

# Economic Commentary

October 25, 2001

## Bank of Canada Struggles to Regain Control

Tuesday's 75 basis point cut by the Bank of Canada in its bellwether target overnight money market rate surprised analysts, all of whom were expecting a 50 basis point cut instead. The rate decision did indeed aim to surprise markets, because it is the surprise feature of a rate cut that usually elicits the most response. But the 75-point cut was also meant to help the central bank catch up with developments in the economy, and regain control of the situation. As I argued repeatedly in my previous commentaries earlier in the year, the Bank's attitude toward the slowdown in North America was too cavalier, expecting that the Canadian economy would escape the worst of the effects of the slowdown south of the border. If the Bank is wrong in its assessment, by the last quarter of the year it will have to slash rates more than it would otherwise have to regain control of the situation. Well, my concern proved correct.

The rate decision has cut the overnight rate to 2.75% (compared to a fed funds rate of 2.5% in the USA), the lowest level in over 40 years! As usual, Canada's chartered banks responded by slashing their prime rates by 75 basis points to 4.5%, a level lower than the record low rate of 1997, when in the face of extremely tight fiscal policy the Bank of Canada tried to compensate with an easy monetary policy.

Economic data now confirm that the slowdown was more pronounced than analysts believed earlier in the year and that it was well on its way well before the September 11<sup>th</sup> terrorist strikes against America. This week's release of economic indicators confirms this. September Leading Indicators fell 0.5%, after a 0.1% drop in August, completely reversing the upward trend that started to emerge from May. Housing resales plunged 11.7% in the USA implying that the US consumer has begun to cut back spending. Durable goods orders plunged 8.5% in September, even worse, the declines are not limited to the sectors affected by the terrorist attacks but are broad based. Meanwhile initial claims were up by 8K to 504K in the week of October 20<sup>th</sup>, almost reaching the highest level recorded in 1990 just prior to the last recession.

Developments so far confirm our earlier assessment that a recession in the second half of this year in the USA is a foregone conclusion. Although Canada's outlook is better than the USA, I seriously doubt that Canada will escape at least two quarters of decline in output -albeit modest declines- given our dependence on the US economy and given the substantial disruptions in our cross border trade that resulted from the intense security tie-ups at the Canada/US border.

With the rest of the world economy in a synchronized slowdown and even recession in Japan and now in some parts of South East Asia and South America, the outlook is continuing to deteriorate.

Paul Martin, Canada's Minister of Finance announced this week that he will be tabling a budget sometime during the first two weeks of December. More and more analysts and policy makers are calling for additional fiscal measures to fight the recession. My view is that Martin will do little of this sort as he doesn't want to jeopardize the painful gains he made in recent years in eliminating the budget deficit. He has already done enough through his multi-year \$100 billion tax cut and now he will raise government spending somewhat (\$3-\$4 billion) most of which will go to beef up Canada's defense and security force in the face of the war against terrorism. The onus to pull the economy out of its slump now seems to be falling on monetary policy, much as it did during the mid-1990s.

It therefore appears almost certain that the Federal Reserve will cut rates by another 25 basis points at each of the next two FOMC meetings (November 6 and December 11) for a total of 50 points which will bring the fed funds rate to a post-war low of 2.0% by the end of the year. It also looks likely that the Bank of Canada will match at least one of the two when it meets for the last time this year on November 27<sup>th</sup>. Thus I can see the overnight rate down to 2.5% by the end of the year and the Canadian prime down to 4.25%.

Looking out to 2002, I am of the view shared by most analysts at the moment, that the recession will give way to a gradual recovery by the second half of 2002. The massive monetary easing that has taken place in 2001 along with the modest tax cuts in North America and Europe, increased spending on defense and security and the fall in oil prices should prove enough to get North America and the global economy growing again. However, the risks are still weighted on the down-side. Geopolitical developments are hard to predict at the best of times. This time, as an editorial in the Economist (October 18<sup>th</sup>) pointed out there are also some additional good reasons to expect that this recession may be worse than that of 1990-91 for the US and the world economy. Their reasons are worth noting.

First, US firms may have to cut back capital investment by as much as 30% more in the months to come because the capacity utilization rate at 75.5% is the lowest since 1983 while the corporate financing gap (capital investment spending less internal cash flow) is at a historically high 2.5% of GDP. As profits continue to slide and bankers become more reluctant to lend, their willingness to continue to finance additional investment might force corporations to cut back their expenditures further. According to some estimates, profits are down 30%, the biggest decline since the 1930s and stand at 8.1% of GDP (down from 12.5% in 1997). Moreover, global growth according to CSFB in 2001 and 2002 may average 1.5% -the slowest two-year growth in over 50 years.

What may be worse, however, is the Economist's argument that the root cause of the current recession is not terrorism but the economic and financial imbalances that built up during the late 1990s. "Firms over-invested and over-borrowed on the back of inflated expectations about future profits. Households borrowed heavily too, believing that share prices would rise forever. These excesses will take time to unwind" and "when debts of firms and households are at record levels relative to income, lower interest rates are less likely to spur new borrowing." To the extent they are right, then interest rate cuts and tax cuts might prove a lot less effective. Then one should expect a deeper and more prolonged downturn, lower inflation and significantly lower long-term bond yields.

I am not yet ready to accept this view, but at the same time I am not complacent enough to reject it. One must be aware that there is always room for things to get worse and at least try to understand why. In the event this scenario does unfold, one at least is more prepared to deal with it.

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