State of the Economy

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The US slowdown spills into Canada

What a difference a year makes. It was only last spring that most economists thought the greatest risk to the US economy was that of overheating. And it wasn't that long ago that there was a great deal of brash talk about the emergence of a new economic order. Some brave economists even pronounced the business cycle a thing of the past. Continuing investment and innovation in high-technology was going to propel productivity ever higher, fuelling high growth rates without fuelling inflation.

Clearly, as the US slowdown shows, the business cycle is alive and well. No doubt remains that the rapid downturn in the US economy has now spilled over the border. The one issue is how severe and protracted the sluggishness will be.

As forecast in the last issue of *The State of the Economy*, the US does appear to have avoided the all-out recession that some economists were predicting. Growth in the first quarter of 2001 was a higher-than-expected 2.0%, increasing from a low of 1.0% in the final quarter of 2000. The seemingly unstoppable American spending spree once again led the way as consumer expenditures rose by an annualized pace of 3.1%, up from 2.8% at the end of 2000.

However, there are still some troubling signs in the US economy. The growth in US consumer spending is being driven almost entirely by credit expansion. Personal disposable income rose just 0.5% in the first quarter of 2001, resulting in the personal savings rate sinking deeper into negative territory to -1.0%. The debt-service burden of households — the amount of personal disposable income needed to pay interest charges on outstanding debts — is at its highest level since 1986. This has created a great deal of financial vulnerability among households that could create further problems for the US economy down the road if the current slowdown is more protracted than expected.

On a more positive note, overall business investment in the US rebounded in the first quarter after posting a small decline at the end of 2000. However, business investment continues to lag behind consumption. Investment in equipment and software con-

tinued to decline, though at a more moderate pace than in the final quarter of last year. Another encouraging sign that the worst is over is that business inventories, particularly in the auto sector, seem to be clearing.

US unemployment rose to 4.5% in April, up from 4.3% in March, and more than half-point higher than the low of 3.9% set in September 2000. While several commentators have pointed to the latest numbers as further signs of a recession, the jump in the unemployment rate is more likely a lagging symptom of the fourth-quarter slowdown. However, there will likely not be much improvement in the US labour market during the second quarter, as the 2.0% growth rate posted in the first quarter of 2001 is probably too low to keep the unemployment rate from falling.

Overall, rising financial instability in the household sector, continuing high trade deficits, and weakness in the labour market should push the US Federal Reserve to introduce further interest rate reductions sooner rather than later. Lower interest rates on consumer credit will help lower the costs of borrowing and should help deflate the value of the American dollar. A decision by the US Fed to lower rates in the US should be matched by the Bank of Canada.

The outlook for Canada

The main risk to the Canadian economy at this point is that the US slowdown becomes more pronounced and protracted than anticipated. However, regardless of how badly the US economy performs this year, Canada should do better. Canadian households have not run down their savings rate in the same way as American households. The fiscal measures announced in the October mini-budget and the recent spending initiatives should mildly offset some of the weakening in consumer demand as employment growth slows and unemployment creeps up in the months ahead.

Overall, the Canadian economy slowed to a modest 2.6% annualized growth rate in the final quarter of 2000, down sharply from the 4% to 5% increases posted in the first three quarters. Predictably, in light of weakness in the US, Canada's export sector

has led the decline, with exports edging up just 1% during the fourth quarter. In fact, the increase would have been even weaker if not for the surge in energy exports.

After a gain of 0.3% in January, real GDP fell by 0.1% in February, largely as the result of weakness in the telecommunications and electronic sectors, both of which have been particularly hard hit by slumping US demand.

Government revenue losses offset by lower interest rates

Since Ottawa's mini-budget last October, it is clear that real GDP growth will not meet expectations and will have to be revised downward by close to a percentage point. This slower growth, combined with the impact of the next round of tax cuts taking effect in fiscal 2001, will reduce projected government revenues by close to $2 billion. However, lower than expected interest rates will partially offset some of these losses by reducing debt service charges.

Stronger than expected growth, higher employment, and more robust corporate profits last year will mean the total surplus for fiscal 2000 will approach $15 billion, well above the $11.9 billion forecast in the October mini-budget. For fiscal 2001, the impact of lower than expected revenues and the recently announced new spending initiatives will likely reduce the government's projected $8.3 billion surplus by $1 billion. Of course, this number could rise if the economy fails to rebound in the final half of the year, but this appears unlikely. Moreover, given the $4 billion dollars set aside in the mini-budget for contingency and prudence reserves, this shortfall will be easily absorbed without jeopardizing the fiscal surplus. In fact, the government will still have ample room to

National accounts

	1998	1999	2000
GDP $1992 (millions)	842,002	880,254	921,485
GDP $1992 per capita	27,987	28,867	29,967
Personal disposable income per capita ($1992)	17,290	17,528	17,871
Labour income (% of GDP)	52.6%	52.1%	51.5%
Pre-tax corporate profits (% of GDP)	9.1%	10.6%	12.0%

offer some additional fiscal stimulus that it should consider if the economy stumbles in the last half of 2001.

Looking ahead, there is little reason, short of a severe and unexpected economic downturn, to suspect that the federal government will be facing a deficit situation in the short to medium term. Assuming for the moment that program spending rises with the rate of inflation and population growth, the federal surplus will likely increase to over $10 billion by fiscal year 2002. This highlights the fact that Ottawa has much more fiscal manoeuvring room than is commonly assumed. In fact, program spending could rise an additional $5 billion in fiscal 2002 and 2003 while still leaving aside $5 billion in contingency and prudence reserves. The dramatic decline in the level of investment in programs — now at 50-year lows when measured as a share of GDP — clearly points to an urgent need for public reinvestment in social programs and public infrastructure. If the current US slowdown becomes more pronounced and continues to spill over the border, then the federal government should be prepared to use its fiscal leverage to help stimulate the domestic economy at the same time as repairing some of the damage caused by fiscal retrenchment in the 1990s.

Labour market stops and starts

The slowdown in fourth-quarter growth in 2000 spilled over into the labour market in the first two months of 2001. After a decline in January and little change in February, however, employment

Federal Government's Fiscal Outlook (billions of dollars)

	1999-00	2000-01 (e)	2001-02 (f)	2002-03 (f)	2003-04 (f)
Revenues	165.7	176.6	173.0	178.5	181.9
Program spending*	-111.8	-119.7	-125.4	-129.1	-132.3
Public debt charges	-41.6	-42.2	-40.3	-39.6	-39.4
Budgetary surplus/deficit	**12.3**	**14.7**	**7.3**	**9.8**	**10.2**
Closing debt	564.5	549.8	542.5	532.7	522.5
Real GDP	957.9	1,038.8	1,081.4	1,144.1	1,204.7
Real GDP growth rate (%)	3.5%	4.7%	2.6%	4.0%	3.6%
Revenues (% of GDP)	17.3%	17.0%	16.0%	15.6%	15.1%
Program spending (% of GDP)	11.7%	11.5%	11.6%	11.3%	11.0%
Debt/GDP ratio (%)	58.9%	52.9%	50.2%	46.6%	43.4%

**For fiscal years 2002 and 2003, it is assumed program spending rises in line with inflation and population growth only.*

did post unexpectedly strong gains in March and April. Despite the job gains, the unemployment rate remained unchanged at 7%.

On a regional basis, the labour market has soured considerably in the Atlantic region compared to one year ago. Between April 2000 and 2001, only Prince Edward Island posted any improvement. From Quebec to Alberta, there was little or no change in the unemployment rate. British Columbia bucked this trend and posted significant improvement, as the unemployment rate in the province is now below the national average for the first time since 1997.

The relatively weaker job market may be beginning to impact on earnings. Real weekly earnings, adjusted for inflation, declined slightly in 2000, but the average hourly earnings of working people finally began showing a long overdue improvement through the first three quarters of last year. Between January 2000 and January 2001, however, real average weekly earnings fell by 0.9%, with a 2.6% decline in the hard-hit manufacturing sector. Average hourly

Labour Market Indicators (%)

	1999	2000	April 2000	April 2001
Unemployment Rate	7.6	6.8	6.8	7.0
Men	7.8	6.9	6.9	--
Women	7.3	6.7	6.6	--
15-24 year olds	14.0	12.6	12.8	12.7
Participation Rate	65.6	65.9	65.8	66.1
Part-time rate	18.5	18.1	18.2	18.0
Self-employed rate	15.7	15.1	15.1	
Unemployment rates by province				
Newfoundland	16.9	16.7	15.8	16.6
Prince Edward Island	14.4	12.0	12.8	11.3
Nova Scotia	9.6	9.1	9.5	10.2
New Brunswick	10.2	10.0	10.2	12.3
Quebec	9.3	8.4	8.5	8.7
Ontario	6.3	5.7	6.1	6.1
Manitoba	5.5	5.6	5.1	5.0
Saskatchewan	6.1	5.2	5.8	5.6
Alberta	5.7	5.0	4.8	4.8
British Columbia	8.3	7.2	7.7	6.6

earnings, adjusted for inflation, also fell by 2.9% overall and by 2.7% in manufacturing industries. The danger now is that the current slowdown will continue to put downward pressure on earnings, just at the time that Canadian workers were finally beginning to share in the benefits of the last two years of strong economic growth.

Bank of Canada should revise inflation targets

Prices of goods and services in the Consumer Price Index rose 2.5% in March 2001 compared with one year earlier, the slowest rate of increase since August 2000. Excluding the impact of higher energy prices, the index rose 2.3%.

With inflation moderating, the Bank of Canada is in a good position to provide more monetary stimulus to the economy in the form of lower interest rates. In fact, recent experience has shown that the economy can tolerate rates of inflation higher than the mid-range of the Bank's 1 to 3 per cent targets. This is confirmed by the US experience that has demonstrated that unemployment rates can fall further than many central bankers had anticipated without triggering excessive inflationary pressures. Over the past decade, the US Federal Reserve has been far more tolerant of inflation over 3% and far more willing to push the envelope on employment growth than the Bank of Canada. There is an important lesson here for the Bank, particularly in the context of the current slowdown. It may be time for the Bank of Canada to consider raising its inflation targets to a 2 to 4% band and to aim to lower the Canadian unemployment rate, in the mid-term, to below 6%.

Average weekly and hourly earnings ($2000)

	1999	2000	Jan. 2000	Jan. 2001	% change Jan.2000-Jan. 2001
Average weekly earnings					
Industrial aggregate	656.03	653.55	659.31	653.37	-0.9%
Manufacturing	801.37	794.52	805.08	784.40	-2.6%
Average hourly earnings					
Industrial aggregate	16.09	16.52	16.71	16.23	-2.9%
Manufacturing	17.76	18.18	18.41	17.92	-2.7%

Note: Starting with the January 2001 data, the Survey of Employment, Payrolls and Hours is now publishing its estimates based on the North American Industry Classification System (NAICS). The NAICS-based estimates are not comparable with the previously reported statistics that were based on the Standard Industrial Classification (SIC) of 1980.

Some economists may be tempted to flag the apparent weakness in the value of the Canadian dollar as reason why the Bank should not move further to ease interest rates. However, the recent decline in the loonie has little to do with monetary policy. The Canadian dollar has fallen relative to the American dollar because the fear of a protracted US slowdown pulling other economies into recession has led to a safe-haven flow of funds into US securities. In fact, the worst hit currencies in recent weeks have been the euro and the yen, while the Canadian dollar, despite flirting with record lows, has fared comparatively better — it has appreciated against the Australian dollar, yen, euro and British sterling. Once fears of a full-blown recession ease, lower interest rates and larger trade deficits in the US will likely deflate the value of the American dollar.

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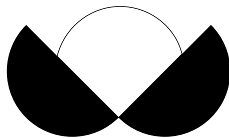

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