

Economic Commentary

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Global Economy at the Brink of Recession: Rates to be Cut Sooner than Expected

Yesterday's terrorist attack on the USA from what appears to be Islamic fundamentalist extremists has changed the world. It was more than an act of terrorism, it was an act of war! The honeymoon period of euphoria and optimism that followed the end of the cold war and the collapse of communism in August, 1990 has ended. We have now entered a new period in world history that will be defined by a clash of civilizations, the western Greco-Judaic civilization vs Islamic fundamentalism; international law and order against terrorism and anarchy; freedom of the individual against collective submission to theocratic laws. Our freedom to walk in public places, to travel by airplane or train, to go and work in large office buildings has been severely undermined. Our communications will now be monitored more than at any other time since the McCarthy period of the 1950s. The economy will not be the same again.

As I reported on Monday's Commentary, the North American economy and by extension the world economy is at the brink of recession. What has kept the economy from contracting has been the American consumer. Yesterday's unprecedented attacks at the World Trade Center in New York and the Pentagon in Washington, D.C. could not have been better timed to deliver a fatal blow on the chances of recovery. It is now almost certain that following these events consumer confidence in the USA -if not in much of the rest of the western world- will decline enough to produce a drop in consumer spending this and the months ahead, thus making a recession almost certain. The incident is viewed as a declaration of war. When the Gulf War started in January, 1991, consumer confidence in the US plunged to the lowest point in eight years. I believe that this time will be no exception.

Since the world economy is highly interdependent, a US recession will hit particularly hard America's major trading partners, especially South East Asia, Mexico and South America and yes Canada as well. With only 14% of exports destined for the US Europe's economy will be less affected, but affected enough to bring the economy to zero growth. With Japan already in contraction, China remains the only other major economy that will keep expanding, but at significantly reduced rates of growth.

This morning the G-7 group of Central Bank governors have indicated that yesterday's events are viewed as a threat to global financial stability and have indicated their intention to employ their lender of last resort power to assist the financial system, as they did after the stock market crash of 1987. This morning the Bank of Japan pumped \$17 billion and the ECB pumped \$63 billion into their respective financial systems. It is therefore certain that central banks will now move in a dynamic fashion to cut interest rates by perhaps 50 basis points, probably sooner than the October 2nd

scheduled policy meeting of the fed. When this happens, the Bank of Canada is certain to follow along in this internationally coordinated move to forestall an erosion of confidence and prevent the world economy from slipping into recession.

My sense is that short-term rates will fall very soon, that bond yields will fall as well as there already is a flight to the safety of government paper, but the economy will not respond fast enough to prevent the inevitable, a world recession. Although I do not expect the recession to last more than six months and I do not expect it to be a particularly deep one. The timing and rapidity of the recovery will depend on what actions the USA and Western governments will take to counteract this terrorist act of war. The longer they delay retaliation and punishing those responsible for these heinous acts, the longer it will take US consumer confidence to revive.

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