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GLOBAL ECONOMIC OUTLOOK IMPROVES...

US 'powering buoyant world economy'

>By Scheherazade Daneshkhu and Krishna Guha in London
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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."

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

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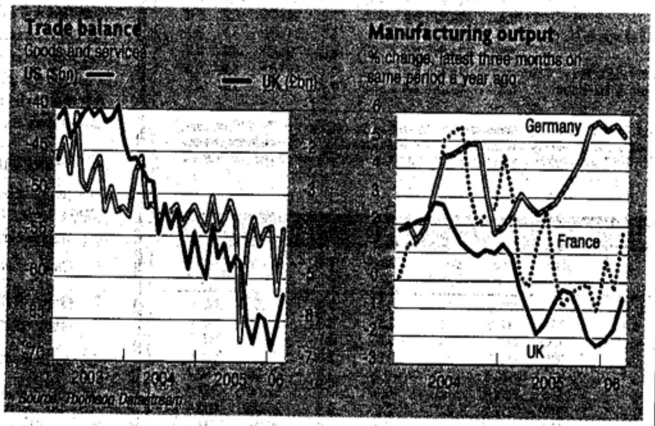
6-5-06

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.

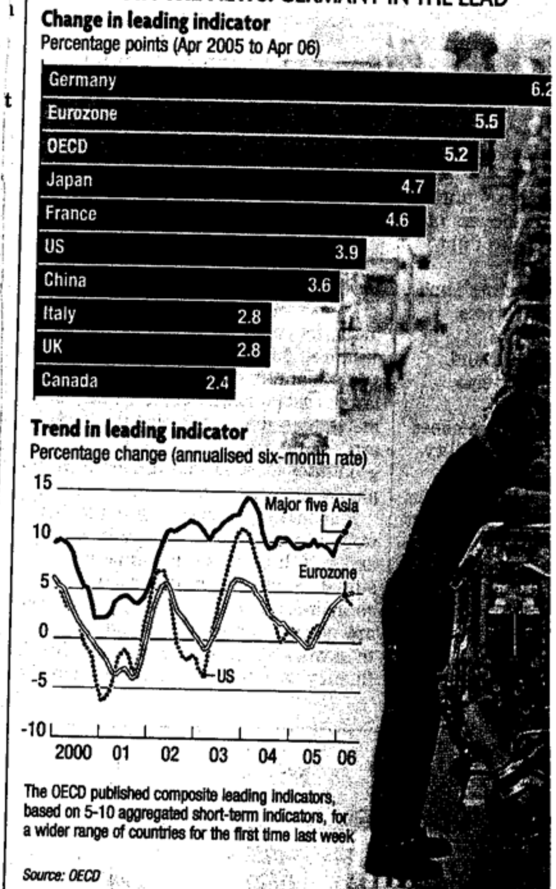
Recovery in the UK's industrial sector remains more muted but survey evidence is pointing to a gradual improvement as global demand strengthens. HSBC is forecasting year-on-year growth to remain unchanged at 0.3 per cent in April on Thursday.

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



Moderate expansion lies ahead for the industrialised world as a w... 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 international 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.

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Good News: World's 2nd largest economy emerges from decade of the doldrums

BCA RESEARCH

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April 4, 2006

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JAPAN: THE SUN FINALLY RISES

- It has taken a long time, but corporate and financial restructuring in Japan have made significant progress in unwinding the excesses and imbalances created by the burst asset bubble of the 1980s.
- A more broad-based economic recovery is taking hold in Japan and the era of deflation is ending. However, policymakers will need to remain cautious about tightening monetary and fiscal policy.
- There are still huge long-run challenges related to a rapidly aging population, a grim fiscal picture and an inefficient service sector. It remains to be seen whether policymakers will take the necessary action needed to deal with these problems.
- The equity market has already risen strongly, but renewed buying by domestic investors should push prices higher over the next year. It is too soon for global investors to cut positions.
- The outlook for Japanese bonds is bearish. The yen should appreciate, but the country's structural problems suggest that it may need to stay a relatively cheap currency by historical standards.

Japan's economy has, at last, succeeded in emerging from its prolonged adjustment phase, which continued for more than a decade, and has embarked on a sustainable growth path with price stability.

Toshihiko Fukui
Governor of the Bank of Japan
March 16, 2006

Into The Light?

Japan's economic performance during the past 15 years has been the worst of any major industrialized country since the Great Depression, reflecting a classic case of post-bubble economic and financial fallout, compounded by disastrous policy errors. Real GDP increased at an annualized pace of only 1.5% between end-1989 and end-2005, half the rate of U.S. growth.[1] However, the country does seem to be finally moving from the economic darkness into the light.

The key reason for optimism is the major progress in unwinding the large excesses and imbalances that were the legacy of the burst asset bubble. The corporate sector is now in good health, the banking system is making good progress in strengthening balance sheets, and the era of deflation is drawing to a close. Moreover, policymakers are unlikely to repeat the previous mistake of tightening prematurely.

The equity market has already responded to the improved outlook, with the TOPIX index rising by more than 40% in the second half of last year. Since then, the index has consolidated, but has just edged above a major resistance level where it peaked on

1 The contrast is even starker in nominal terms with annualized growth of 1.1% in Japan and 5.3% in the U.S.

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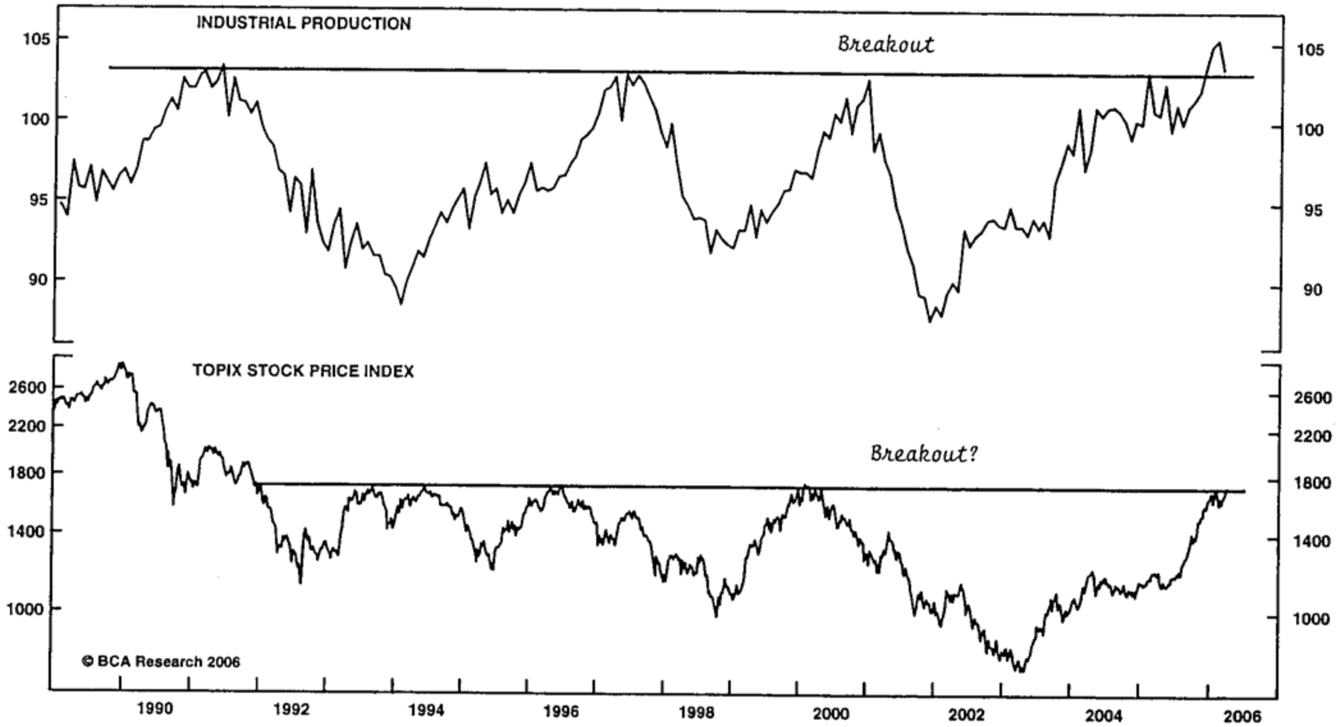
CHART 1
Breaking To The Upside



four previous occasions (**Chart 1**). If this breakout is sustained, it will cement the view that Japan's fortunes have indeed changed for the better.

Before bringing out the champagne, it is important to remember that Japan still faces three serious structural challenges: a rapidly aging population, a grim fiscal situation, and a highly inefficient service sector. These are well-known problems and should already be at least partly discounted in the markets. However, they do create the potential for negative surprises over the medium term.

On balance, we share the positive view of the outlook for the next year or so. The stock market still has upside potential, and the currency should appreciate. Thus, global investors will benefit by having overweight positions in Japanese equities. The corollary is that a return to economic health is bearish for Japanese bonds. The longer-run outlook is still shrouded in uncertainty. The potential for sustained growth is certainly there, but much will depend on whether policymakers take the tough action necessary to deal with the difficult structural backdrop.

Working Through The Post-Bubble Adjustment

During Japan's boom years of the 1980s, there was massive investment in unproductive areas (especially real estate), financed by banks using very lax lending standards. The subsequent bust left the economy with a crushing burden of excess labor and capital, and a wrecked banking system. If that was not bad enough, a timid and delayed response by the Bank of Japan (BoJ) allowed the economy to slip into deflation, and this was exacerbated by some misguided fiscal restraint.

The remarkable aspect of Japan's post-bubble experience was how long it took for the authorities to realize the severity of the situation and take appropriate action. For example, the BoJ only

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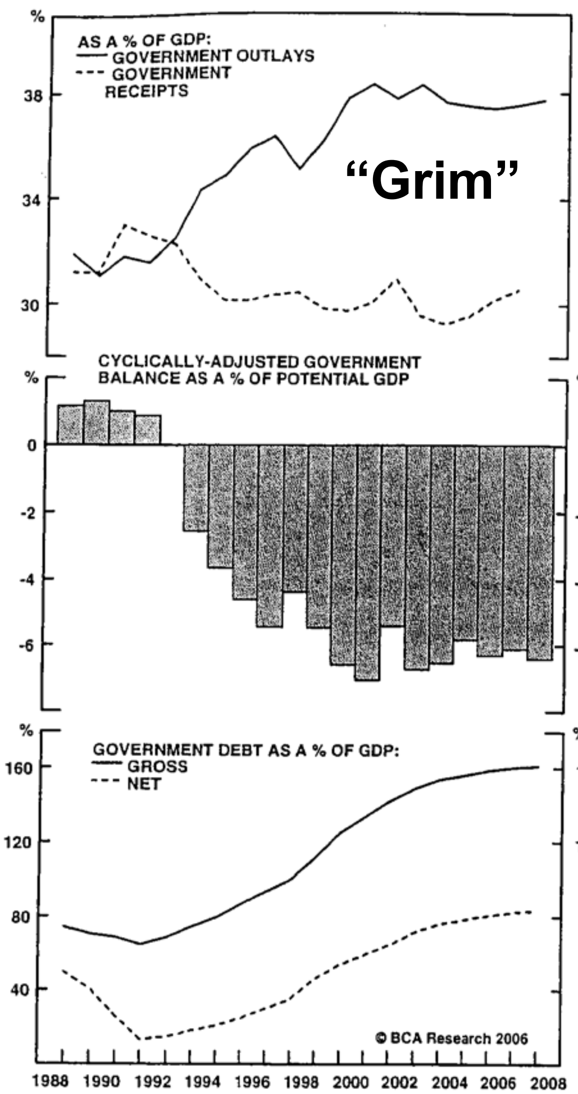
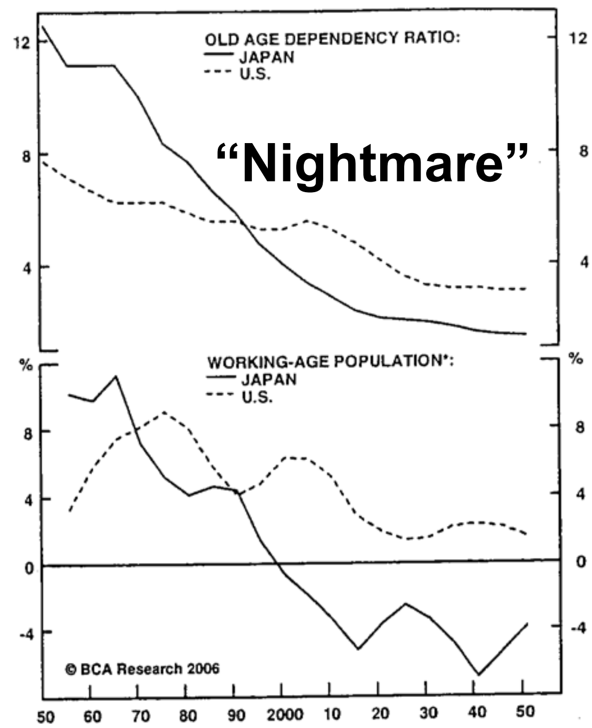
Bad News: World's 2nd largest economy faces a huge Baby-boom retirement financing problem.

CHART 11
The Fiscal Situation Is Grim



SOURCE: OECD

CHART 10
A Demographic Nightmare



SOURCE: UNITED NATIONS, 2004 POPULATION REPORT
*POPULATION AGES 15 TO 64 SHOWN AS A % CHANGE OF 5 YEARS

Structural Challenges

It is well known that Japan faces severe demographic problems because of its rapidly aging population. The ratio of those of working age (15 to 64) to those over 64 has dropped from 6.6 to 3.3 in the past 20 years and is projected to fall to only two in the coming decade. In comparison, in the U.S. there is projected to be 5 people of working age for every retiree by 2015 (**Chart 10**).

The rolling five-year growth rate of the 15-64 year age cohort has already dropped below zero in Japan and will move deeper into negative territory in the years ahead. Conversely, growth in the U.S. will slow, but will stay positive.

Demographic trends in Japan will have powerful effects. It is clearly very negative for fiscal trends as fewer taxpayers will be supporting a rising number of elderly who will require pensions and increasing amounts of medical care. At the same time, a falling labor force implies a very low growth rate for potential GDP — probably in the 1% to 1½% range over the medium term. Moreover, an aging population is not likely to be dynamic or conducive to accelerating productivity growth.

As the population ages, Japan's high saving rate should come down, as should its trade surplus. Fortunately for Japan, it is a huge international creditor nation, and it may increasingly become a rentier nation, living off the income of its overseas assets.

Japan could partially solve its demographic crisis with more immigration, but that seems unlikely to occur any time soon. This means that there will not be any rapid economic growth to bail the country out of its fiscal mess. The authorities face the

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Part of unclear perceptions: are global central banks tightening too much?

As global growth improves, central banks increase tightening…

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.

ABREAST OF THE MARKET

THE 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

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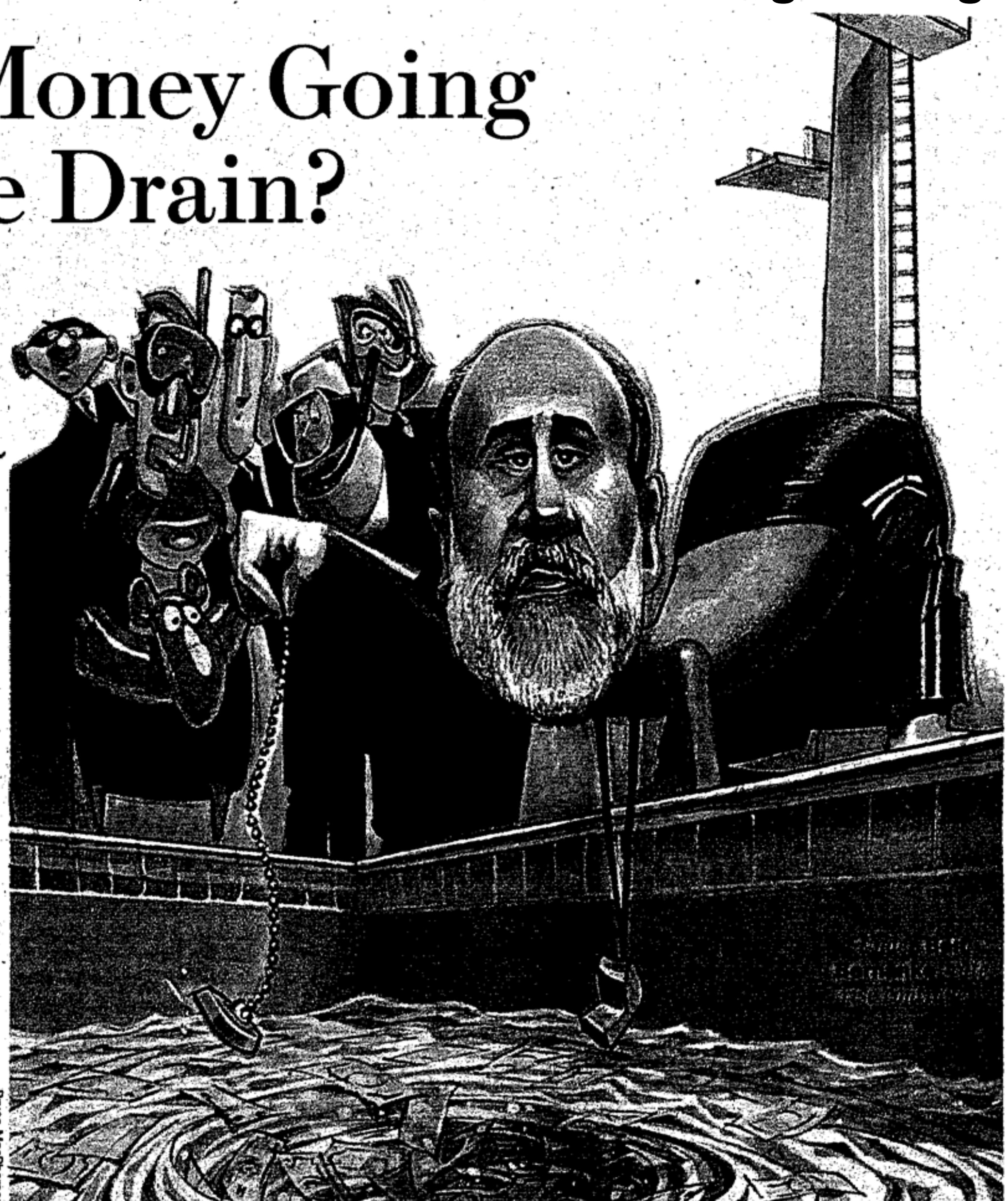


Bruce MacPherson

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 Treasurys.

E20

Global tightening may hit smaller emerging markets hardest…

The fear of central bank tightening is one factor driving the current round of global market turmoil….

A rebound in world markets may not favor those worst hit
MUTUAL FUNDS A7-11

Michigan's economy is in need of the power of the free market
VIEWPOINT A13

World Markets Sink As Worries Spread Of Cooling Growth

Earnings Still Solid So Far

But traders fear rate hikes meant to curb inflation could trigger a slowdown

BY LAURA MANDARO
INVESTOR'S BUSINESS DAILY

Angst about growth prospects pummeled commodities and global stocks again Tuesday.

Gold and copper futures fell 7%, extending major losses. Oil prices dropped $1.80 to $68.56 a barrel, a two-month closing low.

Japan's Nikkei index fell 4.1%. Its 641.1-point loss was its worst since Sept. 12, 2001. London's FTSE 100 slid 1.8% to a 6-month closing low.

Investors pummeled stocks in Colombia, Russia and Turkey. Indian stocks fell 4.4%, wiping out their 2006 gains.

Over the last 25 sessions, emerging market stocks tracked by Morgan Stanley's MSCI index have plunged 21%. That's the steepest fall since 1998 during the Asian crisis, said researcher ISI Group.

U.S. stocks fell, but not as hard. The Nasdaq lost 0.9% and the S&P 500 shed 1%.

"The market's saying we're worried that the Fed will be so focused on fighting inflation, they'll kill growth, particularly earnings growth," said Citigroup's Albert Richards, a small- and midcap equity strategist.

"The markets are sending the central bankers a message — that inflation expectations are receding and growth risks are rising," said David Rosenberg, North American economist for Merrill Lynch, in a note.

Just over a month ago, rising stocks, metals and long-term rates flashed inflation alarms while the Federal Reserve mulled a pause.

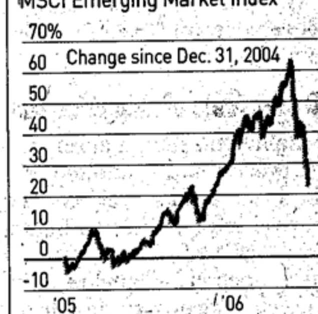
Then Chairman Ben Bernanke and other Fed officials made inflation risks their top priority.

prices and Tuesday of core producer prices failed to boost inflation expectations. Instead, long-term yields have continued to fall.

The 10-year Treasury rate is now 4.97%, well off early May's four-year high and below two-year yields. Such yield curve inversions have often preceded recession.

Nearly half of global fund managers surveyed last week by Merrill Lynch expect worldwide growth to slow over the next year vs. just 14% in May. They've boosted cash levels to historically high levels. (See Mutual Funds on A7.)

Submerging Markets
MSCI Emerging Market Index



Source: Morgan Stanley Capital International

U.S. growth is expected to cool from the first quarter's blowout 5.3% pace. Some Wall Street firms see second-quarter growth near 2%. But many still see growth near the long-term trend of 3.4%.

May retail sales rose just 0.1%, Commerce said Tuesday. Outside autos, they climbed a solid 0.5%.

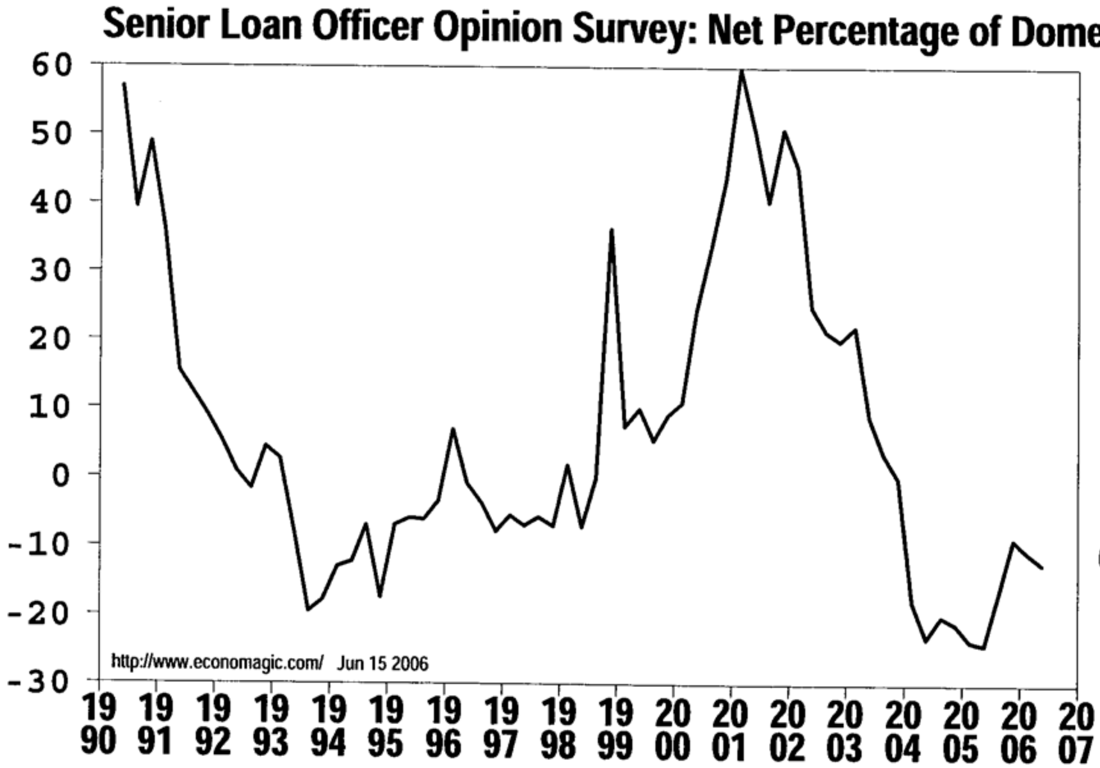
But a slowing housing market, sluggish hiring and high gas prices may finally take their toll.

Small business optimism is near 3-year lows, says the National Federation of Independent Business.

Still, S&P 500 firms are expected to report an 11.2% gain in second-quarter profits, the 12th straight period of double-digit gains.

Overseas data also have been solid. Chinese retail sales jumped 14.2% in May, the fastest yearly

Fear of Central bank tightening may be overblown as Commercial banks have not reduced credit availability….

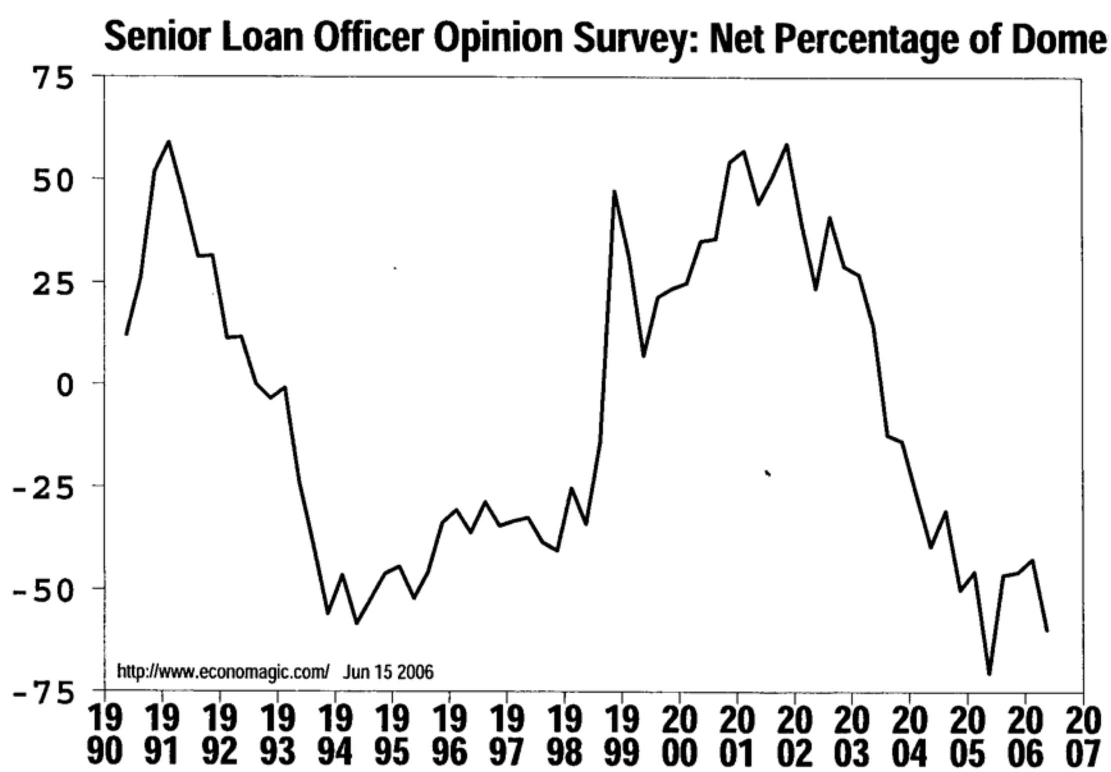


Banks are Still willing to lend…

Not yet Tightening standards on C&I loans …

% of banks tightening standards on C&I loans

increasing spreads on C+I loans



OR increasing spreads …

E22

% of banks increasing spreads on C&I loans vs treasuries