

**THE UNITED STATES ECONOMY IN 2011** has managed to under-achieve even relative to our unambitious expectation. A year ago, we thought that growth would come in close to 3 percent for the year—certainly not great for an economy coming out of a very deep recession. Instead, as shown in Figure 1, through three quarters the economy has expanded at an annual rate of only 1.4 percent. If anything, the labor market has done even worse. We anticipated job growth would be very close to 200,000 per month. Through October (see Figure 2) the actual outcome has been just 125,000. The difference means that unemployment has remained above 9 percent, not the modest decline we had hoped for.

component is centered on Europe and its sovereign debt situation. As in the U.S., leaders have taken half steps that are mostly designed to avoid the fundamental problem and to delay the point of real decision.

Looking to the future, the unfortunate thing is that these political problems seem unlikely to turn in a productive direction in the near term. As a result, we expect that 2012 will be generally similar to 2011: unacceptably slow growth, without much progress in the labor market. To be more specific:

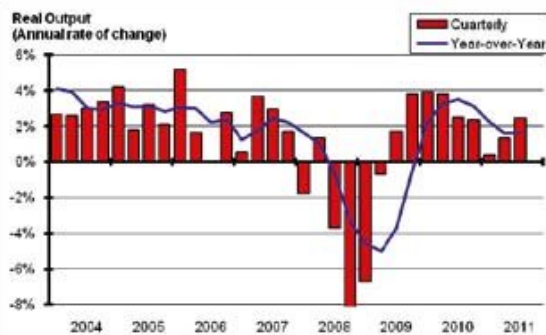
We expect output to grow between 2.5 and 3 percent on a fourth-quarter to fourth-quarter basis. This will be better than 2011, due to somewhat improved household spending and less drag from

report

# THE U.S. OUTLOOK F

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>>> **FIGURE 1: U.S. REAL OUTPUT RATE OF CHANGE, 2004 TO 2011**

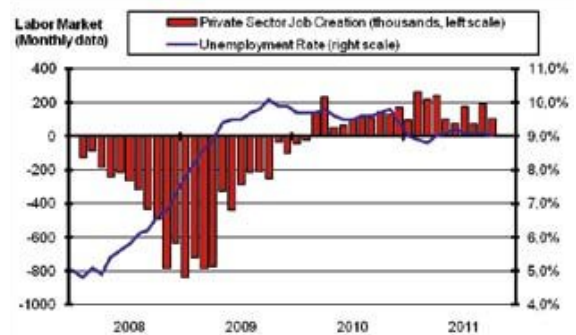


Source: Bureau of Economic Analysis

The blame for this dismal outcome is widely shared, but two items, one man-made and the other an act of God, top the list. The latter was the earthquake/tsunami that hit Japan in April. The disruption to supply chains that the disaster produced had a temporary, but clearly negative, effect during the summer.

The man-made component is the inability of the political sector—both domestically and abroad—to face up to the necessity to make some tough decisions. At home, this has manifested itself as a series of deadline-driven crises that have all ended with a non-decision to delay any substantive action. The cumulative effect has been to ratchet up uncertainty and destroy what remains of household and business confidence that policy will shift from being mostly counter-productive to being a positive force for sustained recovery. The global

>>> **FIGURE 2: U.S. JOB CREATION AND UNEMPLOYMENT RATE**



Source: Bureau of Economic Analysis

the government sector.

Employment will continue to increase, but only enough to allow marginal progress in reducing unemployment. By the end of 2012 unemployment, will still be well above 8 percent.

Higher commodity prices raised inflation significantly in 2011. This situation has moderated recently, and we expect inflation to be well contained in 2012.

The housing sector has hit bottom, but the large overhang of homes in or headed for foreclosure will prevent any significant rebound in construction or prices during most of 2012.

The Federal Reserve lowered short-term interest rates to virtually zero almost three years ago and has said it will maintain this stance through mid-2013. It is also engaging in realignment of its very large



# OR 2012

security portfolio toward longer-term holdings in an attempt to edge down long-term rates. This is unlikely to have any dramatic effect.

Any actions on the federal deficit/debt will be mostly smoke and mirrors with little impact on the actual budget for the next year. Real change will be postponed until after the election.

Thus, we see continuing tepid economic recovery during 2012, with disappointing output expansion, low inflation and a small decline in unemployment. This is better than a slide back into recession, but is a long way from an optimistic outlook.

Moreover, like a year ago, there is a substantial roster of things that could adversely upset our expectations. In terms of immediacy, the European situation tops the list. On a daily basis, news of "progress" or of some impediment is causing triple-digit swings in financial

markets. But, so far, there is little evidence of the will to confront (or even to recognize) the underlying problem—several countries in the EU periphery have been living beyond their means with the excess financed abroad. The result is debt burdens that have become unsustainable. Proposals to date have been focused on the debt problem. Solutions must, however, also deal with the imbalances between current standards of living and those that can be supported by domestic productivity. One way countries have traditionally dealt with this type of problem is by debasing their currency, which leads to a reduction in purchasing power and thereby a lowered standard of living. But the common European currency rules this out for, say, Greece. So the realignment requires more direct political actions, which so far don't seem to be possible.

The U.S. is on a trajectory toward this same problem, but less far along, leaving more time to work out a solution. Our current dysfunctional political situation, however, is squandering that advantage. As in Europe, the problems we face require some fundamental changes. But instead of working on long-term solutions, we have spent the last four years focused mostly on "fixes" that are short-term and temporary (and therefore ineffective). The result has been a lost half-decade. If the political deadlock is not broken by the next election, the danger of a lost decade will be very real.

Finally, the ongoing evolution of China must be mentioned. Regardless of how the European and U.S. problems are resolved, this evolution is likely to be the dominant economic story of the next decade. For the Chinese, the problems are enormous. They must transition from a low-wage economy driven by extraordinarily high levels of domestic investment and exports to a more consumer-oriented structure. Production must shift toward raising productivity, rather than simply expanding scale. The financial system must develop and become more open. These transitions will be extremely difficult to accomplish. Missteps could have significant ramifications for the entire global economy.

But all of this is probably still a ways off. For the next year, our expectation is that neither Europe nor our domestic situation will self-destruct. This will be enough to produce in 2012 a year a lot like 2011—slow growth that doesn't feel much like "recovery," but that's better than possible alternatives.



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