NATIONAL BANK FINANCIAL

WEEKLY ECONOMIC LETTER

March 05, 2001

THE PERFECT STORM?

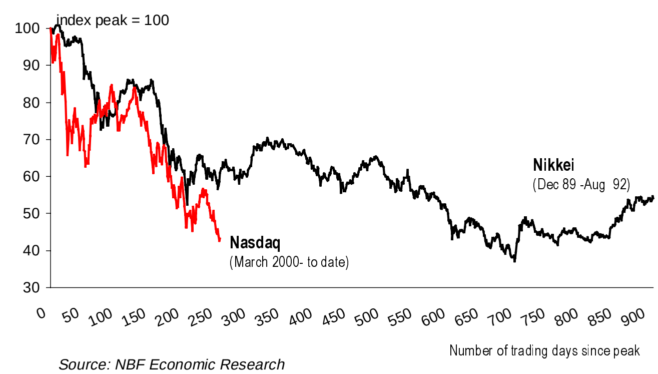
Key Points

- **Could the U.S. fall into a Japanese-style liquidity trap?**
- **Apart from the stock market meltdown, few parallels can be drawn between Japan in the early 1990s and the U.S. today.**
- **In Japan, lending remained bogged down despite the BOJ's efforts.**
- **The mechanisms for transmission of Fed monetary policy are working fine.**
- **Since the Fed cut rates, both money supply growth and bank lending have picked up. This is very encouraging.**
- **The Fed has been stepping hard on the accelerator given that the contraction in U.S. liquidity is relatively mild. Mr. Greenspan is clearly determined to limit the downside for the economy.**

No mercy

The tempest that hit stock markets nearly a year ago still rages. Captain Greenspan is doing his best to reassure everyone on board. He sees calmer seas ahead. But each new wave of downbeat economic and earnings reports seems bigger than the last, dangerously rocking the U.S. supertanker. Confidence is waning. Could this be the perfect storm?

(1) Replaying the Japanese Experience?
Japanese Nikkei, Dec. 89 – Aug 92, and U.S. Nasdaq, March 2000 to date



Source: NBF Economic Research

A year of decline

About a year ago the Nasdaq broke through 5000 and promptly hit the skids. Today the tech-heavy index is down 60% from that peak and equity markets remain stuck in the mud despite the Fed's heavy dose of easing. In this hostile environment, a debate has resurfaced: could the U.S. be reliving the Japanese experience of the early 1990s? As chart 1 illustrates, there are similarities at first glance.

The Japanese experience

The Japanese stock market began to slide in December 1989 and took nearly three years to stage an initial comeback. Even more dramatic is that more than a decade later, the Nikkei hasn't fully recovered yet.

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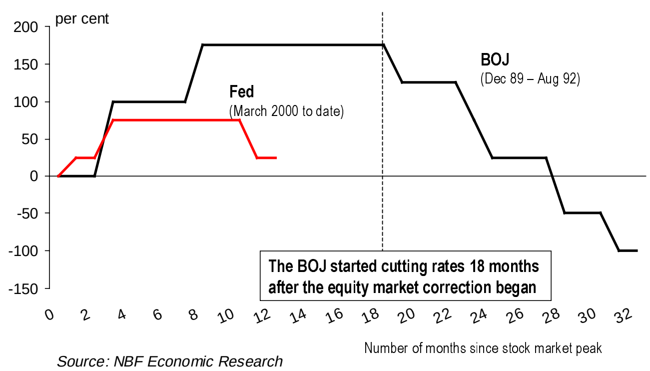
Is there a parallel between the U.S. now and Japan then? In our view, today's situation is quite different.

For starters, the Fed has moved much more quickly to alleviate market tensions. Eleven years ago, the BOJ continued raising rates for nine months after the Nikkei began sliding, 175 basis points in all (chart 2). It did not begin easing until a year and a half after the equity market downturn.

(2) A Very Different Story

BOJ, Dec. 89 – Aug. 92, and the Fed, March 2000 to date



Source: NBF Economic Research

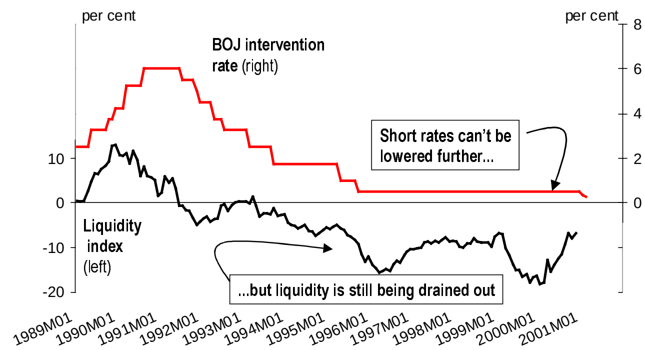
Out of order

There is much more to Japan's gloomy story. Things went wrong because the channels of monetary policy transmission stopped working properly.

When a central bank cuts its intervention rates, it is trying to pump liquidity into the financial system. Usually, the impact of its efforts first becomes apparent in money supply – the volume of money in circulation. For the economy to revive, however, the impact must ultimately be felt in lending volume. Sometimes, the pipes get clogged and rate cuts fail to boost lending. This is what happened in Japan.

(3) What's a Liquidity Trap?

The Japanese experience: BOJ intervention rate & NBF liquidity index



Source: NBF Economic Research

The liquidity trap

Chart 3 plots the BOJ's discount rate and our Japanese liquidity index (bank lending growth minus money supply growth).

After the BOJ started easing in July 1991, money supply growth picked up. But lending continued to fall, leaving our liquidity index stuck in negative territory. Under these conditions, the BOJ had no choice but to cut rates more aggressively. In a desperate attempt to revive a moribund economy, the discount rate was finally cut nearly 550 basis points, from 6.00% to 0.50%.

The problem was that even then, lending continued to contract. The BOJ had fallen into a liquidity trap (chart 3). With liquidity still draining out, the appropriate remedy was to ease further, but this is impossible when interest rates are already zero. Deflation sets in and real rates go up – the perfect recipe for keeping an economy down.

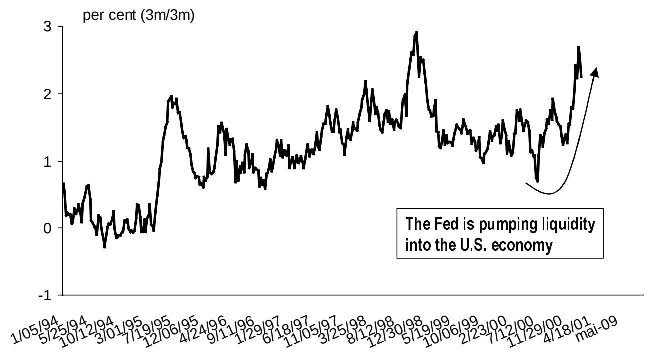
Japan's painful experience shows the extreme difficulty of getting out of a liquidity trap.

Is the U.S. at risk?

In our view, the risk of the U.S. falling into a Japanese-style liquidity trap is extremely low. So far, the Fed's monetary policy transmission mechanisms seem to be working fine:

Step 1. The Fed pumps liquidity into the economy. This is now apparent in the money supply, whose growth has picked up since the Fed cut rates (chart 4).

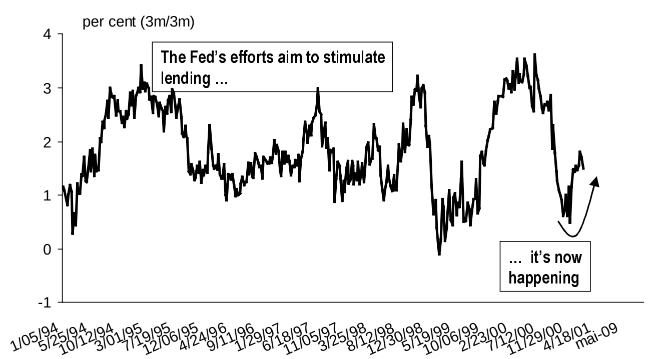
(4) STEP 1: Taps Wide Open
3-month change in U.S. money supply (M2)



Source: NBF Economic Research

Step 2. As noted earlier, the Fed's aim is to stimulate lending. This is now happening. Chart 5 plots the three-month change in U.S. commercial bank loans: lending volume is picking up.

(5) STEP 2: Lending Picks Up
3-month change in U.S. commercial bank loans

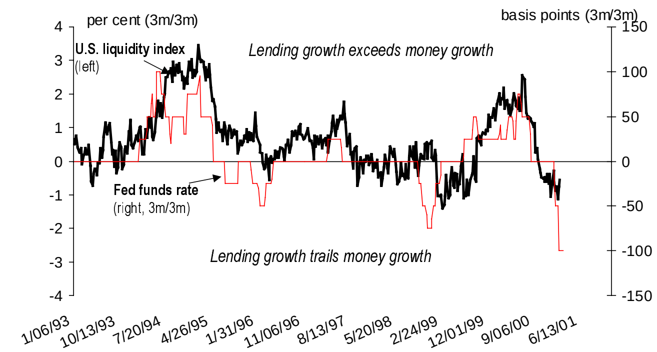


Source: NBF Economic Research

Step 3. The next phase is for lending growth to exceed money supply growth, as the multiplier effect kicks in. This is what our liquidity index measures. Chart 6 plots the three-month change in the fed funds rate together with our U.S. liquidity index (bank lending growth minus money supply growth). The fit is impressive.

What this chart shows is that the Fed tightens when lending growth outstrips money supply growth (i.e. when our liquidity index is positive and rising or high). The Fed cut rates when lending growth falls behind money supply growth (i.e. when our liquidity index is declining or negative).

(6) STEP 3: The Multiplier Effect Kicks In
U.S. liquidity Index (bank lending growth minus money supply growth) vs. fed funds rate (3-month change)



Source: NBF Economic Research

The current easing episode is not different. Our liquidity index went negative in October 2000, signalling lower rates ahead. Three months later, two consecutive half-point cuts were announced. Since then, the index has remained negative but seems to be bottoming. Both money supply and lending are picking up, but lending growth does not yet match money supply growth. In short, the multiplier effect hasn't kicked in yet.

Bottom line

Apart from the stock market meltdown, there are few parallels between Japan in the early 1990s and the U.S. today. In Japan, lending remained bogged down despite the BOJ's efforts, eventually pushing the economy in a liquidity trap.

In the U.S., the mechanisms for transmission of Fed monetary policy are working fine. Since the Fed cut rates, both money supply growth and bank lending have picked up. This is very encouraging. What's more, as chart 6 illustrates, the Fed has been stepping hard on the accelerator given that the contraction in U.S. liquidity is relatively mild. Mr. Greenspan is clearly determined to limit the downside for the economy.

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ECONOMIC CALENDAR : CANADA & UNITED STATES

The Week Ahead
(March 5 – March 9)

US Indicators

Date	Time	Release	Month	Previous	Estimate Consensus	Estimate NBF
06-Mar	08:30	Productivity	2000Q4	2.4%	2.0%	2.0%
06-Mar	08:30	Unit labor costs	2000Q4	4.1%	4.5%	4.2%
06-Mar	08:30	Factory orders	January	1.1%	-3.5%	-4.0%
09-Mar	08:30	Payrolls	February	268k	75k	60k
09-Mar	08:30	Unemployment rate	February	4.2%	4.2%	4.3%
09-Mar	08:30	Hourly Earnings	February	0.0%	0.3%	0.3%
09-Mar	08:30	Hours Worked	February	34.3	34.3	34.1
09-Mar	10:00	wholesale inventories	January	0.0%	0.0%	0.4%

Canadian Indicators

Date	Time	Release	Month	Previous	Estimate Consensus	Estimate NBF
06-Mar	**09:00**	**Monetary Policy Report**	**March**	**5.75%**	**5.50%**	**5.25%**
07-Mar	08:30	Help-wanted Index	February	177	175	174
08-Mar	08:15	Housing starts	February	174K	157K	159k
09-Mar	07:00	Employment	February	0.7k	2.5k	12k
09-Mar	07:00	Unemployment rate	February	6.9%	7.0%	6.9%
09-Mar	08:30	Capacity utilization	2000Q4	86.9%	86.6%	86.6%