GLOBAL MARKETS MONITOR

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Executive Summary

- **US: The dollar received a bounce from dollar-positive economic news from Europe and comments by Treasury officials publicly advocating a strong U.S. dollar. What is the definition of a "strong dollar policy"? What is the economic rationale for a strong greenback? In energy-related news, Bush still opposes price caps on wholesale power.**
- **Canada: BOC cuts interest rates 25bp.**
- **Europe: Germany's Ifo survey reflects a pessimistic outlook in Europe's largest economy, creating a policy conundrum for the ECB, which faces the troubling trio of slowing growth, higher prices and a sliding currency. ECB likely to hold at this week's meeting amid a persistently high prices and a weak euro. Rumors circulate that the central bank may intervene to support the euro's value.**
- **UK: BOE minutes of the May 9 meeting reveal that the MPC voted 8-to-1 to trim short-term interest rates by 25 bp, which suggests that more cuts may be forthcoming. However, it is likely the BOE will retain its existing stance at this week's meeting and leave rates unchanged. If further cuts are imminent, the BOE is likely to trim only incrementally.**
- **Japan: IMF's Koehler sees Japan near recession. Japanese downturn exacerbates bad loans problem.**

Economic and Central Bank Monitor

North America

- **Treasury Officials Repeat Strong Dollar Mantra, Pushing Other Major Currencies Lower:** Secretary O'Neill said May 21st that what he's learned in his job is "that the only acceptable answer is we're for a strong dollar and we're going to continue to be for a strong dollar." This suggests O'Neill, like his Clinton Administration predecessors, will not be pressured into allowing the dollar to weaken to boost export competitiveness. The euro lost ground and fell to new lows this week as weak European manufacturing and French consumer confidence data were released. This is in contrast to stronger than expected US employment data, positive personal income growth and a jump in both consumer confidence and spending data. The economic releases reinforced the belief that the US will recover sooner than Europe. With respect to other currencies, the pound has also weakened recently, recovering from a 6-month low of $1.408 on May 24 to close at $1.41 Friday.
- **What is Meant By a Strong Dollar "Policy"?** Writing in defense of a strong U.S. dollar in April 2001, Bush Administration economic policy advisor Larry Lindsey argued that a strong dollar represents an unequivocal vote of confidence of individual investors and portfolio managers in the attractiveness of holding U.S. dollars and U.S. dollar-denominated assets. Global willingness to hold dollars and dollar assets, which is the fundamental definition of a "strong dollar policy", deepens U.S. capital markets and increases liquidity, which boosts the total supply of dollar-denominated funds available to borrowers, lowering borrowing costs. The three pillars behind the "strong dollar policy" that seeks to preserve the appeal of U.S. assets is (1) low inflation (increases faith in the dollar's purchasing power); (2) a sound business climate based upon a solid institutional framework that fosters investment (with a focus on sensible regulation and moderate taxation); and, (3) an open and robust trading environment (free trade and capital mobility). In other words, a strong dollar stems from a stable, growth-oriented economy with credible monetary discipline, investor confidence in institutions and open access to financial and asset markets. This strongly suggests that intervention in the forex markets would not be a policy choice of the Bush Administration.

- **What is the Rationale Behind a Strong U.S. Dollar for U.S. Investors?** A strong dollar contains inflation by bolstering the purchasing power of both U.S. consumers and producers due to cheaper imports, which lowers the cost of production. Crude oil is traded in U.S. dollars; when the U.S. dollar is strong, the U.S. enjoys a cost of production advantage over other countries, which must sell their domestic currency to buy oil. Also, the strong dollar allows the U.S. economy to grow at a faster pace, with a larger import bill as domestic output expands, without triggering upward price pressures. In addition, a strong dollar has mitigated inflation and has allowed U.S. policymakers to use interest rates to concentrate on domestic economic objectives rather than on supporting the dollar in FX markets. Lower interest rates encourage domestic capital investment and boost consumption, the backbones of the 10-year U.S. economic expansion. However, the strong dollar has negative implications as well. The U.S. is the largest net debtor to the rest of the world and runs a $432 billion current account deficit that must be financed by a consistent capital inflow of portfolio and long-term investment from abroad. A current account deficit driven by investment-led import demand is less worrisome than a deficit driven predominantly by excessive consumption, as long as it is financed with inflow of foreign capital. If the foreign appetite for U.S. financial and physical assets recedes, a strong U.S. dollar may fall out of favor. However, this is the time when a strong dollar policy is needed most.
- **Bush Still Opposes Price Caps on Wholesale Electricity**: While visiting California, President Bush said price caps would only "make the [power] shortage worse." In a meeting with the President, California Governor Gray Davis argued that the Federal Energy Regulatory Commission (FERC) has a responsibility to lower wholesale prices until it can get additional power generation capacity online over the next 12 to 18 months. President Bush rejected the governor's plea for controls on soaring wholesale electricity prices, but agreed to dispatch FERC Commissioner Pat Wood to "understand firsthand" the state's crisis and to investigate why Texas natural gas sold in California is more than double the price of the same gas sold in New York. The price of natural gas is the primary fuel for electricity-generation in California and hence is key to the cost of its electricity. Gray Davis, in response, said that California would file suit against the FERC to force the federal agency to lower or cap wholesale electricity prices and to enforce the law that requires that such prices be "just and reasonable." It's unclear how effective such a lawsuit would be. On Tuesday, the U.S. Court of Appeals in San Francisco declined to hear a similar suit, saying it had no reason to intervene. The supply and demand imbalance has sent power prices to record levels, caused rolling blackouts and raised fears of a recession in the world's sixth largest economy. Governor Davis sent a letter to President Bush from 10 economists who warned that a failure by FERC to "act now ... will have dire consequences" for California, the nation's largest state economy.
- **BOC Trims Rates 25 bp Last Week:** The Bank of Canada cut interest rates May 29 by only a quarter of a percentage point yesterday instead of a more aggressive 50 bp cut, because it is more concerned about rising inflation than faltering economic growth. The BOC stated its concerns about inflation, "given the sustained increases in energy prices, the bank will need to be vigilant for signs of broader effects on consumer prices." The April consumer price index rose to a higher-than-expected annual rate of 3.6 percent, up from 2.5 per cent in March, and well above the Bank's 1 to 3 percent inflation-control target range. The core rate, excluding volatile energy and food prices, stood at 2.1 percent in April, up from 1.7 percent in March. After announcing the interest rate cut, the central bank noted that while domestic demand continued to show resilience, the overall rate of expansion has fallen below the economy's potential. The BOC attributed much of the slowdown to reduced U.S. demand for Canadian products. More than 85 percent of Canada's merchandise exports are sent to the U.S. "The possibility that the economic slowdown in the United States could last longer than anticipated is the main risk to the outlook for the Canadian economy," the BOC released in a statement after the interest rate cut. The Bank of Canada shaved a quarter of a percentage point off both its overnight lending rate, now 4.5 per cent, and its bank rate, now 4.75 per cent. With the latest reduction, the Bank of Canada has lowered its key rate by 125 basis points this year, half of the reduction that Fed officials have implemented during the same period.

Europe

- **Further Evidence of a Sluggish Economic Activity in Europe's Largest Economy:** Pessimism is the economic watchword in Europe this week. Germany's closely watched Ifo survey that monitors overall business confidence (primarily from the manufacturers perspective) recorded a worst than expected 92.5 level in April (following 93.9 in March), or a 9 percent decline from last May's six-year high of 102. The survey also indicates lower expectations (suggesting confidence could slide further) and a more grim assessment of current economic conditions. Industrial production fell 2.8 percent in April and German shoppers are spending less, which has been blamed on rising prices. Since Germany accounts for one-third of European output, falling demand in Germany will likely pull down the demand across the euro-zone. The German economy grew by half a percent in the first quarter, or 0.3 percent higher than the previous quarter.
- **While ECB Will Likely Sit Out a Rate Cut Due to Stubborn Inflationary Pressures and a Weak Euro:** The ECB faces a policy conundrum with slower output and rising prices. Despite the fact that higher prices are being driven recently by largely temporary factors (such as the effects of foot-and-mouth disease on prices of meat substitutes), the euro has weakened substantially in the last week, putting further upward pressure on prices in the euro-zone. The euro closed at a six-month low of $0.8453 on Thursday but retraced some of its losses by Friday to close at $0.8475. The euro has lost 10 percent of its value vis-à-vis the U.S. dollar since the beginning of the year, and more than half the depreciation has occurred since May 1. The ECB is allowing themselves more flexibility to cut rates further in the next few months based on President Duisenberg's comments that the 12-nation rate of inflation would fall below the ECB's 2 percent target in 2002.
- **ECB Intervention Dispelled by Duisenberg**: ECB President Wim Duisenberg has tried to dispel rumors that the European central bank would intervene in the foreign exchange markets to prop up the value of the euro, because, he says, the level of the euro did not pose a further threat to inflation. The ECB has probably concluded that the spillover from high oil prices and a weak euro late last year is already reflected in headline inflation numbers and that the dominant price pressures (e.g. energy, food) are largely outside of its control. However, if the ECB thinks the market is placing a one-way bet on the euro, that would certainly increase the attractiveness of an intervention. Indeed, Bundesbank President Welteke said the ECB may buy euros "if we thought it appropriate and likely to be successful." In terms of any coordinated effort to support the euro, the Japanese monetary authorities are more prone to participate in a joint intervention than the U.S. would be, given the U.S. Treasury's strong dollar stance, to help stem the slide of the euro vis-à-vis the yen in order to bolster Japanese export competitiveness. The euro has weakened 7.1 percent vis-à-vis the yen since May 1. Japanese vice minister for international affairs Kuroda said this week that the euro was "too weak." To be successful, central bank intervention in the FX markets must carry the element of surprise and must be jointly coordinated. Without support from other major central banks, it is more likely that any intervention now by the ECB would bring about only temporary adjustments to the euro's value, unless backed by positive economic growth. Growth differentials still largely drive the strength of the U.S. dollar (and the recent euro weakness) now that the U.S. is showing some signs of recovery while economic data coming out the euro-zone economy continue to record weak results.

- **BOE Vote Unanimous for Recent 25 bp Cut, Downside Risks Remain:** Only one member of the MPC voted for a more aggressive 50 bp cut at the early May meeting, but the unanimous vote for 25 bp indicates that the BOE may trim rates again as it monitors whether the balance remains in the direction of weaker growth. As the market is still learning about how the MPC reacts to news, the Committee prefers to retain "its recent practice of small changes in the repo rate rather than aggressive moves that might have to be followed by quick reversals". The minutes from the May 10 meeting reveal that for some members "not much, if any, downside news had been needed since the committee's April meeting to justify a further easing." Indeed, May's *Inflation Report* indicated that the outlook for the U.S. is weaker than in February and is the principal downside risk to growth and inflation in the U.K. However, the MPC will need "clearer evidence" of a slowing in consumption growth to justify a deeper cut in interest rates, the minutes said. Consumption growth indicators to watch closely are retail sales, car registrations, the housing market and household money and credit growth. U.K. retail sales rebounded in April after rising 0.6 percent m-o-m (or, 5.9 percent y-o-y, the fastest annual pace since Jan. '00) after sluggish March sales. Although robust, April's sales were flat compared to January and February's 0.6 mom rise. Reflecting higher energy and food prices, RPIX inflation (ex-mortgage interest payments) edged up from 1.9 percent y-o-y in March to 2.0 percent in April (jumping 0.7 percent m-o-m). Although still well below the government's medium term RPIX target of 2.5 percent, the MPC regards a 2.0 percent result as close to the 2.5 percent target. **The slight uptick in inflation coupled with firm consumption growth will probably prevent the BOE from cutting rates when it meets on June 6. Also, given the Conservative's rhetoric the last time the BOE cut interest rates, the BOE will be mindful of the election on June 7th.**

Asia/Pacific

- **IMF's Koehler Sees Japan Near recession:** Horst Koehler, Managing Director of the IMF said, "Unfortunately, recent numbers in Japan have not been favorable," and that Japan's economy is likely to experience a downturn, with "one or two quarters of negative growth" this year. The Japanese government released weak data this past week as industrial inventories rose to their highest level for four years and industrial production fell 1.7 percent m-o-m in April (following a 2.1 percent contraction in March), while unemployment climbed to a near-record level and consumer spending shrank, suggesting that Japan is close to recession. Koehler called on the Bank of Japan to "forcefully" implement its promise to keep monetary policy very loose. Trying to keep up the pressure on the Japanese government to act over the banking system, Mr. Koehler, reiterated that "dealing with the bad loan problem is number one priority. . . restoring the banking system to health is a pre-requisite of restoring the economy to health." He added that he welcomed the promises that Mr. Koizumi, the new prime minister, has made to tackle bad loans and that the Japanese government will introduce more pro-market reforms - even if these measures lead to a temporary recession.
- **Japanese Downturn Exacerbates Bad Loans Problem:** The main banking watchdog in Japan, FSA, released data suggesting the recent economic downturn has left new non-performing loans appearing almost as quickly as the banks can write off existing bad loans. The FSA said the total level of bad loans for the big 16 banks stood at Y11,600bn ($95.8bn) at the end of March. Although this was Y1,000bn lower than the level reported last September, it also followed some Y4,400bn worth of write-offs, indicating banks have found another Y3,400bn of new non-performing in these six months. The increase in problem loans reflects the weakness in the general economy during the past fiscal year and the deteriorating financial health of debtors. If bad loans continue to appear at this pace, Mr. Koizumi will find it hard to meet his pledge to solve the problem. The government has called on the banks to remove their obvious bad loans in the next two years and any new bad loans within three years. However, at present the banks are reporting only around Y2,500bn of operating profits each year, which means they will have to dip into capital to make any rapid write-offs or receive an injection of public funds, which is political suicide for Mr. Koizumi.

G-7+ Central Bank Monitor

Country	Official Interest Rate	Current (%)	Change from prev. bias	Last Change	Next MPC Mtg.
The Americas					
United States	Federal funds rate	4.00	19 Dec 00 (-250 bps)	15 May 01 (-50 bps)	26/27 June 2001
Canada	Overnight rate	4.50	23 Jan 01 (-125 bps)	29 May 01 (-25 bps)	17 July 2001
Europe					
ECB	ECB rate	4.50	10 May 01 (-25 bps)	10 May 01 (-25 bps)	7 June 2001
U.K.	Base rate	5.25	11 Jan 01 (-75 bps)	10 May 01 (-25 bps)	5/6 June 2001
Asia/Pacific					
Australia	RBA cash rate	5.00	6 Feb 01 (-125 bps)	4 Apr 01 (-50 bps)	5 June 2001
New Zealand	Official cash rate	5.75	13 Mar 01 (-75 bps)	16 May 01 (-25 bps)	4 July 2001
Japan	Overnight call rate	0.00	28 Feb 01 (-25 bps)	19 Mar 01 (-25 bps)	15 June 2001

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ENA RESEARCH GROUP, *COUNTRY RISK AND FOREIGN EXCHANGE*

Economic Calendar – June 4 to June 8, 2001				**(all times are CST)**	
Country	**Mon. June 4**	**Tues. June 5**	**Wed. June 6**	**Thurs. June 7**	**Fri. June 8**
The Americas					
U.S.	Light Vehicle Sales (May)	Redbook Factory Orders (May) NAPM Non-mfg Productivity (Q1-R) **Richmond Fed President Broaddus to address the Washington Association of Money Managers**	Mortgage Applications (June 1) Treasury Strips (May)	Jobless Claims (June 2) Wholesale Trade (Apr) Chain Store Sales (May) Consumer Credit (Apr)	
Canada			Building Permits (Apr)	Help Wanted Index (May)	Employment (May) Unemployment (May) Housing Starts (May) IVEY PMI (May)
Europe					
ECB	**Italy:** ISAE Business Survey (Apr)	**Euroland:** Business and Consumer Confidence (May) PPI (Apr) **Italy:** New Car Registrations (May) **Ecofin Meeting**	**Euroland:** Business Climate Indicator (May) PMI (May) Unemployment (Apr) **Germany:** PMI (May) **France:** Monthly Budget (Apr) **Italy:** PMI (May)	**Germany:** Manufacturing Orders (Apr) Employment (Mar) Unemployment (May) **ECB Meeting and Press Conference**	**Euroland:** GDP (Q1-P) **Germany:** Industrial Production (Apr)
U.K.	Money Supply (May) BRC Sales Monitor (May)	Halifax House Prices (May) PMI (May) CBI Distributive Trades Survey **MPC Mtg Begins**	New Car Registrations (May) **Monetary Policy Meeting Ends**	Construction New Orders (Apr) Housing Starts and Completions (Apr) Industrial Production (Apr)	
Asia/Pacific					
Japan		Leading Indicators (Apr) Household Spending (Apr)	Foreign Currency Reserves (May)	Machinery Orders (Apr) Money Supply (May) Bank Lending (May) Wholesale Prices (May)	
Australia	Current Account Balance (Q4)	RBA Cash Target (June) GDP (Q1)	Employment (May) Unemployment (May)		
NZ			Retail Sales (Apr)		

Singapore					Foreign Reserves Total (May)