1.4 percent. The titanic stock of nonperforming loans in banks and enterprise balance sheets further suppresses healthy credit growth. While the recent boom in the stock market eased the situation and contributed to the positive performance in 2003, the current strengthening of the yen (particularly against the U.S. dollar) might have the opposite effect on the Japanese economy and damage the fragile upswing.

North America

The economies of the NAFTA members are closely integrated through trade. Canada and Mexico are strongly dependent on U.S. demand for their exports. Real GDP growth for 2004 in Mexico (about 3.5 percent) and Canada (about 3 percent) are expected to be slightly below the world average. However, their export performance into the U.S. depends to a great deal on the exchange rate against the U.S. dollar. Should the dollar further devalue, this trend might impair Mexico and Canada's economic outlook.

The risks

Finally, after years of advanced warnings, the U.S. dollar value on foreign exchange markets has begun to slide. A controlled decrease of the dollar value is, on its own, a welcome and necessary adjustment of exchange rates that might help bring international trade more into balance. However, this necessary adjustment process seems to be hampered by conflicting regional interests.

A closer look at international trade reveals surprising patterns. The U.S. balance of trade is in a deficit of more than $530 billion a year due to trade imbalances with a handful of countries, namely China, Japan, Canada, and a few smaller Asian economies. China's trade balance shows a modest surplus of around 1 percent of GDP, indicating their large surplus with the U.S. is balanced by large deficits with other countries. The Japanese current account surplus, on the other hand, is around 2.9 percent of GDP and shows a rising trend.

Obviously, a major depreciation of the U.S. dollar against the Chinese yuan and the Japanese yen could help correct this imbalance in world trade, but these countries do almost anything to avoid a depreciation of the U.S. dollar against their currency. The yuan is nominally fixed against the dollar at a parity of about 8.2 yuan to the dollar. To avoid

pressure on the currency, Chinese monetary authorities buy enormous quantities of U.S. dollars and dollar-denominated securities on the foreign exchange markets. China and Hong Kong together hold central bank reserves of around $495 billion. Taiwan has piled up $190 billion in official U.S. dollar reserves, while South Korea holds $142 billion. Japan also admits to massive dollar purchases. Consequently, the dollar has sharply depreciated by more than 35 percent against the euro since 2002, by around 19 percent against a basket of other rich countries' currencies, but by only 10 percent against a broader basket that includes emerging-market currencies.

Therefore, the U.S. current account, so far, has not adjusted as expected. The burden of adjustment stays with a few industrial countries that allow their currency to freely float against the dollar, including Canada. This might have depressive consequences on the relative competitiveness of those countries' exports and impede their economic growth, particularly in the euro area and Canada. In addition, if a soft landing of the dollar is blocked, markets might one day overreact and enforce a dramatic drop in the dollar exchange rate with devastating consequences for all international trading partners. ◄

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Financial Forecast

John A. Boquist

Edward E. Edwards Professor of Finance, Kelley School of Business, Indiana University, Bloomington

William L. Sartoris

Professor of Finance, Kelley School of Business, Indiana University, Bloomington

The past three years have been tough on investors with declining stock market returns and low interest rates. Furthermore, notable companies such as Enron, Worldcom, and United Airlines have gone bankrupt, wiping out the entire stock valuations of these companies. Add to this mix the ethical lapses of some managers and investment advisors, as well as the lack of responsible corporate governance at many companies, and it is easy to see why financial markets are now on edge with investors wondering whom they can trust.

Not all the news is bad: housing demand remains strong and families who own their own homes have seen rapid increases in value in many markets. Low interest rates have helped stimulate the real estate market, allowing homeowners to refinance at low rates and fuel their urges to consume. Since we forecast many of these trends will continue next year, financial markets are exhibiting a new reality.

Interest rates

Interest rates have generally fallen during the past twenty years, due in large part to wringing inflation out of the economy. Since short-term rates have fallen much more than the long-term rates, the yield curve is the steepest that we have seen since the early 1990s. Historically, the spread between short- and long-term rates is a precursor to economic activity—the currently observed high spread is generally followed by an expansion and rising interest rates. Thus, we expect to see a slight rise in interest rates over the next year, with the short-term Fed Funds rate in the 1.75 percent to 2.00 percent range and long-term treasury bond yields in the 5 percent to 6 percent range by the end of 2004. Corporate interest rates will also exhibit small increases next year. Mortgage interest rates bottomed out at about 5.25 percent in early summer and have since increased to approximately 6 percent. We expect mortgage rates to also rise over the next year to a level of 6.5 percent. The prime rate will be near 5 percent by the end of the year.

Corporate Profits

Corporate profits are expected to rise about 9 percent next year as the economy continues to grow and recover from the recession. In fact, third quarter earnings this year are expected to be 20 percent above the level of last year. Corporate profits and cash flows continue to be adversely affected by employee health insurance premiums, which rose 14.8 percent last year, and underfunded pension plans, which stand at a $216 billion deficit for the S&P 500 companies. Since stock market value affects the value of many pension funds, an increasing stock market may mitigate this problem slightly. Global competition remains fierce in many markets—particularly autos, light trucks, and sport utility vehicles—but the continued weakness in the dollar will help exporters remain competitive. In addition, productivity increases will offset gains in labor compensation. Fortunately, the continuing low interest rate environment has enabled many companies to refinance their debt at lower rates and rebuild their balance sheets. Overall, there has been a deleveraging of corporate balance sheets. The generally positive outlook for 2004 will encourage firms to expand capital investment and employment to meet the expected increase in demand for goods and services, as well as replenish reduced inventory levels. We see very few reasons to expect a business slowdown or the cataclysmic deflationary scenario some pundits are forecasting for the U.S. economy.

Stock Market

From the early 1990s to 2000, the stock market experienced an incredible and unprecedented bull run—fueled by increased productivity and declining interest rates due to the drop in inflation. That encouraged many investors to fully commit to stocks as their primary investment asset. Unfortunately, from March 2000 through March 2003, the market (as measured by the S&P 500) lost about 49