

# **CORNERSTONE INVESTORS NETWORK**

## **ANNUAL ECONOMIC OUTLOOK and MARKET FORECAST**

**by Stewart Bishop  
January 27, 2007**



Archives at: <http://www.FullHouseTrader.com>

## FUTURES QUICKSCAN: SETUPS & TRENDS

Thurs, Jan. 25, 2007

Long/  
Short/  
Watch

### METALS

Copper	Strong W4 rally likely, towards 280-300. Bull trap. Thereafter a test of the 250 lows and W5 base building	
Lumber	Base building. Very low OI. Needs direction But W5 is in.	
Gold	Short pop upward is likely, no great opportunity	
Silver	Erratic pattern. Wait for it to clear up	
Platinum	Erratic pattern	
Palladium	Great long-side blip trade a few weeks ago. Sidelines.	
Lumber	Likely is forming an important intermediate bottom. Watch for long-side opportunities to set up.	W

### ENERGIES

Crude	Seasonal rally is favored. Thereafter picture is murky. Cannot rule out lower lows eventually.	L
H.Oil	Like it for a spike upward. Keep tight stops or hedge	L
Nat Gas	Watch this for long-side opportunities. Probably in process of building a base. H&S appearance.	
Gasoline	Very low open interest. A market waiting for action. Favor the long side here.	L

### GRAINS

Corn	Due for a rest at least. Most serious correction since rally began early 2006. Favor sidelines or hedged shorts.	S
Soybeans	Very bearish, short term, perhaps longer.	S
Wheat, C	Somewhat erratic. Let the pattern clarify.	
Rice	Likely to correct shortly. Sidelines	

## SOFTS

Cocoa	Great short-sale a couple weeks ago.	
Coffee	Probably one more upleg to this market, but getting a bit tired.	
Cotton	Likely to trade down towards lower end of range in sideways market	
O.J.	Very serious correction is most likely Thereafter review the pattern.	
Sugar	Be patient. A great long-side setup is developing Look for sugar to bottom between 9.00 & 9.50	W

## MEATS

Feeder C.		
Live C.	Congesting... pattern has sideways drift.	
Live H.	Locking into sideways price and indicator spiral. Open Interest very low. Watch to trade in the direction of any serious breakout.	W
Pork Bellies	Current 6 mo move a bit topy. Sidelines	

# **2007 FINANCIAL THEME: IMPACT of GLOBALIZATION**

**The much ballyhooed Age of Globalization is now here with major implications for markets & economies.**

- 1) Growth rate differentials**
- 2) Policy differentials. Ex: Some nations tightening while others are accommodating**
- 3) Creditor Nations vs. Debtor Nations**
- 4) Currency implications and pass-through effects on competitiveness & market attractiveness**
- 5) Other nations besides the U.S.A. are becoming drivers of the global economy. Unlike the past, they may be able to start or maintain a recovery when the U.S. is weak. In turn this “foreign momentum” may in time become a “3<sup>rd</sup> stimulus” to the U.S. economy, in addition to fiscal & monetary policy.**
- 6) “Perception and Policy Spillover”. Now that other nations’ policies are more globally important, their actions are now discounted in markets worldwide.**
- 7) Inflation risks as nation’s compete for limited resources.**

# Just How Good Is Globalization?

Question Is Pondered by Key Leaders Amid Workers' Worries

By **MARCUS WALKER**  
Davos, Switzerland

1-25-07

**T**HE BUSINESS and political leaders who gather every year at the World Economic Forum have long shared a creed: Globalization is good.

That still is generally true. But this year, many of them are questioning whether it is good for the ordinary wage-earning people they employ—or in many cases, no longer employ—at their companies.

A new refrain is emerging in Davos this year: Globalization isn't working for everyone.

Stagnating wages and rising job insecurity in developed countries are creating popular disenchantment with the free movement of goods, capital and people across borders. If unchecked, popular fears could turn into a political backlash that could lead to protectionism—or at least make broad free-trade agreements harder to achieve in the future.

"The anxiety is there, because we have competitors that didn't exist 10 or 15 years ago," German Chancellor Angela Merkel, who arrived in Davos yesterday, said in an interview last week. Governments in the developed world, she said, have to persuade their own middle class—a group used to a relatively stable economy in the postwar decades—to embrace a life of constant change and challenge.

In theory, less-developed countries win from globalization because they get jobs making low-cost products for rich countries. Rich countries win because, in addition to being able to buy inexpensive imports, they also can sell more sophisticated products like machine tools or financial services to emerging economies.

"The first win is there, but the second win is going to the owners of capital rather than labor," says Stephen Roach, chief economist at Morgan Stanley.

Many companies in the U.S. and Europe have been able to squeeze workers' pay increases by threatening to move production abroad. In the past decade, real labor incomes in the U.S. have grown at roughly half the rate of labor productivity, Mr. Roach says.

The reason for this is simple: With the emergence of China, India and countries from the

former Soviet bloc, companies from the established economies of North America, Europe and Japan have more choices on where to invest. That puts them in a stronger bargaining position with workers in their home countries.

"There is compression of wages as a result of the number of workers competing for jobs," says Laura Tyson, dean of London Business School. As a result, an ever-larger share of national income in the U.S., Japan and Western Europe is going to company profits. The share that flows to workers is dwindling, which explains why worker anxiety is becoming an election issue in the U.S. and elsewhere.

Others at Davos say the problem isn't capital versus labor, it is that changing technology and trade patterns put high-skilled workers increasingly in demand, reducing the demand for less-skilled workers. "Skilled workers are enjoying rapid wage increases, but unskilled workers have had very slow wage rises in recent decades," says Ken Rogoff, a professor of economics at Harvard University.

To be sure, many businesspeople in Davos believe the problem is one of perceptions, and that fears about trade undermining living standards in developed countries are misplaced.

"What can we do to educate politicians to the reality that a rising tide floats all ships?" asks E. Neville Isdell, chief executive of Coca-Cola Co. In politics, the voices of interest groups can outweigh the wider good, he says.

"We have to develop a less academic approach to explaining the benefits of globalization."

Mr. Isdell hopes governments will make the case that when U.S. companies move some jobs to China, the resulting gain in productivity can create a larger number of new jobs at home. The irony of heightened anxiety over job security, he says, is that it comes at a time of low unemployment in the U.S. and other advanced economies such as the United Kingdom.

The problem, many participants agree, is that workers in the West aren't equipped for today's pace of change, in which jobs come and go and skills can quickly become redundant.

"You have to have a better education system from preschool onward," says William McDonough, vice chairman of Merrill Lynch & Co. He recognizes, however, that improved education is a long-term remedy that won't help those feeling the pressure of rising global competition today.

"A shorter-term strategy is to have more assistance for workers who are laid off," Mr. McDonough says. "I think we need to be much more helpful as a society to people who are the victims of globalization." Such aid should be supported by the state, he adds.

Others support programs like the Scandinavian-style retraining of workers who lose their jobs. "Paradoxically, we need a bigger role of the public sector in the economy to make markets work better," says Nouriel Roubini, chairman of Roubini Global Economics, an online economic-advisory service.

## Labor vs. Capital

Where national income goes in the 13 euro-zone nations, the U.S., U.K., Japan and Canada



Sources: National sources; Morgan Stanley research

WSJ.COM

Globalization is contributing to ever-increasing corporate cash flow.

Job and other security may be less stable.

Wages not growing as fast in the industrial world.



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GLOBAL ECONOMIC  
OUTLOOK IMPROVES...

US 'powering buoyant world economy'

>By Scheherazade Daneshkhu and Krishna Guha in London

>Published: April 19 2006 21:30 | Last updated: April 19 2006 21:30

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The US remains the main engine of growth for the world economy, but most emerging countries – including China, India and Russia, are showing buoyant activity, the International Monetary Fund said yesterday.

The twice-yearly World Economic Outlook contrasted the state of the world's two most important regional laggards – Japan and the eurozone. While the Japanese expansion was now well-established, domestic demand growth in the eurozone remained subdued.

The IMF raised sharply its forecasts for growth in Japan, by 0.8 percentage points from September to 2.8 per cent this year and by 0.5 points to 2.1 per cent in 2007. And, although it raised its growth forecast for the eurozone to 2 per cent this year, it trimmed its forecast for next year to 1.9 per cent.

The main reason for the downgrade to next year's figures came from a more pessimistic view of growth in the Eurozone's major economies of Germany, France and Italy.

Although it believed that the expansion in the euro area "seems to be gaining some traction" it said consumption was still weak leaving the area vulnerable to shocks.

Household consumption was particularly weak in Germany and was expected to remain subdued until employment picked up and the effect of rising oil prices on incomes wore off.

The IMF listed a number of risks to its 2 per cent growth forecast for the eurozone, including a sharp rise in the euro and a renewed spike in oil prices. It also said the large rise in house prices in Spain and Ireland "could pose downside risks to consumption."

Its assessment of prospects for the eurozone contrast with the more optimistic pronouncements of the European Central Bank which started raising interest rates in December amid signs that eurozone economic activity was finally gaining momentum.

By contrast, the IMF regarded the upturn in Japan as "well-grounded" and remained "solidly on track." While cautioning that there were upside risks to growth and urging against interest rates being raised too quickly, it regarded the expansion as increasingly driven by domestic demand and "underpinned by rising employment, buoyant corporate profits, and a turnaround in bank credit growth."

Solid domestic demand would propel growth to 2.8 per cent this year, falling back to 2.1 per cent in

2007.

“Arguably, it would be better for the Chinese economy to avoid this higher inflation route to restoring external balance since inflation tends to distort markets,” the WTO said. “A more flexible exchange rate regime could enable China to operate a more independent monetary policy.”

While the IMF upgraded its forecast for global growth this year by more than half a percentage point to 4.9 per cent, it said the global economy needed a large fall in the dollar to correct imbalances.

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**Find this article at:**

<http://news.ft.com/cms/s/d6a0c57a-cfe2-11da-80fb-0000779e2340,s01=1.html>

Check the box to include the list of links referenced in the article.



**While the global economic outlook is reasonably strong, the IMF sees dollar depreciation as necessary to correct large trade and budget deficits.**

⑧

# Global Economy is Strong: Europe, Japan, India, etc.

Asia/Pacific

## Japan's Central Bank Remains Optimistic About the Economy

TOKYO—Japan's central bank produced an upbeat forecast for the economy, indicating that a further rise in interest rates this year is still possible—though unlikely.

Members of the Bank of Japan's policy board on average forecast that gross domestic product would grow 2.4% in the fiscal year that ends March 31, unchanged from their forecast in April.

They predicted the consumer-price index would rise just 0.3% from the previous year, compared with a 0.6% forecast in April—but that difference stemmed from a change in the calculation method for the index, and didn't reflect any shift in outlook.

"The economy is likely to experience a sustained period of expansion with domestic and external demand increasing," the bank concluded.

The report came in spite of recent soft economic data, which have pointed to weak consumer spending. Overall household spending fell 6% in September from a year earlier, marking a ninth straight month of decline, the government announced yesterday in the latest dowbeat news. Unemployment rose to 4.2% in September from 4.1% in August. The rate

Europe

## Inflation Declines, Confidence Index Rises in Euro Zone

BRUSSELS—The euro zone's economic picture continued to brighten yesterday, as reports showed that economic confidence in the 12 nations that use the euro rose to a five-year high in October while annual inflation unexpectedly fell to 1.6%.

Lower oil prices have helped keep annual inflation in range of the European Central Bank's goal of just below 2%. Annual inflation in the euro zone was 1.7% in September, down from 2.5% in May and June. October's figure is a first estimate; final data will be released Nov. 16.

Meanwhile, the European Commission said its index of economic sentiment among executives and consumers in the euro zone rose to 110.3 from 109.3 in September—the highest level since February 2001. Further good news came from France, where September's unemployment rate declined to a five-year low of 8.8% from 9% in August. But retail sales in Germany, where business sentiment had recently risen, fell 1.7% in September from the previous month.

Yesterday's data didn't change market expectations that the ECB will keep interest rates steady at its meeting tomorrow and signal a quarter-point rise.

## European Bank Holds Key Rates But Hints at Rise

By JOELLEN PERRY

FRANKFURT—The European Central Bank hinted at a quarter-point rise in benchmark interest rates next month but left rates unchanged at 3.25%, a move that was widely expected.

ECB President Jean-Claude Trichet said the bank's 18-member governing council will monitor possible threats to price stability with "strong vigilance," a phrase that has become associated with an imminent rate increase. The ECB sets monetary policy for the 12 nations that use the euro currency.

As U.S. growth continues to slow, a spate of rosy euro-zone data could represent the peak of the region's surprisingly resilient recovery. Still, the ECB and Mr. Trichet gave no signals about the possible path for interest rates in 2007.

Noting that the risks to euro-zone growth posed by a U.S. economic slowdown could be offset by lower oil prices

## Holding Steady

The European Central Bank left rates unchanged but signaled a possible increase next month. The ECB's short-term interest-rate benchmark:

GLOBAL ECONOMIC SNAPSHOT

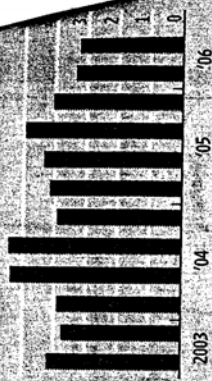
## Trade Balance/Latin America

Difference between exports and imports of goods and services; percentage of total gross domestic product, quarterly frequency

COUNTRY	LATEST	PREVIOUS	2006 FORECAST
Mexico	-0.79%	-0.06%	-0.99%
<b>Brazil</b>	<b>+3.25</b>	<b>+3.35</b>	<b>+3.82</b>
Argentina	+5.91	+4.86	+4.78
Venezuela*	+19.73	+16.12	+19.40
Colombia	+0.45	-0.08	-1.80
Chile	+15.34	+13.60	+12.43
Peru	+7.70	+4.99	+6.03

Note: A negative number indicates a trade deficit and a positive number indicates a surplus. \*Annual date

Source: Moody's Economy.com



## India Lifts Key Rate To Rein In Inflation Amid Economic Boom

MUMBAI, India—India's central bank lifted its main short-term lending rate in a cautious move to keep inflation and bank lending in check as India's economy booms.

The Reserve Bank of India raised its repurchase rate, or overnight lending rate, by 0.25 percentage point to 7.25%. The bank left its reverse repurchase rate, or overnight borrowing rate, un-

The rate increase is a step to try to lower the inflation rate and the surging amount of bank lending as India's economy continues to record some of the world's fastest expansion, said Reserve Bank Gov. Y.V. Reddy.

"Global conditions do not warrant an intervention," the governor told reporters, pointing to easing inflationary pressures from high oil prices. "But there are some signs of demand pressures" as the Indian economy grows, he added.

The central bank lifted its inflation-adjusted gross-domestic-product growth target for the year ending March 31 to around 8% from its earlier target of between 7.5% and 8%. The bank maintained its inflation target of 5% to 5.5%

WSJ 11-3-06

## Stronger Growth Is Forecast in '06 For EU Countries

A WALL STREET JOURNAL News Roundup The European Commission again raised its forecast for economic growth this year in the 12 countries that use the euro, predicting 2.6% growth, up from 1.4% in 2005. Growth for the 25-nation European Union as a whole is expected to rise to 2.8% from 1.7% in 2005.

"After years of disappointing results, the European Union economy in 2006 will be at its best since the beginning of the decade," said EU Economic and Monetary Affairs Commissioner Joaquin Almunia. The growth estimates were revised from September's forecasts of 2.5% for the euro zone and 2.7% for the entire EU.

GLOBAL ECONOMY STILL ROBUST... AND CENTRAL BANKS KEEP RATES TIGHT

13



# More Nations are Primary Global Economic Drivers

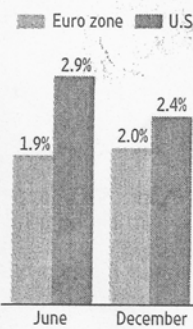
## Global Economy Gets Momentum Outside U.S.

**A**FTER YEARS of depending on the U.S. economy for support, the world economy may finally have its own legs to stand on.

The economy slowed throughout 2006 and seems to be starting 2007 without great momentum. Economists surveyed by Blue Chip Economic Indicators last month estimate that U.S. gross domestic product—the broadest measure of output—will grow 2.4% in 2007 versus 3.3% in 2006.

In the past, a U.S. slowdown would portend a global slowdown.

2007 GDP forecasts



Source: Blue Chip Economic Indicators

But economists have been ratcheting up their growth forecasts outside the U.S. For the euro area, they expect GDP to grow 2% in 2007, more than the 1.9% growth they projected in June. Forecasts for China have risen from 8.6% to 9.3%.

### Economists

like to call this decoupling. The U.S. and other economies seem to be going down different paths.

Deutsche Bank economists Peter Hooper and Torsten Slok see other examples. Movements in the Institute for Supply Management's monthly index of U.S. manufacturing activity have in the past foreshadowed similar changes in the Ifo Institute's index of German business sentiment by about six months. Over the past year, the relationship has broken down. The ISM index has trended lower but Ifo hasn't followed: it has surged.

Purchasing-manager reports for more than a dozen other countries show stronger manufacturing activity than the U.S. Only Greece lags.

Deutsche Bank economists say it's too early to declare an end to the world's dependence on U.S. growth. Globalization means interdependence should be deepening, not breaking down.

But maybe the U.S. will latch on to growth elsewhere. If the U.S. buys less from the rest of the world and the rest of the world buys more from the U.S., the U.S. trade imbalance could narrow, notes ITG economist Robert Barbera.

There are other ways for it to narrow, like a sharp drop in the dollar, followed by usurious interest rates or raging inflation. Decoupling might be a better way to get the job done

12-6-06

# Europe Gives Global Economy a Surprise Boost

Continued From First Page

market measures remain unpopular. But governments, companies and unions have made enough organic change to restore some of the Continent's lost dynamism. And better growth in the \$10 trillion euro-zone economy means better growth in the 25-nation European Union, whose \$14 trillion economy is about the same size as the U.S.'s and accounts for 30% of world GDP. (Twelve of the 25 EU nations use the euro.)

Europe's revival is reflected in the rising value of its currency, the euro, which at \$1.33 is close to its highest level ever against the dollar—\$1.36—touched at the end of 2004. That partly reflects dollar weakness against many other currencies, but it is also because currency markets believe the European Central Bank in Frankfurt will continue raising interest rates against a backdrop of solid growth.

Germany, for years the sick man of Europe, has led the revival, reclaiming its place as the region's growth engine. Painful measures to boost efficiency and productivity put German companies—especially makers of machine tools and other industrial equipment—in a strong position to exploit the recent boom in global trade. While other euro-zone industries haven't restructured in the same way, they have also enjoyed rising exports amid the fastest pace of global

here there are signs of improvement. Euro-zone consumption rose by 0.6% during the third quarter, helped by strong spending in Germany. In a sign of the retail market's gradual recovery, Europe's biggest retailer, Carrefour SA of France, recently announced a 7% rise in third-quarter sales, including more than 5% growth in France, where its megastores have struggled against fierce competition from discount chains in recent years.

But the robust outlook could still crumble if the euro rises further against the dollar into next year. The currency's appreciation is beginning to revive bad memories of 2003 and 2004, when a surging euro snuffed out embryonic upturns in the euro-zone economy.

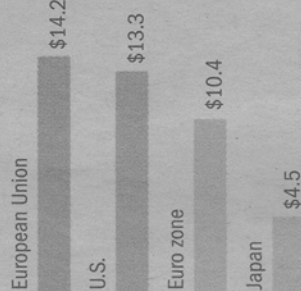
The impact was very bad in all industries competing with products made in the dollar area. My feeling is we will have a hard time in front of us," says Andrea Tomat, president of Italian sport-shoe maker Lotto Sport Italia SpA.

Other risks to Europe's revival include planned tax increases in Germany and Italy, whose governments are trying to rein in budget deficits to comply with EU fiscal rules. Germany's plan to raise its value-added tax—equivalent to U.S. sales tax—by three percentage points to 19% in January is causing particular worry, given the fragile confidence of German consumers. Most economists be-

### Engines of Growth

Among the top economies...

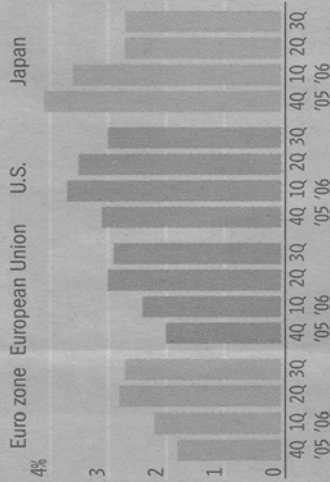
Estimated 2006 GDP, in trillions



Note: Euro zone includes 12 of the EU's 25 nations

Europe is picking up speed

Year-to-year percentage change in GDP



Sources: International Monetary Fund; Eurostat

European countries, but less markedly than in Germany. Companies in Italy, France and Spain haven't cut costs or jobs or raised productivity as aggressively as their German counterparts. Labor costs in Germany have fallen by nearly 1% a year on average since 2000, but have risen by nearly 4% a year in Italy in the same period, according to the European Commission, the EU's executive arm.

In Germany, the severity of the downturn and joblessness led to far-reaching

# ECB to raise interest rates as industrial output firms

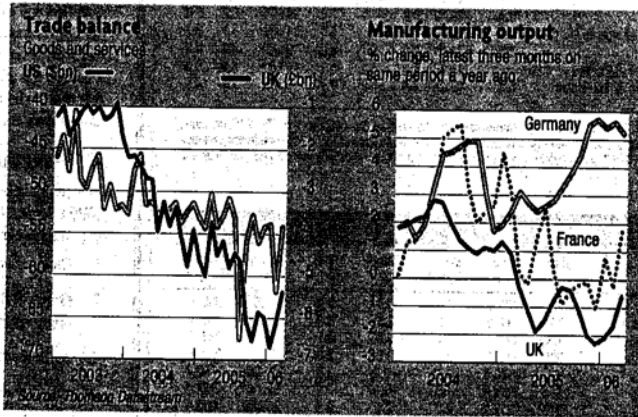
The European Central Bank is widely expected to raise interest rates by 25 basis points to 2.75 per cent on Thursday as growth in industrial output strengthens, while the Bank of England will keep rates on hold at 4.5 per cent as recovery in the UK's manufacturing sector remains more tentative.

A 50 basis points increase this week by the ECB is a real possibility according to the Royal Bank of Scotland, which highlights upward pressure on core inflation, a significant increase in consumers' inflation expectations and a clear improvement in manufacturing and services activity in the second quarter.

"Core inflation rates are set to rise further in the immediate future," said Kevin Gaynor of RBS. "Companies are attempting to pass on supply chain price increases and households seem resigned to higher inflation ahead."

Inflationary pressures will be evident in service sector purchasing managers' reports, due out this week. The prices charged by eurozone companies are rising at their fastest level for five years, while the new business measure continues to strengthen, pointing to a further improvement in activity levels. The employment measure has risen for six consecutive months and is at the highest level since March 2001. This ties in with the European Commission survey that reported the largest monthly fall in unemployment concerns on record.

Labour market improvements



but are expected to pick up. Eurozone retail sales figures, due on Wednesday, are expected to show a year-on-year rise from 0.2 per cent in March to 2.4 per cent in April.

On Friday, growth in German industrial production is forecast to rise from 3.9 per cent in March to 4.6 per cent in April, while French industrial production growth is expected to firm from 1.9 per cent to 2 per cent.

Recovery in the UK's industrial sector remains more muted but survey evidence is pointing to a gradual improvement as global demand strengthens. HSBC is forecasting year-on-year growth to remain unchanged at 0.3 per cent in April on Thursday.

The headline measure for UK service sector PMI is expected to ease back modestly in May but attention will focus on the prices charged measure, which has risen sharply since January.

improvement in May with higher spending on flat-screen televisions as consumers prepare for the football World Cup.

Friday brings UK trade data that have been distorted in recent months by valued added tax fraudsters. The underlying picture suggests the trade deficit has deteriorated and is acting as a drag on gross domestic product growth and that import prices are rising, which could push inflation higher. The consensus forecast is for the deficit to rise from £5.5bn (\$10.4bn, €8bn) in March to £5.9bn in April.

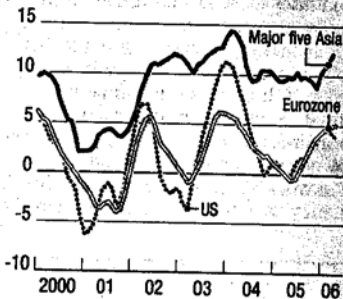
The dollar could come under renewed selling pressure with the release of US trade data on Friday. The US sucked in \$71.6bn (£55.4bn, £38bn) in petroleum imports in the first quarter, up 35 per cent on the same period a year ago. US oil demand remains robust and the total trade deficit is expected to widen.

## NUMBER IN THE NEWS: GERMANY IN THE LEAD

Change in leading indicator  
Percentage points (Apr 2005 to Apr 06)

Germany	6.2
Eurozone	5.5
OECD	5.2
Japan	4.7
France	4.6
US	3.9
China	3.6
Italy	2.8
UK	2.8
Canada	2.4

Trend in leading indicator  
Percentage change (annualised six-month rate)



The OECD published composite leading indicators, based on 5-10 aggregated short-term indicators, for a wider range of countries for the first time last week

Source: OECD

Moderate expansion lies ahead for the industrialised world as a according to OECD composite leading indicators. Expectations of s with last year, come mainly from countries that have recently bee and France have seen the largest jump in leading indicators in the weak and is joined near the bottom of the table by Canada and U

STRONG  
ECON.  
OUTLOOK  
GLOBALLY,

## ECONOMY

# Strong Japan data confirm upturn

By David Pilling in Tokyo

Japan's economy grew a real annualised 3.1 per cent in the three months to March, according to revised figures released yesterday.

The data gave further reassurance that Japan is on track to achieve its longest postwar recovery.

It compared with a preliminary number showing real annualised growth in gross domestic product of 1.9 per cent in the March quarter. That number, less than half the previous quarter's annualised growth, had disappointed some observers.

Quarter-on-quarter gross domestic product growth was revised up from 0.5 to 0.8 per cent. Annualised nominal growth grew 1.6 per

cent, compared with a preliminary estimate of just 0.2 per cent.

Japanese GDP numbers are frequently revised and the new set of data is more in line with original forecasts.

However, economists said the new figure would help the Bank of Japan, which is keen to end its zero interest rate policy within the next few months. Takehiro Sato, economist at Morgan Stanley, said: "I know the BoJ is getting quite nervous at the equity markets, so today's upward revision is encouraging."

Japan's benchmark Nikkei index has lost nearly a fifth of its value since peaking in March. Although falls have been precipitated by interna-

tional volatility and do not reflect Japan's economic fundamentals, economists have speculated that the BoJ would find it hard to raise rates while markets were falling.

The Nikkei index rose for the second day running yesterday after a straight week of decline, putting on 0.56 per cent to end up 82.17 points at 14,833.01.

Richard Jerram, economist at Macquarie Securities in Tokyo, said Japan's economic recovery had become much better balanced between exports and domestic demand. The latter had been pushed along by robust capital spending and gradually rising consumer confidence.

Jesper Koll, economist at

Merrill Lynch, said the domestic demand story remained intact, as profits gradually fed into better job security, higher wages and rising consumer confidence.

According to revised figures, personal spending, which accounts for 55 per cent of GDP, rose a real 0.5 per cent, compared with an initially reported 0.4 per cent. Exports rose 2.7 per cent but were outstripped by imports, which increased 3.5 per cent.

The fact that growth is domestically led is "ideal", said Mr Sato. "This implies Japan's economy is resilient to external shocks." The domestic demand deflator, a broad measure of prices, rose 0.1 per cent, a good sign deflation is being defeated.

ES

# Nations with positive trade balances are building huge exchange reserve stockpiles.

## China's Reserves Near Milestone, Underscoring Its Financial Clout

By ANDREW BROWNE

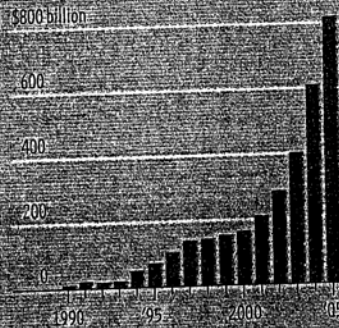
BELJING—Sometime in the next few days, China's holdings of foreign currencies and securities will top \$1 trillion—a sum greater than the annual economic output of all but nine countries. The rapid growth in these so-called foreign-exchange reserves has made Beijing a colossus in the financial world, cushioned against shocks at home, but potentially able to trigger them abroad.

How China manages its growing pool of wealth has major repercussions for the global economy. Beijing's reserves totaled \$987.9 billion as of Sept. 30 and are growing by roughly \$20 billion a month. That total compares with the about \$1.2 trillion in assets under management at U.S. mutual-fund giant Fidelity Investments.

As the pot grows, the secretive and sophisticated portfolio managers at China's central bank are trying gradually to boost their country's returns on its foreign-exchange holdings, at least in part by making somewhat riskier but higher-yielding investments. Last spring, an unsuccessful effort to divine their intentions sparked a

### Growing Nest Egg

China's foreign-exchange reserves



Source: China Statistic Yearbook

steep run-up in the price of gold.

For the U.S., how China deploys its reserves is a question of some consequence. Most of China's currency reserves are invested in U.S. dollar-denominated debt, such as U.S. Treasuries, which are considered the

*Please Turn to Page A9, Column 1*

Chinese Reserves Explode as  
They finance U.S. Deficits + Wars,

# Already deep in debt, the U.S. now borrows to finance wars. Cost and interest will be passed to future generations.

THE CHRISTIAN SCIENCE MONITOR  csmonitor.com

from the January 16, 2007 edition - <http://www.csmonitor.com/2007/0116/p01s01-usfp.html>

## How US is deferring war costs

**As war spending on Iraq and Afghanistan nears the levels for Vietnam and Korea, concern is rising over the 'borrow now, pay later' approach.**

By **Ron Scherer** | Staff writer of The Christian Science Monitor

NEW YORK

To pay for World War II, Americans bought savings bonds and put extra notches in their belts. President Harry Truman raised taxes and cut nonmilitary spending to pay for the Korean conflict. During Vietnam, the US raised taxes but still watched deficits soar.

But to pay for the ongoing wars in Iraq and Afghanistan, the US has used its credit card, counting on the Chinese and other foreign buyers of its debt to pay the bills.

Now, as President Bush is promising to boost the number of troops in Iraq, there is increased scrutiny over how the US is going to pay for it all.

The US is spending about \$10 billion a month on Iraq and Afghanistan. By the end of this year, the total funds appropriated will be nearly \$600 billion – approaching the amount spent on the Vietnam or Korean wars, when adjusted for inflation.

However, the actual impact of the war on the economy is different than in the past, largely because the US economy is so much bigger now. During World War II, some analysts calculate that the US spent as much as 30 percent of its gross domestic product (GDP) on the war effort. The Korean War, at its spending peak in 1953, represented 14 percent of GDP; Vietnam was about 9 percent. The current war, however, is less than 1 percent of America's annual \$13 trillion GDP.

### Payment due: in the future

The US can certainly afford the war, says budget analyst Stan Collender, a managing director of Qorvis Communications in Washington. But the spending is taking resources from other areas, he notes. Because the US is borrowing to finance the war, the cost will be borne by future generations. "And it's still going to be one of the most expensive wars we have ever fought," he says.

Unlike in previous major wars, the United States has cut taxes at the same time it has increased military spending. "It's fair to say all of the money spent on the war has been borrowed," says Richard Kogan, a senior fellow at the Center on Budget and Policy Priorities, a think tank in Washington. "But eventually everything has to be paid for."

### Congressional questioning

Congress hopes to hold hearings on the financial implications of the war before the president releases his budget proposal for fiscal year 2008 on Feb. 5. Democrats, now in the majority, plan to ask a wide range of questions,

## Euro displaces dollar in bond markets

Print

By David Oakley and Gillian Tett in London

Published: January 14 2007 22:08 | Last updated: January 14 2007 22:08

The euro has displaced the US dollar as the world's pre-eminent currency in international bond markets, having outstripped the dollar-denominated market for the second year in a row.

The data consolidate news last month that the value of euro notes in circulation had overtaken the dollar for the first time. Outstanding debt issued in the euro was worth the equivalent of \$4,836bn at the end of 2006 compared with \$3,892bn for the dollar, according to International Capital Market Association data.

Outstanding euro-denominated debt accounts for 45 per cent of the global market, compared with 37 per cent for the dollar. New issuance last year accounted for 49 per cent of the global total.

That represents a startling turnabout from the pattern seen in recent decades, when the US bond market dwarfed its European rival: as recently as 2002, outstanding euro-denominated issuance represented just 27 per cent of the global pie, compared with 51 per cent for the dollar.

The rising role of the euro comes amid growing issuance by debt-laden European governments. However, the main factor is a rise in euro-denominated issuance by companies and financial institutions.

One factor driving this is that European companies are moving away from their traditional reliance on bank loans – and embracing the capital markets to a greater degree.

Another is that the creation of the single currency in 1999 has permitted development of a deeper and more liquid market, consolidated by a growing eurozone.

This has made it more attractive for issuers around the world to raise funds in the euro market. And, more recently, the trend among some Asian and Middle Eastern countries to diversify their assets away from the dollar has further boosted this trend.

René Karsenti, executive president of ICMA, said: "It is the stable interest rates in Europe that have helped and the fact that [the euro] has strengthened and shown resilience."

Since the start of 2003, the European Central Bank's main interest rate has fluctuated only 1.5 percentage points, ranging from a low of 2 per cent in the middle of that year to 3.5 per cent, its rate today.

In comparison, the Fed funds rate, the main US interest rate, has fluctuated 4.25 percentage points, ranging from 1 per cent in the middle of 2003 to 5.25 per cent, its level today. The euro has also risen to trade around \$1.30 against the dollar, from around parity three years ago. Sterling issuance has grown in the past three years, reinforcing its attraction as a niche currency among some investors. The yen, in comparison, has fallen out of favour.

Overall, international capital markets have doubled in size in terms of bond issuance during the past six years.

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**ERM unified  
currency created  
a deeper market**

**Central banks  
diversify away  
from the dollar**

**Euro interest  
rates are more  
stable**

Euro economists discuss merits of devalued dollar...  
 Would not consider it unless Asians were participating...

# ECB May Continue Raising Rates

*European Bank Chief Hints At Slower Pace of Increases Amid Inflation Risk, Growth*

By JOELLEN PERRY

FRANKFURT—The European Central Bank looks set to continue raising interest rates after yesterday's increase, but at a slower pace than at present, amid strong growth and inflation risks.

In comments after the central bank raised its key interest rate for the 12-nation euro zone by a quarter point to a five-year high of 3.5%, ECB President Jean-Claude Trichet said interest rates remain "low" and inflationary risks lie "on the upside."

Mr. Trichet also implied the central bank might slow from its every-other-month pace of interest-rate increases to monitor economic data early next year, when a stronger euro and a German sales-tax rise could cloud the economic outlook.

European stock markets neared a 10-day high after Mr. Trichet's comments, as traders priced in a slower rate-raising cycle, although some economists still believe the ECB will raise rates in February.

Mr. Trichet said he shared the view of the Federal Reserve that a U.S. economic slowdown would be "smooth," and declined to comment on the euro's recent sharp strengthening against the dollar, which could damage euro-zone exports by making them more expensive.

The euro has surged more than 4% against the dollar in the past three months, in part on expectations that the ECB will continue to raise rates, in contrast to the Fed. Mr. Trichet repeated earlier comments that "excessive volatility" in currency markets is unwelcome.

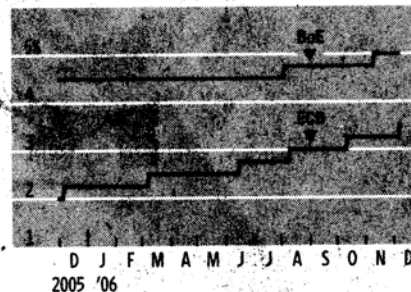
The Bank of England left rates in Europe's second-biggest economy on hold at 5%. The pound hit a 14-year high of \$1.98 last week, a change that some analysts say could moderate further rate rises, even as inflation risks mount. Home prices in the United Kingdom rose at an annual rate of 9.6% in the three months to November, the fastest pace since March 2005, according to the Halifax House Price Index.

## A Fine Balance

The euro's surge didn't keep the European Central Bank from raising interest rates yesterday, while the Bank of England left its key rate on hold amid the pound's rise.

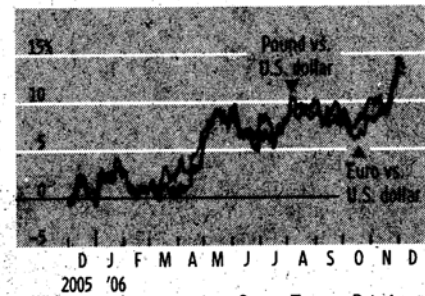
### The Rates

Short-term interest rate targets



### The Currencies

Cumulative percentage change



Source: Thomson Datastream

Economists note that the ECB focuses more on the euro's trade-weighted average, which measures its value against a basket of currencies, than on its value against the dollar.

"They [the ECB] say a dollar decline is part of a desirable sort of global rebalancing," says Erik Nielsen, chief European economist for Goldman Sachs in London. "But the big thing about that is that it should be accompanied by Asian currency appreciation, which hasn't happened yet." Mr. Trichet declined to elaborate on Asian currency movements.

Underlying the ECB's sixth interest-rate rise in a year is policy makers' belief that inflationary pressures persist, even though November's inflation rate of 1.8% compared with a year earlier was below the central bank's ceiling of just under 2%.

The ECB's concerns include money-supply rates far above the bank's preferred range, the potential bleed-through of oil's past highs into other prices, and Germany's planned tax increase.

With economic growth strong and unemployment lower than in recent years at 7.7%, policy makers also worry that wage gains could stoke inflation.

Mr. Trichet said wage gains should "take into account productivity developments...[and] the still-high level of unemployment."

German engineering and metalworkers, due to start salary negotiations in

February, have won political backing for calls to end an era of wage restraint that has kept companies competitive.

Noting that "domestic growth in the euro zone is expected to maintain its relatively strong momentum," Mr. Trichet also unveiled new projections from euro-zone central-bank staff who foresee stronger-than-expected growth and moderating inflation this year and next, suggesting the area could weather a U.S. slowdown better than previously expected.

Progress remains uneven, however. Italian third-quarter gross-domestic-product growth of 0.3% showed a decline in exports, which could sharpen if the euro continues rising.

The new central bank projections now see 2006 euro-zone gross-domestic-product growth of 2.5% to 2.9%, up from a September forecast of around 2.5%. Growth next year could range from 1.7% to 2.7%, also a bit higher than forecast in September. The projections included 2008, with growth forecast of 1.8% to 2.8%.

Lower oil prices also should bring down inflation in the near future, Mr. Trichet said, noting the new projections' revised inflation expectations for 2006 downward, to a new range of 2.1% to 2.3%, while the inflation rate next year will run 1.5% to 2.5%. Previous forecasts called for an inflation rate around 2.4% this year and next. The forecasts show 2008 inflation of 1.3% to 2.5%, with a midpoint of 1.9%, squarely within the ECB's preferred range.

A variety of regulatory policies going on simultaneously  
 Some nations tightening, some expanding... How  
 Might the policies of one affect the others?

# Asia considering a Unified action to bring about Orderly revaluation (decline) of the dollar...

## Leading Asian Economist Urges Joint Action on Dollar

By KEITH BRADSHAW

HONG KONG, Dec. 7 — A senior Asian Development Bank official said on Thursday that the dollar was likely to decline further, and he called for East Asian countries to make sure that their currencies rose in unison and did not diverge.

The remarks by the official, Masahiro Kawai, represented the first time that the bank — or for that matter, any important monetary institution in Asia — had urged collective action by East Asian nations to manage the current slide of the dollar. National monetary authorities in the region together hold more than \$3 trillion in foreign reserves, most of it in dollars, and their huge purchases of dollars this year have played a crucial role in limiting the American currency's decline until now.

"We believe that some U.S. dollar depreciation would be necessary, and collective joint appreciation of the East Asian currencies could be needed" to manage the decline, Mr. Kawai said. "It's very important for

the East Asian currencies to appreciate collectively against the U.S. dollar."

He said further that China had accumulated excess foreign exchange reserves by intervening in the market to hold down the value of its currency, known as the yuan or the renminbi. Large foreign exchange reserves in China — they exceeded \$1 trillion in October, according to the official news media — and elsewhere in East Asia are also making it harder for countries to control their own monetary policies, and they run the risk of incurring losses in the management of these reserves, Mr. Kawai said.

"If there had been no foreign-exchange market intervention," he added, "the renminbi would have been appreciating at a much faster rate."

That stance is likely to be welcomed and echoed next week by Treasury Secretary Henry M. Paulson Jr. when he travels to Beijing with Ben S. Bernanke, the Federal

Reserve chairman, and a delegation of cabinet officials.

Mr. Kawai is one of Japan's most influential economists and has served as an adviser to the Federal Reserve, the International Monetary Fund, and the Japanese central bank, as well as chief economist for East Asia and the Pacific at the World Bank.

Though he cautioned that the Asian Development Bank was not making its own forecast on the value of the dollar, Mr. Kawai said that the consensus among economists was that the American current-account deficit — the broadest measure of trade — could be substantially trimmed only if the dollar declined by an average of 30 to 40 percent when weighted by the portion of American trade conducted with each country.

If their currencies appreciate together, Mr. Kawai said, East Asian economies can withstand a 30 percent decline before the weakening dollar makes their exports too ex-

pensive. The United States accounts for no more than a fifth of the exports of even the biggest Asian exporters, he said.

So even if the value of the dollar declined 20 percent, and East Asian currencies moved as a bloc, Mr. Kawai said, the trade-weighted appreciation would be only about 4 percent — a fifth of 20 percent. That, he said, would be manageable.

East Asian economies "can cope with a significant appreciation, *vis-à-vis* the United States if it's managed in an appropriate way," he said.

Currency experts said that while the coordination suggested by Mr. Kawai would be useful, it would be hard to achieve, given the competing interests of countries in the region, their differing relationships with the United States and their varying domestic economic challenges.

If the dollar looks as if it is certain to slide, then the central bank that sells a large chunk of its dollar reserves first may preserve a greater share of the value of its foreign currency holdings than other central

## Dropping Dollar Is Pushing UAE Toward the Euro

Associated Press

DUBAI, United Arab Emirates—The wilting U.S. dollar is pushing the United Arab Emirates, a close U.S. ally, to convert eight percentage points of its foreign-exchange reserves into the healthier euro, the central-bank governor said.

The Emirates' nearly \$25 billion currency reserves are currently 98% dollars. That percentage will drop to 90% in six to nine months if the bank's directors approve the switch, as is expected, Central Bank Governor Sultan Bin Nasser al-Suwaidi said.

The sale itself is a small one, worth about \$2 billion. But the implications of a cash-rich friend of Washington selling off its dollars is a sign that central banks elsewhere may be looking to cut losses from a dollar widely expected to slip further in 2007.

"It's a prudent move, and it's indicative of broader thinking," said Simon Williams, HSBC's chief Middle East economist. "It's another factor that will exert downward pressure on the dollar."

Late in New York yesterday, the dollar was at €1.3146, from €1.3125 late Wednesday.

A bigger worry for the U.S. Federal Reserve is that the six energy-rich Gulf Arab countries may consider converting dollar holdings in their far larger government investment funds, which Mr. Williams said keep more than \$1 trillion under management. Gulf governments typically don't release the compositions of those funds.

"If they're moving those assets out of the dollar on the same scale, that's a much bigger deal," Mr. Williams said.

Selling dollars on that scale could force the Fed's hand toward tightening monetary policy to help support the dollar. That would mean higher rates for adjustable mortgages, auto loans, credit cards and other debt.

The six Gulf Cooperation Council countries—the Emirates, Saudi Arabia, Kuwait, Qatar, Bahrain and Oman—enjoy a collective current-account surplus of about \$220 billion this year, which must be invested in foreign assets.

With a faltering dollar, Mr. Williams said a smaller amount of that energy surplus will flow into U.S. assets.

"A good chunk of that will still flow toward the U.S., but less than in the past," he said. "The Fed will be watching this very closely."

## Dollar role as reserve currency is diminishing somewhat...

As global growth improves, central banks increase tightening... Perceptions of Tightening, and "spillover of policy" will increasingly affect the markets.

# Is Easy Money Going Down the Drain?

*Anxious Markets Closely Watch Push by World's Central Banks To Cut Off a Speculative Binge*

By E.S. BROWNING  
And JUSTIN LAHART

6-5-06

**T**HE PROBLEMS ROILING the world's financial markets lately can be summarized in a simple sentence: Central bankers are draining away some of the easy money that has made investors' lives comfortable for years.

Whether once-hot investments such as Florida condos, developing-country stocks, gold and copper recover or continue to cool could depend on how serious the central bankers decide to be. If they keep mopping up the excess liquid cash they had helped pour into the markets, they will eventually slake the world's thirst for speculative investments, forcing investors toward established stocks, government bonds and other safe investments. If they decide to go easy, as Japanese officials recently have been doing, then maybe some of the speculative investments can hang on.

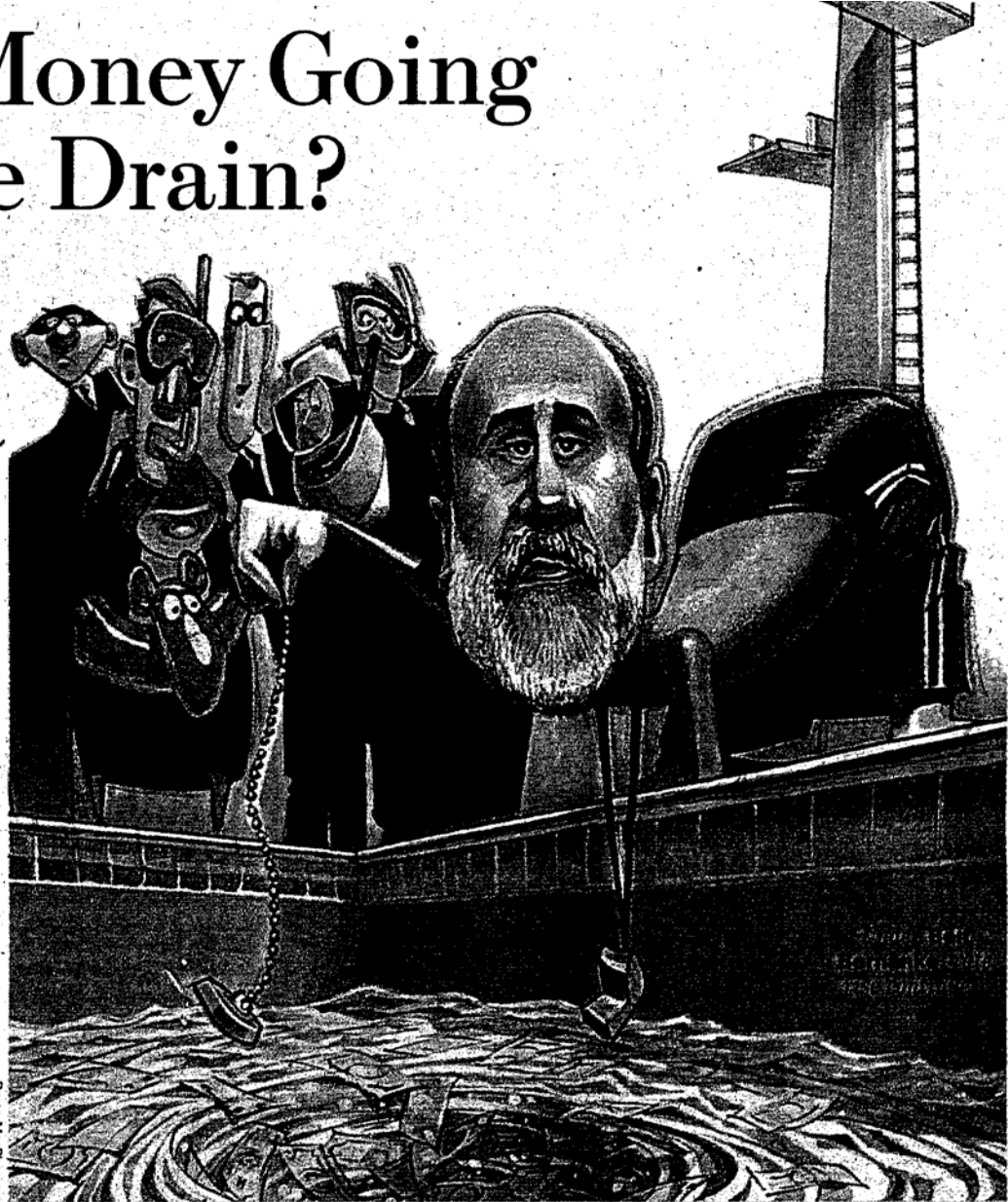
"The question of our time is how much do we, the markets, have to have our hand held by a promise from the central banks to always be kind and gentle," says Paul McCulley, a fund manager and economist for bond-fund giant Pacific Investment Management Co.

The situation stems from the painful 2000-2002 bear market. Fearing price deflation that would cause a recession or even depression, central bankers slashed rates and pumped money into the world's financial system by buying bonds, funneling deposits into commercial banks and generally tossing money at the problem.

They avoided economic disaster. But the side effect was an eruption of questionable investments. Companies couldn't use all that cash to build businesses, so a lot wound up in the financial markets. Speculators borrowed at tiny interest rates in Asia and profited by buying higher-yielding bonds in the U.S. Americans loaded up on cheap mortgages, plasma television sets and real estate. With the world economy booming, the speculative money flowed not only into copper and zinc, but also into gold; silver—even timberland.

Many investment pros think those speculative days are gone. "My brother-in-law is no longer flipping condos in Miami. His credit line has been

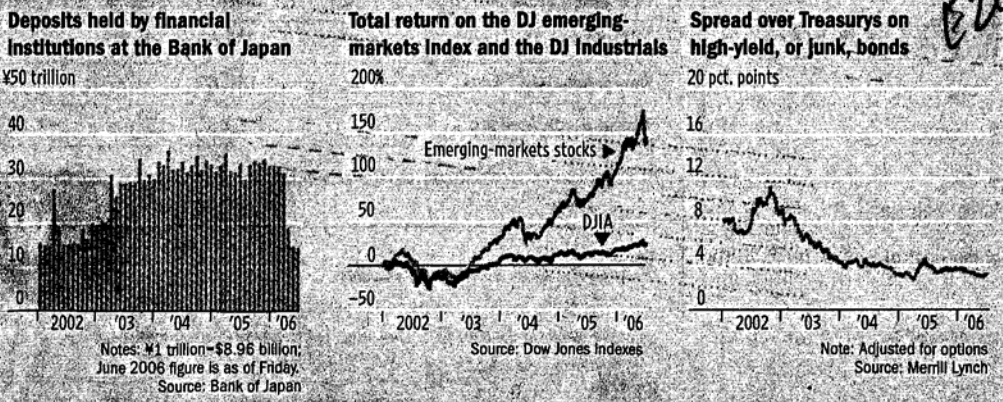
Please Turn to Page C7, Column 4



Bruce MacPherson

## Risky Business

As central banks in Japan and elsewhere reduce the flood of easy money, less-safe stocks have suffered. Yet investors are accepting junk-bond yields that are just a bit higher than those on less-risky Treasuries.



E20