

Economic Commentary

September 10, 2001

Slowdown Spreads Around the World; Economic Recovery Postponed to 2002: Further Rate Easing Ahead

The latest economic statistics that were released over the last ten days confirm that not only isn't an economic recovery in sight for the second half of the year but the slowdown has spread globally and may be deepening in the USA. There are signs that with higher than anticipated job losses, the US consumer might be about to throw in the towel and if he does, the US economy will slip into a recession. The implications are that there is not going to be an economic recovery in the second half of this year, as was widely anticipated; that short-term interest rates will have to be eased further in North America and Europe and the US dollar will lose ground against the euro. Bond prices are set to rally, with the medium term spectrum expected to rise more than the long-term end.

More specifically the key data released recently showed that:

- Growth in the US has slowed to an annualized rate of 0.2% in Q2 from 1.3% in Q1, bringing the year-over-year rate of growth to 1.2%. Business investment plunged as did net exports (exports fell faster than imports). What kept the economy moving was higher government and especially consumer spending which managed to grow by 2.5% in Q2, down from 3.0% in Q1. But continued layoffs, high indebtedness (debt servicing has reached 14% of disposable income, a 15-year high), low saving rate and falling consumer confidence are making it increasingly difficult to maintain spending.
- US slowdown has spilled into Canada as expected. Canadian growth has slowed to an annualized rate of 0.4% in Q2 from 2.0% in Q1, bringing the year-over-year rate of growth to 2.1%. Business investment managed to rise modestly in Canada but consumer spending was almost flat (rising only by 0.3%). Canada's economy continues to outperform the US but this provides little solace if our economy starts to shrink.
- Americans trimmed their inventories a lot more aggressively in Q2 than did their Canadian counterparts which suggests that in Q3 Canadians will have to cut back output a lot more aggressively than the Americans.
- Although the NAPM for new orders and production staged a rally in August, which pushed the index up to 47.9 (reading below 50 suggests that the manufacturing sector is declining) the new non-manufacturing NAPM index fell to 45.5 in August, suggesting that contraction has firmly

spread into the service sector of the economy which amounts for a higher share of GDP.

- Consumer confidence in the US fell to 91.5 in August from 92.4 in July, and this despite continued rate cuts by the fed, the issuing of tax rebates by the IRS and improved stock prices (well up from their April lows).
- Both the US and Canada registered strong employment losses last Friday: in the US 113,000 jobs disappeared in August, bringing the total since May to 199,000 while in Canada employment edged down by 8,000 jobs (35,000 jobs since May). The much higher than expected job losses in the US shocked analysts and pushed down the Dow Jones index by more than 230 points, one of the biggest one day losses of the year. The unemployment rate jumped to 4.9% in the USA (from 4.5%) and 7.2% in Canada.
- Also on Friday morning, the Japanese government announced that the economy shrank at a steep annualized rate of 3.2% in Q2, which if not reversed in Q3 is sure to put the Japanese economy (the world's third largest after Europe) into recession. Japan is of even greater significance to the North American economy than it is to the European given the greater trade links with Japan.
- Also Friday morning figures out of Germany showed a much greater than expected drop of 1.5% in industrial production for July, on top of June's negative figures.

The above developments clearly suggest that the US federal reserve when it holds its next regularly scheduled meeting on October 2, will trim the fed funds rate by another quarter of a point to 3.25%, the eighth consecutive cut this year and might have to do so again at its November 6th meeting and perhaps again on December 11th.. In fact, the futures funds market is already factoring a quarter point drop in rates for October and many analysts are predicting a fed funds rate as low as 2.75% by the end of the year!

On Canada's side of the border, it seems that my earlier assessment that David Dodge has been too cavalier as far as Canada's prospects are concerned in the face of a steepening slowdown in the US and world economy has proved correct. By not being aggressive enough in trimming rates during the summer, now that the slowdown is greater than expected and that many indicators are going into negative drive (GDP contracted by 0.2% in June and employment fell in August), he has to do much more to help the ailing economy. This expectation has pushed the Canadian dollar below 0.64 to the lowest levels in five months. It seems certain, therefore, that when the BOC convenes for its policy meeting on October 23rd and again on November 27th that the Bank of Canada will cut rates another 50 basis points. These cuts should bring the target for the overnight rate

(the equivalent to the US fed funds rate) to 3.75% in October and perhaps 3.5% in late November and the prime rate to 5.5% in October and 5.25% in December.

The question of the moment is why the steep rate cuts so far this year (300 basis points in the US, 175 points in Canada and 50 points in the euro-zone) along with well timed tax cuts in Canada and since July in the USA have not helped enough to stabilize the economy? My answer is that they have. By bolstering consumer confidence in the USA they have dampened the fall in spending that would have otherwise occurred worldwide. However, the bust in the high technology (dot.coms and telecommunications, media and technology) has been a lot greater than initially anticipated, the US dollar has stayed stronger a lot more than most expected and rate cuts take more time to make themselves work though the system. Moreover, there is evidence that the Bush tax cut is not being applied against spending but against debt reduction and saving in the US which is thwarting the expected stimulative effect of the move. In addition, the ECB may have been too slow to trim rates in the euro-zone while restructuring in Japan has yet to take hold.

In the face of this situation, either we will see increasing signs of stabilization over the next few months (the best that we can hope for right now) or we will see the US economy turn into recession in the second half of this year (the worse that can happen). The next month's figures will confirm the direction the economy is taking. Even if the economy manages to avoid an outright recession (two consecutive quarters of decline in GDP), short-term interest rates will still need to be cut, because the performance will be so weak that monetary authorities will not want to risk a downturn in the economy.

Thus, it is safe to expect another 50 basis point reduction in US rates (to 3.0% in the fed funds rate), 50 basis point reduction in Canada (to 3.5% in the target overnight rate) and another 50 basis point reduction in the ECB repo rate (to 3.75%).

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