The Economic Forecast

Economic conditions in the late 1990s were unlike any the nation had experienced in a generation. The nation experienced unprecedented growth, fueled in part by the technology industry. However, the economy began to weaken during 2001. The terrorist attack on September 11 was a shock the weakened economy could not withstand.

Virginia, like the nation, also experienced robust economic growth over the past four years. The driving force of the Commonwealth's economic engine was Northern Virginia, particularly its dynamic and fast-growing high-tech sector. Although Virginia has consistently outperformed the nation in most key economic indicators and its economy may be somewhat insulated, it is not immune to national cyclical downturns.

Virginia's economic performance has a direct impact on the revenues the Commonwealth receives and the services that are demanded. As the economy slows, the Commonwealth experiences a slowing in revenue collections and an increase in the demand for services such as unemployment compensation and Medicaid.

The national economy began to slow in fiscal year 2001

The U.S. economic expansion shattered the record for longevity during the first half of fiscal year 2001. However, after four years of ideal economic conditions, economic growth weakened significantly later in the fiscal year. The U.S. economy officially entered a recession in the fourth quarter of fiscal year 2001.

Here is a look at some of the economic indicators during fiscal year 2001:

Growth in U.S. Gross Domestic Product (GDP) slowed considerably. The value of all goods and services produced within the U.S., adjusted for inflation, grew at 2.7 percent in fiscal year 2001. Growth in total personal income was 6.6 percent, while growth in wages and salaries increased by 7.5 percent.

Consumer spending was still solid but below the vigorous rate of fiscal year 2000. Consumer spending experienced solid growth in fiscal year 2001, increasing by 4.0 percent. Only the resiliency of the consumer sector kept real GDP

U.S. economy falls into a recession

	ACTUAL		*FORECAST*		
	2000	***2001***	***2002***	***2003***	***2004***
Real GDP	4.5%	2.7%	(0.5)%	2.6%	4.6%
Total employment*	2.5%	1.4%	(0.5)%	0.3%	3.1%
Unemployment rate	4.1%	4.2%	5.7%	6.8%	5.6%
Inflation -- CPI	2.9%	3.4%	1.9%	1.6%	2.2%

*Total nonagricultural employment. Figures represent percent change over previous year, except unemployment rate, which is a percentage. Data based on October WEFA standard forecast. Source: Department of Taxation growth from falling into negative numbers.

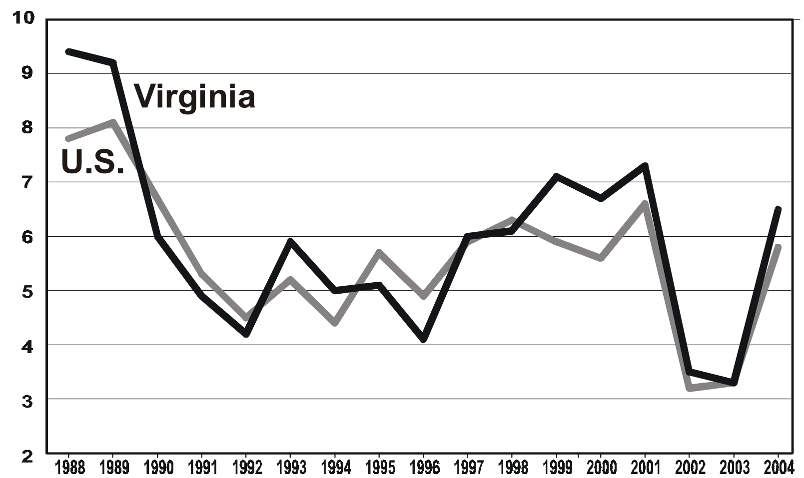
Job gains fell short of the forecast. Total nonagricultural employment in the U.S. increased by 1.4 percent during fiscal year 2001, lagging behind the forecast of 1.7 percent. Growth in manufacturing, finance, insurance, and real estate, and services fell short of their respective forecasts.

Inflation was slightly higher than expected. The surge in energy prices drove the consumer price index (CPI) slightly ahead of forecast. The actual increase in the CPI was 3.4 percent, higher than the forecast of a 3.0 percent increase.

The Fed was aggressive as the economy slowed. From January through June 2001, the Federal Reserve Board cut the federal funds rate at six consecutive meetings, including five dramatic cuts of fifty basis points. The Fed cited significant weakness in the economy and increased risks of a near-term recession.

Personal income growth in Virginia to slightly exceed the nation's in 2004

Percentage growth in personal income



Data for 2002through 2004 are forecasts. Source: Department of Taxation

U.S. expected to experience a four-quarter recession

At the November meeting of the Governor's Advisory Council on Revenue Estimates, it was recommended that the economic outlook include a four-quarter recession covering all of fiscal year 2002. Economic predictions for the next three years include:

- Real GDP growth is expected to fall by 0.5 percent in fiscal year 2002, and then increase by 2.6 percent and 4.6 percent in fiscal years 2003 and 2004, respectively.
- Job growth is expected to decline in fiscal year 2002, barely grow in fiscal year 2003, and finally recover at a robust rate in fiscal year 2004.
- Lower employment growth, slower personal income growth, plunging consumer confidence, and a diminished wealth effect should contribute to reduced consumption growth in the future.
- The slump in business investment has largely been responsible for the weakening economy. The manufacturing sector has been mired in a slowdown that is now expected to get worse before it gets better. The uncertainty from the terrorist attack has caused businesses and consumers to put purchase decisions on hold. Business spending on equipment and software is not expected to bounce back until fiscal year 2003.
- Despite highly stimulative monetary and fiscal policies, inflation should remain benign over the forecast horizon.
- With the economy currently in a recession, the Fed is expected to reduce interest rates to lower than two percent before the end of the year.

Virginia's economy solid in fiscal year 2001 despite the national slowdown

Virginia's economy continued to thrive in fiscal year 2001 despite the national slowdown. The Commonwealth has several advantages over other states that buffer its economy in times of cyclical downturns: proximity to the federal government, stable high-tech industry, economic diversity, and desirable tourist destinations accessible to the populous areas of the eastern seaboard.

Employment growth was robust in fiscal year 2001, with most job sectors expanding at higher-than-expected rates. Nonagricultural employment increased by 2.6 percent, outpacing the official forecast of 2.0 percent growth. Particularly strong growth was recorded in the services sector, in the transportation, communication, and public utilities (TCPU) sector, and in the construction sector. The unemployment rate was 2.3 percent, 0.3 percentage points lower than the official forecast.

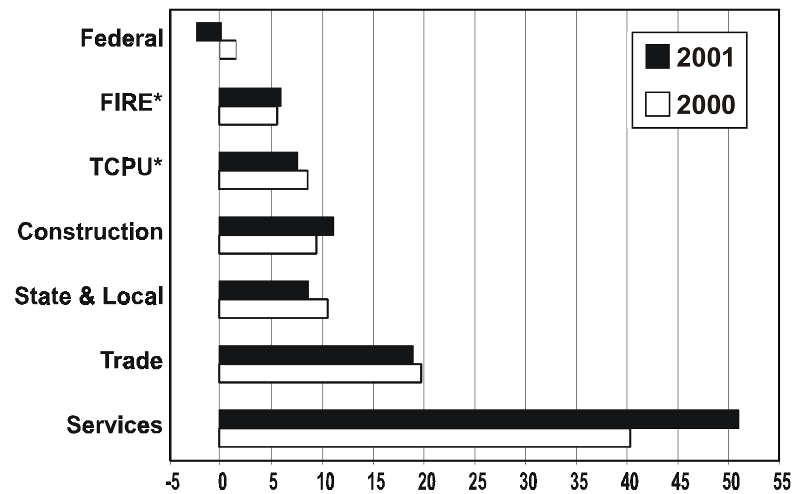
Here is a look at regional employment in Virginia during fiscal year 2001:

Northern Virginia

Northern Virginia, home to most of Virginia's high-tech industries, experienced the best job growth among the major metropolitan areas during fiscal year 2001. Of Virginia's four major regions, only Northern Virginia had job growth above the statewide average. The region's employment growth of 5.7 percent generated over 64,000 jobs, accounting for 72 percent of the statewide increase.

Service sector again the dominant producer of jobs

Jobs in thousands



*Finance, Insurance, and Real Estate (FIRE). Transportation, Communication, and Public Utilities (TCPU). Source: Department of Taxation.

Growth in services employment again led the region by creating 35,600 jobs, a very robust 7.7 percent increase. Business services, where many of the high-tech jobs are listed, grew at 9.7 percent. The robust performance in this subsector was surprising given the national economic slowdown and the fallout in the tech sector. Northern Virginia was insulated from the tech downturn due to strong federal demand, its focus on software rather than the battered hardware industry, and a diversification towards the Internet and consumer market.

The building boom in Northern Virginia continued unabated, with construction employment increasing by a strong 6.9 percent. Northern Virginia accounted for six out of every ten new construction jobs in the state. TCPU, the other employment sector with many high-tech jobs, increased by 8.4 percent, double the statewide average.

Richmond/Petersburg

Jobs in the Richmond-Petersburg metropolitan statistical area increased below the statewide average at a 1.9 percent rate during fiscal year 2001. The region added 10,700 new jobs, over 12 percent of the statewide increase. Services growth of 4.3 percent contributed the largest share (6,400 jobs), followed by the trade and FIRE sectors (1,700 jobs each). The lack of worldwide demand for high-tech manufactured components led to a 1.9 percent decline in manufacturing, a loss of 1,900 jobs.

Norfolk/Newport News/Virginia Beach

Employment in the Norfolk-Newport News-Virginia Beach metropolitan statistical area lagged statewide job growth with an increase of only 0.9 percent. The Tidewater area added 6,200 new jobs, or seven percent of the statewide increase. The trade and construction sectors led the growth by adding 2,100 and 1,600 new jobs, respectively.

Balance of the state

The balance of the state also lagged statewide job growth with an increase of 0.8 percent, or 8,400 jobs, comprising over nine percent of the statewide increase. Services and trade employment were responsible for the bulk of the growth in the balance of the state. The services sector produced the most new jobs in this region, increasing by 9,000 jobs or 3.1 percent.

The manufacturing sector, which accounts for about 20 percent of employment in the region, lost another 10,600 jobs, mainly in the apparel and textile industries. As most of the old-line manufacturing activity is located in the more rural areas of Virginia, these areas have been affected more severely by the national manufacturing recession.

Recession will continue in fiscal year 2002, and recovery will begin in fiscal year 2003

Although the nation is expected to fall into a four-quarter recession in the current fiscal year, Virginia should escape the harshest impacts of the cyclical downturn. The September 11 attack and the continuing war on terrorism will affect Virginia through decreased consumer and business spending. However, the Commonwealth will benefit from increased government and defense spending. Despite the expected increase in federal dollars flowing to Virginia, the fiscal year 2002 employment forecast is the lowest growth rate since the 1990s recession.

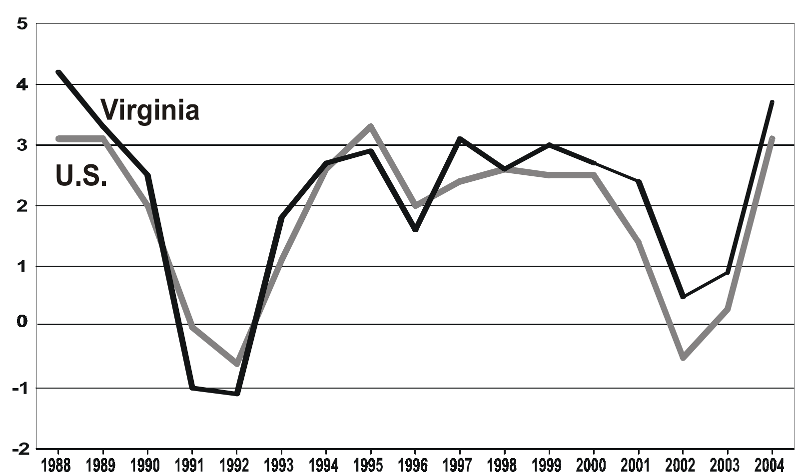
Virginia is well positioned compared to other states to weather the national economic storm. The most important factor insulating Virginia's economy is the large and diverse presence of the federal government. Given that Virginia is somewhat insulated from the national downturn, the recovery in fiscal years 2003 and 2004 is expected to be less robust in the Commonwealth than the national recovery. Since the downturn in Virginia is expected to be less severe than the national recession, the state will have less ground to recover than the nation as a whole.

Here is a look at what economists are predicting for Virginia in fiscal year 2002:

- Virginia's personal income growth is expected to fall sharply to a rate even lower than that seen in the

Virginia employment growth at lowest rate since 1990s recession

Percentage growth in nonagricultural employment



Data for 2002 through 2004 are forecasts. Source: Department of Taxation last recession. Growth in wages and salaries is slowing considerably from its fiscal year 2001 pace, growing at 4.2 percent.

- Virginia is expected to experience four consecutive quarters of negative growth. Employment growth remains barely positive in fiscal year 2002, growing at 0.5 percent. Job growth in fiscal year 2003 will be only marginally better, with an expected growth rate of 0.9 percent. The slowdown is most severe in the services, TCPU, and FIRE sectors.
- Services employment is forecast to decelerate, growing at only 0.8 percent.
- Construction employment is expected to experience another year of solid growth in fiscal year 2002, growing by 6.5 percent. However, the construction sector is expected to slump considerably in fiscal year 2003, declining by 0.9 percent.
- Employment in wholesale and retail trade is expected to be flat.
- Virginia's manufacturing sector will continue to shed jobs. Employment is expected to decline by 4.2 percent.

Predictions for the near future

In summary, Virginia's first recession in a decade started in the fourth quarter of fiscal year 2001 and is expected to continue throughout fiscal year 2002. Employment is expected to decline for three consecutive quarters and personal income growth should fall sharply.

Economic conditions in fiscal year 2003 are expected to be sluggish. Job growth is forecast to again be below one percent and personal income growth is expected to remain close to the fiscal year 2002 rate. A recovery is not expected to begin in earnest until fiscal year 2004.