

## Economy.com's Macro Outlook

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The entire global economy is struggling. Economies ranging from Germany to Japan to much of Latin and South America are engulfed in recession. Even previously more strongly expanding economies, such as Britain and Australia, also have weakened in recent months. Only the Chinese economy continues to expand with any consistent vigor.

The U.S. economy has come to a virtual standstill. Real GDP is barely growing, while manufacturing production is sliding. What output gains are occurring have not been sufficient to ignite any net job creation. After losing 1.75 million jobs in 2001, the economy created no jobs last year, and payrolls resumed declining at year's end. Job losses in manufacturing, commercial construction, travel, distribution, and investment banking continue to all but trump job gains in home construction, educational services, healthcare, defense, and mortgage banking.

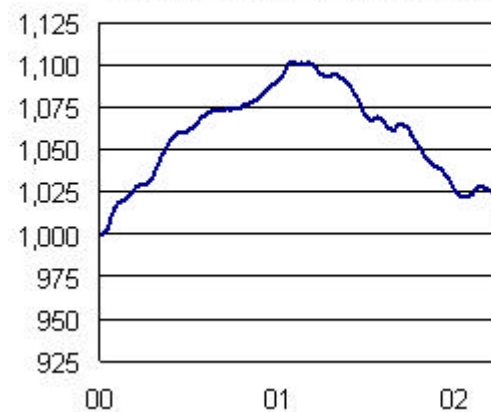
Unemployment and underemployment are high and rising. The number of unemployed and those who have fallen out of the labor force, but say they want a job, has risen from 10 to 13 million or from 7% to 9% of the labor force over the past two years. The number of workers with part-time jobs who would prefer full-time jobs has risen by 1 million over the same period to 3% of the labor force. The number of self-employed is also rising rapidly, many of whom are likely workers unable to find preferred jobs in larger businesses.

The economy's difficulties are evident from coast to coast. Large metropolitan economies, ranging from Boston and New York City in the Northeast to Atlanta and Dallas in the South to Chicago and Detroit in the Midwest to the Bay Area of California and Denver in the West, are engulfed in full-blown recessions. Close to one-third of the nation's 300 metropolitan areas remain in recession. Solid growth is occurring in only a handful of economies across the country, notable being southern California and south Florida.

At the center of the global economy's difficulties is the specter of war with Iraq. Higher energy prices are weighing on household incomes and corporate profits. The economic corrosive of higher energy prices is even more substantial for continental European and Asian economies than for the U.S. economy; because the U.S. produces nearly one-half of what it consumes, and has a large service and information oriented business sector, the U.S. is less energy dependent.

A pall has descended on global investor, business and consumer confidence. Not only is the threat of war undermining psyches, but the mounting bickering between the U.S. and its allies over just how to proceed against Iraq is particularly unsettling. Although it is still widely accepted that the U.S. military would be quickly successful in an invasion of Iraq, it is widely held that there is a small possibility that the invasion could go terribly wrong. Dark scenarios abound, ranging from more protracted engagement with Iraq, to the overthrow of the Saudi royal family by religious hard-liners, to the specter of more global terrorism. Although only a small probability is likely being attached to these very pessimistic scenarios, even remotely possible is affecting global spending and investment decisions.

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C&I loans outstanding, \$ bil, 4 w



As long as the threat of an Iraqi confrontation looms, the U.S. economy will be at risk of unraveling back into recession. A handful of timely economic statistics is particularly useful in gauging the economy's direction.

The number of initial claims for unemployment insurance is a particularly sensitive economic barometer. This week's count, and thus not subject to the measurement problems that plague survey-based statistics, especially at economic points. Calculating a four-week moving average of claims is useful to abstract from the effect of seasonal adjustments and various temporary factors. Weekly claims totaling close to 400,000, which is where they are currently, are indicative of an economy that is creating no net new jobs. If claims consistently fall closer to 350,000 per week, then job growth will resume, and recession risks will fade. If, however, claims rise to near 450,000 per week, then the economy is likely to be in recession.

Consumer confidence as measured by the weekly ABC/Money Magazine poll is a useful barometer, particularly in the economy. Confidence only falls precipitously at the start of recessions, as it did in early 2001. Confidence is once again falling rapidly, as the weakening stock and job markets and the Iraq conflict take their toll. If this measure of confidence doesn't soon stabilize, odds are the economy would be already in recession.

The dark economic implications of the recent slide in confidence are being at least partially mitigated to date by strong applications for mortgage loans to purchase a home. The weekly purchase loan application index available from the Mortgage Bankers Association remains near a reading of 350, signaling that home sales and homebuilding will remain strong at least until early spring. A decline in the index toward 300 would suggest that housing, the economy's strongest indicator, is weakening and that the recovery is likely failing.

A gauge on whether the economy is gaining any traction is provided by commercial and industrial loans outstanding at commercial banks. The weekly data provided by the Federal Reserve Board provide information regarding the strength of demand by U.S. businesses, as well as underwriting standards of lenders. As long as C&I loans outstanding are falling, they have been since early 2001, it is unlikely that businesses are aggressively expanding their operations (see chart). C&I loans are often used to finance new investment, particularly inventory investment. Until businesses resume investing, the economy remains fragile.

The Wilshire 5000, a proxy for the value of all publicly-traded stocks, is a real-time barometer of investor sentiment. Numerous and significant links between changes in stock prices and the economy, any large change in prices has important implications for the near-term direction of the economy. The Wilshire is currently trading at over \$8 trillion. If it falls below \$8 trillion for more than a few weeks, then the economy will likely be headed back into recession. If it rises above \$8 trillion, an expansion is taking root.

Overall, the economic barometers currently suggest that the U.S. economy is just barely skirting recession. Indeed, the odds that the economy is, or will soon be, back in recession remain very high at one-in-three.

Any measurable improvement in the economy is incumbent on the successful resolution to the Iraqi conflict. It is expected that an invasion will occur in the next few months and that the U.S. military will be successful. Oil prices are expected to rise to near \$40 per barrel at the start of the conflict, but quickly fall back to \$25 per barrel as it becomes apparent that the U.S. is in control of Iraq's oil fields. Confidence is expected to rebound soon thereafter, igniting a stronger global economic rebound.

Given the many risks to this sanguine outlook and the cloud this is hanging over current economic activity, the need for the passage of a substantive fiscal stimulus package is mounting. While the Bush administration has stated that it is expected to pass this summer, there are significant pressures on policymakers to act much more quickly. The economic cost of not providing quick support to the flagging economy is substantially greater than the downside of providing support that was ultimately found to have been unnecessary.

Thus, it is assumed that a stimulus package costing the government some \$75 billion this fiscal year and \$50 billion

will become law this spring. The package will include the elimination of the marriage tax penalty, a child tax credit acceleration of the personal income tax cuts now legislated to take effect in 2004 and 2006, investment incentive: businesses, and some additional monies for hard-pressed state governments.

With a bit more help from fiscal policymakers, the economy's prospects are expected to brighten promptly post-Ir increasingly evident, however, that even after the Iraqi confrontation becomes history, fears of future terrorism an geopolitical concerns will not fade quickly, and thus remain a long-running, global economic millstone.

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