



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



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Recovery Loses Momentum

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Almost all of the incoming data have pointed to a global slowdown in economic activity in the second quarter. In the U.S., the housing sector's nascent recovery has screeched to a halt, exacerbated in the Gulf coastal states by the disastrous oil spill. Consumers have tightened their belts once again as retail sales and auto sales have slowed and confidence has waned. And the business sector continues to hoard cash and refrain from signing on new workers, using temps instead. The average duration of unemployment has now surged to another record-high, at 35.2 weeks; yet, the Congress has failed to extend unemployment insurance benefits, taking roughly \$40 billion out of the economy. Moreover, the new crisis for fiscal restraint precludes the possibility of further fiscal stimulus. Many countries, such as the U.K., the Eurozone and Japan, are actively cutting government spending and raising taxes. China, as well, has tightened sufficiently to cause the leading economic indicators to drop, with some suspecting the economy could slow to a 7.5% annual rate. Commodity prices have fallen sharply in response to weakening demand.

Banks worldwide have also been hoarding cash in anticipation of Basel III, the coming stricter rules on bank capital, liquidity and leverage. Canadian banks are carrying excess capital, while banks elsewhere are downsizing their balance sheets and reducing risk, all of which diminishes the flow of funds to smaller businesses and less-creditworthy households. The foreclosure problems in the U.S. continue to plague local economies, and state and local governments are laying off workers and cutting programs at an enormous rate. This puts more pressure on the federal government to assist the local authorities, exacerbating the federal deficit and encouraging further demands for spending restraint in Washington.

No wonder the stock markets have tanked and Treasury yields have fallen sharply. Deflationary forces are evident in the U.S., and will keep the Fed on the sidelines for months to come. But monetary policy alone can only do so much. Economists are arguing among themselves about the efficacy of fiscal stimulus, especially in the form of government spending programs. Some argue that they are ineffective in boosting the economy, having a multiplier effect of less than one. They suggest that tax cuts, particularly for business and investment, would reduce the deficits by boosting animal spirits and competitiveness. Those same people are against the extension of unemployment insurance benefits because they see it as a deterrent to aggressive job search, suggesting that a meaningful number of the long-term unemployed are refraining from actively looking for work or refusing low-paying jobs as long as the UI cheques are coming.

The other side of the argument is Keynesian, suggesting that government spending does boost economic activity and, while government debt is rising, the increase has been less than the decline in debt in the private sector. Without continued fiscal stimulus, the overall economy would be even slower, exacerbating the government budget deficit and prolonging the duration of unemployment. While this side might argue for tax cuts as well as spending increases, they would not suggest that the tax cuts would pay for themselves.

These inherently empirical questions theoretically could be resolved by testing their validity using real-world experience. Many point to the Reagan years to validate the supply-side argument that tax cuts, rather than spending increases, boost economic activity enough to reduce the budget deficit. Others point to the premature tightening in fiscal policy in the U.S. and Europe in the mid-1930s as exacerbating and prolonging the Depression. The problem is that the data are muddy and econometric analysis is too blunt a tool to “prove” either case, so reasonable people can argue extreme opposite positions with conviction.

Bottom Line: One thing we do know, the global economic recovery has lost momentum. The global economy is deleveraging, not in the government sector, but in the private sector to such an extent that total debt is falling, which inevitably slows growth. The proposed deficit-cutting measures in Europe and Japan will further slow economic activity, at least in the short-run. This slowdown will be compounded by the overhaul of global financial regulation, which will force banks worldwide to hoard additional capital, reduce risk, and thereby reduce the availability of credit—another undeniable dampener to economic activity. These actions will reduce household and business debt, but if governments, at the same time, constrain their own deficit spending, the economy will begin to contract once again.

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