



The Economic Forecast

Review of fiscal year 2003

The economic recovery picked up momentum over the summer and appears to be gaining strength. Economic growth was somewhat weaker than expected in fiscal year 2003. The buildup to the war in Iraq dampened third quarter growth and effectively stalled the recovery. The labor market remained in a slump and ended the year with a net job loss. Nonetheless, with incomes bolstered by gains from mortgage refinancing activity and federal tax cuts, consumers continued to sustain the recovery.

Like the nation, the Virginia economy also experienced a prolonged slump in the labor market, but turned the corner near the end of fiscal year 2003. Job losses abated over the year and the state finished the year with a modest gain in employment. The Northern Virginia region, long the driver of economic growth in the Commonwealth, appears to be recovering from the effects of the high-tech implosion that accompanied the 2001 recession.

The national economic recovery continued in fiscal year 2003

The U.S. economic expansion continued its slow pace of recovery during fiscal year 2003, although job growth remained elusive.

Growth in U.S. Gross Domestic Product improved considerably. The value of all goods and services produced within the U.S., adjusted for inflation, grew at 2.7 percent in fiscal year 2003. Growth in total personal income was 3.1 percent,

while wages and salaries increased by 1.6 percent.

Consumer spending sustained the recovery. Consumer spending experienced solid growth in fiscal year 2003, increasing by 2.9 percent. The lowest interest rates in 40 years not only buoyed the housing market, but sustained the refinancing boom well beyond expectations. Federal tax cuts also put additional cash into consumers' pockets.

Despite the general strengthening of the economy, the recovery remained jobless. Total nonagricultural employment in the U.S. declined by 0.5 percent during fiscal year 2003. Employment fell in the manufacturing, construction, and transportation, communications, and public utilities sectors. The information and professional and business services sectors – primary drivers of growth during the 1990s – also continued to lose jobs in fiscal year 2003.

The federal funds rate reached the lowest level since the late 1950s. The Federal Reserve Bank lowered the federal funds rate target twice over the year – by 50 basis points in November 2002, and 25 basis points in June 2003.

U.S. economy gains strength

	Actual		Forecast		
	2002	2003	2004	2005	2006
Real GDP	0.8%	2.7%	3.8%	4.0%	3.6%
Total Employment*	(1.0)%	(0.5)%	0.1%	2.2%	2.0%
Unemployment	5.5%	5.9%	6.2%	5.9%	5.8%
CPI	1.8%	2.2%	1.6%	1.5%	1.8%

*Total nonagricultural employment. Figures represent percent change over previous year, except unemployment rate, which is a percentage. Data based on the October 2003, Global Insight standard forecast. Source: Department of Taxation

Virginia's economy began its recovery in fiscal year 2003

Although the war in Iraq undoubtedly stunted growth, the Virginia economy was somewhat stronger than expected during fiscal year 2003. Job losses abated over the year and the Commonwealth finished the year with a modest increase in employment.

Nonagricultural employment grew by 0.2 percent in fiscal year 2003, outpacing the official forecast of a 0.4 percent decline. Job growth was evident in finance, insurance and real estate, and the government sector. The services sector, however, once again provided the bulk of the growth. Health and education provided the most new service jobs, while professional and business services employment fell. The high-tech industry's malaise continued, with employment falling in the information sector for the second year in a row. Manufacturing employment continued to slide, and job losses occurred in construction, trade, and transportation, communication and public utilities.

Here is a look at regional employment in Virginia during fiscal year 2003:

Northern Virginia

In Northern Virginia, which represents about a third of all jobs in the state, employment grew 0.2 percent during fiscal year 2003. High-tech jobs continued to disappear. The professional and business services and information sectors combined lost 13,300 jobs over the year. Solid gains in education and health services and leisure and hospitality services offset the losses.

Richmond/Petersburg

Jobs in the Richmond-Petersburg metropolitan statistical area (MSA) declined by 0.8 percent in fiscal year 2003, a loss of about 4,400 jobs. The manufacturing sector alone lost 2,500 jobs, and professional and business services declined by 3,600. The losses were par-

tially offset by gains in education and health services and government.

Norfolk/Newport News/Virginia Beach

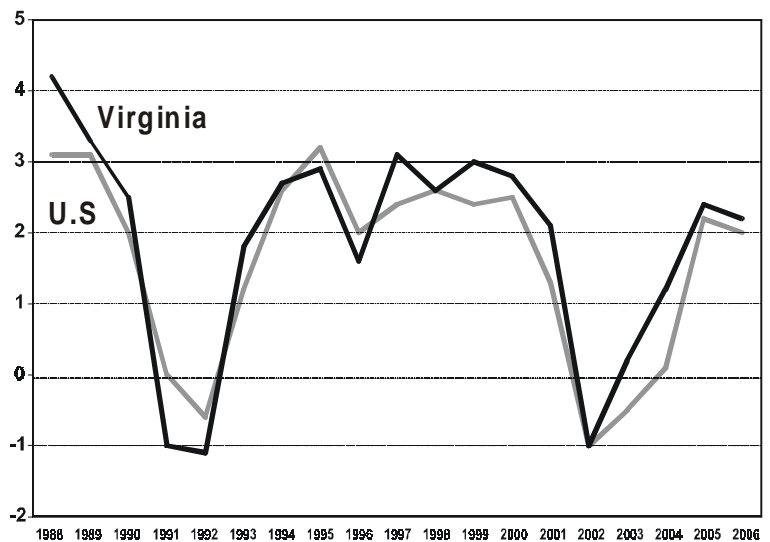
The Norfolk-Newport News-Virginia Beach MSA experienced the strongest growth of Virginia's regions, with 0.5 percent growth, or 3,300 new jobs in fiscal year 2003. The deployment of many of the military personnel due to the Iraq war resulted in sluggish economic growth. However, the number of ships and soldiers returning to the area in May through July was the largest since the conclusion of the Persian Gulf War in 1991. Similar to the pattern throughout the nation, the strongest gains in employment were in education and health services, while manufacturing employment continued to decline.

Balance of the state

Employment in the balance of the state increased by 0.4 percent, an additional 4,100 jobs. Gains in education and health services, leisure and hospitality, and other services offset losses in the manufacturing sector.

Virginia employment growth gradually improves over forecast horizon

Percentage growth in nonagricultural employment



Data for 2004 through 2006 are forecasts. Source: Department of Taxation

U.S. economic outlook expects sustained growth

The economic momentum gained over the summer has continued to strengthen and recent indicators suggest the strength is broad-based. Employers have finally begun to add jobs and consumer confidence is improving. At the November meeting of the Governor's Advisory Council on Revenue Estimates, the consensus economic forecast was for a stronger recovery. Highlights of the economic outlook for the next two years include:

- ▶ Real Gross Domestic Product (GDP) is expected to increase by 3.8 percent in fiscal year 2004, 4.0 percent in fiscal year 2005, and 3.6 percent in fiscal year 2006.
- ▶ Although labor market conditions are improving, job growth is expected to be flat in fiscal year 2004, before increasing 2.2 percent and 2.0 percent in fiscal years 2005 and 2006, respectively.
- ▶ Real consumer spending should pick up over the next two fiscal years, increasing by 3.6 percent in fiscal year 2004, 3.8 percent in fiscal year 2005, and 3.1 percent in fiscal year 2006.
- ▶ Business investment – largely responsible for the weakness in the economic recovery – is

finally reviving. Attractive prices for capital goods and three years of postponing investment should spur spending, particularly on equipment and software.

- ▶ Despite highly stimulative monetary and fiscal policies, inflation should remain moderate over the forecast horizon.
- ▶ The Federal Reserve Bank is not expected to raise interest rates in the short term.

Growth in the Virginia economy expected to accelerate in fiscal year 2004 and beyond

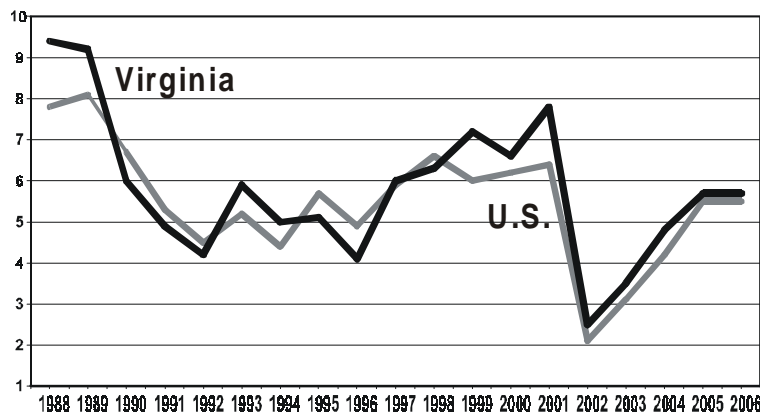
The Virginia economy has emerged from recession and fiscal year 2004 should be a year of gradually accelerating growth. The service sector will continue to drive growth, while the high-tech industry should pull out of its two-year malaise. Increased defense-related spending and the recent improvement in business spending on equipment and software should support growth in this sector.

Here is a look at what economists are predicting for Virginia:

- ▶ Virginia's personal income is expected to grow 4.8 percent in fiscal year 2004, and 5.7 percent each year in fiscal years 2005 and 2006. Growth in wages and salaries should pick up considerably from last year's pace, growing at 4.8 percent in fiscal year 2004, 5.9 percent in fiscal year 2005, and 5.7 percent in fiscal year 2006.
- ▶ Modest employment growth of 1.2 percent is expected in fiscal year 2004, followed by solid 2.4 percent growth in fiscal year 2005 and 2.2 percent in fiscal year 2006.
- ▶ Employment in the services sector is forecast to grow 1.9 percent in fiscal year 2004, about the same rate as last year, then jump to 3.9 percent and 3.7 per-

Personal income growth to slightly exceed the nation's over the forecast horizon

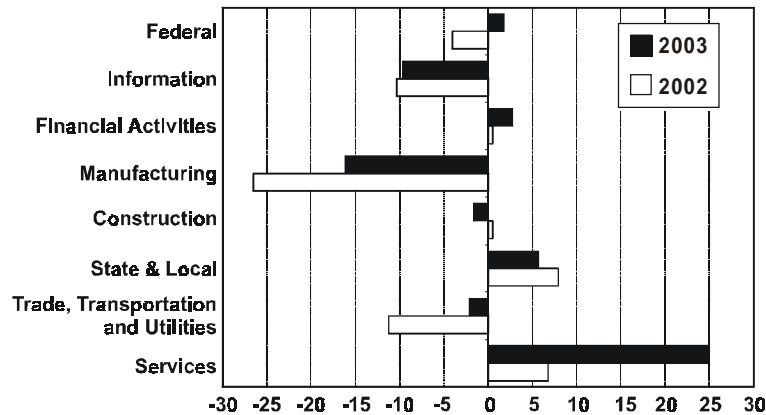
Percentage growth in personal income



Data for 2004 through 2006 are forecasts. Source: Department of Taxation

Service sector again dominant job-producer

Percentage growth in nonagricultural employment



Source: Department of Taxation

cent in fiscal years 2005 and 2006, respectively.

- ▶ Construction employment is expected to rebound with 3.1 percent growth in fiscal year 2004, then slow to 0.6 percent in fiscal year 2005. Growth in fiscal year 2006 is expected to be 2.7 percent.
- ▶ Employment in trade, transportation and utilities is expected to grow 1.0 percent, 2.3 percent, and 1.6 percent in fiscal years 2004 through 2006.
- ▶ The forecast expects Virginia's manufacturing sector to begin its recovery by fiscal year 2006. Employment is expected to continue falling by 3.3 percent in fiscal year 2004, remain flat in fiscal year 2005, then increase marginally in fiscal year 2006.