Economic Commentary

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More Rate Cuts in the Pipeline

Last Friday's employment numbers proved why Greenspan is in a hurry to cut interest rates. In April, the US experienced the largest one-month decline in jobs since February 1991, the start of the last recession. Non-farm payrolls plunged 223,000 jobs, and this on top of a 53,000-job decline in March. Eight of the last twelve times since 1951 payrolls have fallen for two consecutive months the economy has gone into recession. Job losses have now spread into the service sector while preliminary estimates for May suggest that the erosion in jobs will continue. The job losses pushed the rate of unemployment to 4.5%, up from 3.9% in October 2000. Equally worrisome is the fact that during April the labour force shrank by 111,000, otherwise the jump in the unemployment rate would have been steeper.

On Tuesday, the US Department of Commerce announced that first quarter productivity growth slumped 0.1%, lowering to 2.8% the year-to-year rate of growth down from 6.3% in Q2, 2000. Hourly compensation jumped by 5.2% in the quarter which pushed up unit labour costs to 3.1% on a year-over-year basis. The rising trend in labour costs underpins inflation, which may limit the Fed's willingness to cut rates.

Many analysts view the steep rise of US productivity in the late 1990s as a consequence of the pronounced economic boom that was experienced in the USA. Now that the boom is giving way to the bust, productivity numbers are bound to suffer. Notwithstanding the inflationary concerns that lower productivity numbers imply, the US Federal Reserve now remains more concerned with growth rather than inflation. Besides, recessions are deflationary and they tend to correct inflation by themselves.

Therefore, it looks increasingly likely that the Fed will cut the fed funds rate by another 50 basis points to 4.0% when the FOMC meets on Tuesday, May 15th. Given that the slowdown is sharper than originally thought and given that the Fed is aggressively trying to prevent a recession, it looks increasingly probable that the Fed will continue cutting rates through the summer to the 3.5% – 3.75% level.

In the meantime, economic news in Canada suggest that the slowdown on this side of the border may be bigger than what the Bank and Canadian forecasters had originally anticipated, reinforcing the view that the David Dodge might have to get more aggressive in the months to come. Therefore, it looks increasingly likely that the Bank of Canada will cut rates by 50 basis points to 4.5% when it meets at the end of the month (May 29th) and cut them by *at least* another 50 basis points by August. All together these actions may bring the bank rate down to 4.0% and the prime rate to 5.5% by late August.

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