Economic Commentary

July 13, 2001

Slowdown in US Eases but Accelerates in the Rest-of-the-World: Further Rates Cuts Ahead

Last week two major releases of economic news shaped the outlook. The release of the National Association of Purchasing Managers' Index of factory activity and the release last Friday of Employment data for both sides of the border. The NAPM index showed the first improvement since November of last year, rising in May to 44.7 from 42.1. Still, a reading below 50 suggests that the US manufacturing sector continues to contract. Nevertheless, markets reacted positively to this peace of news because it implies that contraction in the industrial sector may have hit bottom. Lets hope so.

On the other hand, both Canada and the USA lost jobs in June, almost all of them in the manufacturing sector. In Canada, total employment fell by 13,000 jobs, but the unemployment rate remained at 7% for the fourth consecutive month because 18,000 people stopped looking for work. In the United States, a decline of 114,000 payroll jobs pushed the jobless rate to 4.5%, from 4.4% in May, the third consecutive drop in employment.

Analysts said that job losses open the door for further cuts in rates in both countries, discounting earlier speculation that the US Federal Reserve and perhaps the Bank of Canada were done with their series of rate cuts since the beginning of the year. In fact, the fed funds futures market now prices the August contract with a 113% probability for a 25 bp cut. That's where the market believes the Fed's job ends. The October and November contracts both price funds at a 3.50% low before the trend turns toward moderately higher rates and a 25 bp tightening fully priced into the February contract.

All told, the job market is still holding up better in Canada than in the USA, although the pace has dipped substantially in the past year. The Canadian economy has been creating an average of fewer than 5,000 jobs each month compared to a monthly average of 25,000 last year. Total employment in Canada has been growing at a 1.1% annual rate compared to an annual rate of decline of 2.1% for the USA. Disconcerting, however, was evidence that job losses in Canada have begun to spread outside the manufacturing sector to the service sector, with transportation, hospitality, information and culture being negatively affected.

In the meantime, the slowdown that begun in the USA, has now gone global. Japan is in recession. Industrial production fell by 3.9% in the year to May, accelerating to a decline of 17.2% over the past three months alone. The Bank of Japan's Tankan Index of business confidence fell sharply while in May the unemployment rate rose to a record high of 4.9%. Consumer prices fell by 0.5% in the year to May, while the core rate of inflation fell to -0.7%, the largest decline on record.

The euro-zone saw a further decline in manufacturing activity in June. The Reuters-NTC purchasing managers' index fell from 48.5 in May to 47.9 in June, its lowest level since December, 1998. Euro growth is now projected to average 1.9% for 2001, down sharply from an expectation of 2.6% at the beginning of the year.

Making matters worse, however, has been the crisis that has hit Argentina. With a fixed rate peg against the US dollar and a $128 billion US external debt it is hovering at the brink of default. Coupled with a sharp slowdown in manufacturing exports from South-East Asia and Turkey's economic crisis, emerging markets are suffering their biggest drop since 1998. With demand slowing and a flight to quality out of emerging market debt to the safety of US treasury securities, growth in emerging countries is slowing sharply and the risk of the crisis from spreading across South America (Brazil and Chile will be affected the most, but even Mexico is already feeling the pinch) and perhaps to South East Asia. Thus, the risks of a global economic slowdown have risen sharply over the past few weeks.

At this point it is certain that the Fed will proceed with another quarter point cut in the fed funds rate when it holds its next regularly scheduled FOMC policy meeting on August 21st (the next meeting takes place on October 2nd and is perceived as too long a wait). This, the seventh cut will bring the funds rate to 3.5% from 3.75% currently.

The question is what will the Bank of Canada's monetary policy committee do when it meets next Tuesday (July 17th)? The bank rate in Canada, which was last lowered on May 29th now stands at 4.75%. It is important to note here that the bank rate is the upper limit of a 50 basis point band with the key overnight financing rate at 4.25%. Since the fed funds rate is the Canadian equivalent of the overnight rate, presently there is only a 50 basis point positive differential in favour of Canada. If the BOC cuts rates next week by a quarter, it will narrow this differential to only 25 points until the Fed's next meeting on August 21st, which may be too close for comfort given our struggling Canadian dollar.

The Bank of Canada may choose to play it safe and wait for the August 21st US rate cut before easing rates further in Canada. I would say that a 25 basis point cut to 4.5% in the bank rate (and 4.0% in the overnight) is a certainty by the end of August. What is not certain is whether the Bank will choose to make the cut before, i.e. next week or wait till the end of August.

If David Dodge maintains the cautious approach that he has taken so far this year he will sit this one out. Sticky inflation and tax cuts on our side of the border would support this view. If, on the other hand, he becomes more concerned about the spreading global slowdown he may decide to be more decisive and cut the bank rate by a quarter point next week and sit out the next one when the Bank meets again on August 28th, one week after the next FOMC meeting. The deteriorating international outlook and the repercussions of this for Canadian growth in the second half of the year argue for the later. If I were in his position, I would take the more aggressive approach and cut rates on July the 17th. If I were to make a bet, I would expect him to wait until August.

The outlook for the Canadian dollar is mixed at this time. Although the medium to long-term outlook is decidedly positive, the short-run outlook much depends on what the BOC does with rates next week and with the continuing erosion in the international growth outlook and its implications for commodity prices.

On the fixed-income side, with 10yr+ Canadian bond yields at 6.09% compared to 5.25 (10 yr) - 5.65% (30 yr) in the US, I believe that long term rates will come down by as much as 50 basis points by the end of August, especially if financial crisis in emerging markets heats up further over the next two months.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.