GLOBAL MARKETS MONITOR

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Economic and Central Bank Monitor

North America

- **California Crisis Leads to Debt Defaults:** California is under siege, not from Mother Nature's common curse of earthquakes, floods or fire but rather from the basic need for power and the $11.5 billion accumulating loss to pay for it. Demonstrating the severity of the financial crunch, the two utilities strapped for cash defaulted on their commercial paper this week, PG&E on $76 million and Southern Cal Edison (SCE) on $32 million. Edison also suspended payment to bondholders. Both utilities were downgraded to below investment grade ("junk") this week by the major credit rating agencies. Defaults and downgrades have put the two utilities out of compliance with the terms of their loan agreements, making the full amount of loans and credit lines due immediately. Solomon Smith Barney estimates that banks have lent $2.2 billion to PG&E and Edison. Bank of America extended PG&E a $850 million credit line last year and J.P. Morgan Chase was the lead bank on a $1 billion credit to Edison. If SCE and PG&E file for bankruptcy, it would be the largest and third largest bankruptcies, respectively, in U.S. history, involving $20 billion combined, putting more creditor dollars at risk than any bankruptcy in history. Creditors owed money by the two utilities include banks, power suppliers, and thousands of governmental, individual and institutional investors who hold bonds and other debt securities. Utilities are generally considered a very safe investment, only two publicly traded electrical utilities have declared bankruptcy during the Great Depression. The outcome of bankruptcy is uncertain since the solution to this problem will be politically driven.
- **State of Emergency - Power Blackouts and Emergency Legislation:** Two straight days of controlled outages, which avoids a system-wide blackout but rotates over many neighborhoods in large areas of the state, caused many to be stranded in elevators, and left airlines at the San Francisco International airport scrambling for jet fuel. Blackouts only exacerbate the threats to California's economic growth already undermined by high energy prices. In response to the energy crisis, legislators adopted an emergency plan on Thursday to bail out the utilities with taxpayer's money. Lawmakers would not write the blank check that Governor Davis wanted, however, they approved a $400 million measure, which will buy some time to solve the crisis. Although PG&E's lawyers are preparing for all contingencies, including bankruptcy, executives remain hopeful that bankruptcy can be averted by brokering a deal with state officials and power generators. Possible solutions include power generators extending payment schedules of the almost $2 billion due in March as well as bailouts from taxpayers and ratepayers, including haircuts to investors. Both utilities have accumulated about $12 billion of debt because of a rate freeze, which prevents the utilities from passing the high cost of wholesale electricity to consumers. Despite the legislative action, it is only temporary, the final cost of the state's intervention is still uncertain, as is who will ultimately bear the cost of the crisis, and how the outstanding debt will be paid, notably if the utilities declare bankruptcy. Nevertheless, it's clear California's economy and creditors of the utilities will ultimately shoulder most of the economic burden through some combination of large investment losses, higher taxes, skyrocketing energy bills, and the loss of businesses as companies decide to pick up shop and move out of state.
- **Bush Against Price Controls:** President-elect Bush rejected a request for price controls by Governor Davis, calling them " a short-term delay of a needed solution." He blamed the crisis on California's "flawed" deregulation legislation and insisted that the answer is more deregulation, not regulation. Bush also stated that Washington "can help to some extent' but it would be directed at easing environmental regulations that are preventing power plants from running at full capacity. California's power problems are also spilling over its neighbor's borders. Northwestern states have been required on emergency orders to ship power to California, draining those states of power needed at home and raising prices. Businesses in Oregon, for example, can expect 30 to 40 percent electricity rate hikes, while California has experienced only a 7 to 9 percent increase. Fearing an economic shock to the rest of the U.S. economy, Washington policymakers are going to seriously assess the California crisis as the House Energy and Commerce Committee promises a "top-to-bottom" review of the country's strategic energy policies.

Europe

- **ECB Leaves Rates Unchanged:** Although the ECB held interest rates at 4.75 percent this week, concerns about inflationary pressures from rising wage settlements and high oil prices last year linger in Europe and until inflation eases further, the ECB will likely hold interest rates steady. Inflation of 2.9 percent in November is well above the ECB's target of 2.0 percent. However, as the Euro-land economy shows signs of a slowdown, the ECB may follow the Fed's lead by cutting rates soon. Germany's closely watched Ifo survey of business sentiment, which many say is a strong gauge of turning points in the European economic cycle, fell in November to its lowest level in a year. Many Europeans, on the other hand, believe that internal demand will be the main engine of economic growth and help to offset the impact of slowing demand from the U.S. "It used to be the case that when the US caught a cold, Europe got pneumonia. But those times are over," according to Jean-Claude Trichet, the Bank of France governor.
- **Euro As a Foreign Currency Reserve Gets A Boost From China and European Bankers:** China's central bank governor boosted confidence in the euro by saying that Beijing had no intention of reducing its reserves of the currency, despite its slide vis-à-vis the U.S. dollar since January 1999. The governor of the People's Bank of China expects the euro to appreciate this year and said that the bank had not made a real loss on the currency's depreciation last year. China has $166 billion in foreign exchange reserves. French Finance Minister Laurent Fabius, who expects the euro to reach parity with the U.S. dollar in the coming weeks, and his German counterpart Hans Eichel urged central banks to hold more of their reserves in euros, which are an attractive "diversification" instrument for central banks and investors. Euro-denominated reserves already account for 12.5 percent of global official reserves (while US accounts for 66 percent) and have considerable prospects for expansion, Fabius said.

Asia/Pacific

- **High-Level Dissention in Japan Over Yen:** Japan's central bank and the finance ministry are at odds over the yen. Bank of Japan (BOJ) Governor Hayami asserts the yen is "too low," probably fearing a weak yen could lead to a sell-off of Japanese equity positions that could further weaken the slumping stock market. By contrast, Finance Minister Miyazawa doesn't appear troubled by the yen's slide, on the hopes that exports will be more competitive. The yen rose as high as Y116.95 today following Thursday's fall to an 18-month low of 119.90. BOJ decided this week to leave rates unchanged at 0.25 percent, although Hayami has asked for an investigative report by February 9 on how to boost liquidity, implying a possible return to the zero interest rate policy (ZIRP) which it abandoned in August. The main question, driven more by the weakness in the stock market than a weak yen, is whether reducing interest rates in Japan will renew investor's interest in equities and bolster Japan's anemic economy. Japan's economic growth will be trimmed 0.4 percentage points if U.S. growth slows to about 2 to 3 percent, Miyazawa said. He also said the impact of slower economic growth will be offset if the yen holds at about Y120 vis-à-vis the U.S. dollar.
- **Quantitative Easing Suggested by LDP Panel To Boost Japanese Stock Market:** A political debate is underway in Japan to determine how to boost stock prices and is centered on the merits of returning to the ZIRP or adopting a policy of quantitative easing. A panel has been setup by Japan's ruling coalition to discuss the range of measures to support the ailing stock market. Committee chairman Hideyuki Aizawa said that reinstating the ZIRP would be ineffective and urged the BOJ to consider quantitative easing, aimed at injecting cash directly into the banking system through outright buying of Japanese government bonds (JGBs), an action the BOJ has rejected outright. Some analysts believe re-instituting the ZIRP would be "too little, too late". Other possible measures under consideration to boost stock prices include allowing Japanese companies to own their own shares (share buy-back programs). Given the severity of the stock market's 37 % decline from its 2000 high of 20,833 and pessimistic reports from consumers, the BOJ may act decisively, as the U.S. Fed did in early January, by providing a badly needed stimulant.

- **Downtrodden In Japan:** The Japanese are likely to spend more of their winter bonuses on meeting daily expenditures rather than on leisure activities, according to a December survey of consumer sentiment in Japan. Also, 65 percent of those surveyed were nervous about job security (up from 61 percent in October), and one-third felt that the economy will deteriorate, up from 26 percent in October.

Commodity News

- **OPEC Cuts Production On Fears of Lower Demand From Slower Economic Growth, But Gives Iraq the Upper Hand:** As widely expected, OPEC decided to reduce oil output by 1.5 mbd starting February 1st at last week's extraordinary ministerial meeting in Vienna (for a new OPEC output quota total of 25.2 mbd, excluding Iraq). However, the net reduction in oil production is likely to be more in the range of 1.2-1.3 mbd because some OPEC member countries aren't producing at their quota levels. The choice of how many barrels to cut per day was predicated on the assumption that Iraq's oil production would return to its normal level (approx. 2.8 mbd). In a political campaign to dismantle sanctions, Iraq has disrupted the flow of its oil by maintaining a surcharge on oil exports outside the UN oil-for-food framework. In an effort to reassure the market and achieve price stability in a volatile situation, the Saudi oil minister has said that the OPEC 10 (excludes Iraq) "would be ready to adjust our production levels (to future shifts in Iraq's oil export levels). So, even though people are saying that there will be a further output reduction in March, there may in fact be an increase in March." According to global crude oil demand projections by the International Energy Agency (IEA) and Centre for Global Energy Studies (CGES), if Iraq raises its output to normal levels, supply under the new quotas just announced would exceed demand in 2Q01 by as many as 2.5 mbd. OPEC's chief economist predicts that oil supply will exceed demand this spring by almost 3 mbd. If this supply-demand imbalance occurs, OPEC may be obliged to cut production even further as stocks build. However, if Iraqi exports don't resume in full, CERA estimates that 2Q01 inventory levels could be as low as 0.6 mbd. This would tighten the market and could push prices above $30/b again. If Iraq is only pumping 500,000 b/d, as many suspect, returning to normal production levels would more than offset the reduction announced Wednesday by OPEC. Thus, near-term decisions by the OPEC 10 on whether to raise or lower output in order to keep basket prices in the $22-$28/b range will depend on Iraq.
- **Report Recommends Below $20/Barrel Oil to Avert Global Economic Slowdown:** The Saudi oil minister said OPEC is in favor of a reasonable price level for oil around $25/b for the OPEC crude mix. In its "Monthly Oil Report", the CGES argues that OPEC production cuts aimed at $25/b could further damage economies already hit by last year's high crude prices. CGES reports that in order to avoid a serious slowdown in economic growth the world needs oil prices to fall below $20/b. Lower oil prices needed for global economic recovery would occur if OPEC had left production as it was, the report said. "Low demand growth and no OPEC cut would see prices ease over the course of 2001 to average $20/b by 4Q01. OPEC appears to believe the world can live happily with $30/b oil. It is wrong." CGES expects global demand for oil in 2001 to rise by an incremental 1.3 mbd, which assumes a slowdown in the U.S. of 2.5-3.0 percent in 4Q00. This estimate is lower than the 2 mbd demand increase forecast by the OECD, IEA and U.S. department of Energy (assuming 4 percent growth worldwide and 3.5 percent in the U.S., obviously outdated). CGES expects Dated Brent would average $28/b in 4Q01 due to insufficient stockpiling during the year.

- **Mixed Outlook for Base Metals:** A median forecast of a Reuters poll of 21 global metals and mining analysts showed most base metal markets up but lower or mixed results for nickel, tin and zinc. One major factor effecting the outlook on base metals in 2001 is the slowdown in the U.S. economy. Projections of average prices (cents/lb.) are as follows: (Note: Green denotes expected rise in prices, Red denotes expected fall in prices, Yellow denotes mixed results)
  - **Aluminum**: 73.0 (2001), 75.5 (2002). 2000 level: 70.3.
  - **Copper**: 86.0 (2001), 93.0 (2002). 2000 level: 82.2.
  - **Lead**: 22.0 (2001), 23.0 (2002). 2000 level: 20.6.
  - **Nickel**: 326.5 (2001), 322.5 (2002). 2000 level: 391.8
  - **Tin:** 245.0 (2001), 250.0 (2002). 2000 level: 246.4
  - **Zinc**: 50.0 (2001), 52.0 (2002). 2000 level: 51.1
- **Consolidation in European Zinc Industry:** Swiss-based Xstrata (39.5 owned by metal trader Glencore) is expected to acquire Spanish Asturiana de Zinc. Its uncertain whether Glencore, which has a substantial interest in zinc, will combine its other zinc interests with Xstrata, which has been interested in adding an exchange-traded metal to its portfolio. This combination would give a Glencore-controlled European smelting capability of about 680,000 tonnes a year, which would exceed Union Miniere's 500,000 tonnes, Finnish Outokumpu's 230,000 tonnes, and Australian MIM and Pasminco at 200,000 tonnes each smelting capacity. Profitability of smelters is closely linked to the metals price, since part of their processing payment comes in the form of "free" metal. Zinc is suffering from a global slowdown.

Country Credit Rating Activity

- **Philippines' Rating Affirmed by S&P:** S&P affirmed the Philippine's BB+ long-term foreign currency sovereign credit rating (one notch below investment grade) this week and the B rating on its short-term foreign currency sovereign rating. The outlook on the long-term ratings remains negative, as it has been since October 19, 2000. The Republic of the Philippines has been plagued recently by prolonged political turmoil driven by cabinet resignations and President Estrada's suspended Senate trial on corruption charges. Until a resolution to the political stalemate is reached, Philippine's weak public finances will further erode and investor confidence will continue to plummet. Allowing policymakers to focus on economic management once they restore political stability and investor confidence will enhance the country's external liquidity needed to fulfill its financing needs, improve its weak growth prospects and relieve the pressure on the financial system from high interest rates. The country's growing fiscal deficits raise its vulnerability to external factors, which could exacerbate its public debt burden, and potentially lead to a lower credit rating, S&P stated.

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	6.00	19 Dec 00 (-50 bps)	3 Jan 01 (-50bps)	30 – 31 Jan 2001
Canada	Overnight rate	5.75	3 May 99 (+125 bps)	17 May 00 (+50bps)	23 Jan 2001
Europe					
ECB	ECB rate	4.75	4 Nov 99 (+225 bps)	5 Oct 00 (+25 bps)	1 Feb 2001
U.K.	Base rate	6.00	8 May 99 (+100 bps)	10 Feb 00 (+25 bps)	7 – 8 Feb 2001
Asia/Pacific					
Australia	RBA Cash rate	6.25	2 Nov 99 (+150 bps)	2 Aug 00 (25 bps)	6 Feb 2001
New Zealand	Cash rate	6.50	16 Nov 99 (+200 bps)	17 May 00 (+50 bps)	14 Mar 2001
Japan	Overnight call rate	0.25	17 Aug 00 (+24 bps)	17 Aug 00 (+25 bps)	9 Feb 2001

Economic Calendar – January 22 to January 26, 2000					**(all times are CST)**
Country	**Mon. Jan.22**	**Tues. Jan.23**	**Wed. Jan24**	**Thurs. Jan.25**	**Fri. Jan.26**
The Americas					
U.S.	Leading Indicators (Dec) Federal Budget (Dec) Auction of T-Bills: $23.0 Bil	Redbook	Mortgage Applications (Jan19) Auction of 2-year notes: $10.0 Bil	Jobless claims (Jan20) Employ Cost Index (Q4) Existing Home Sales (Dec) Help-wanted Index (Dec) Auction of Buybacks: $1.0 Bil	Durable Goods (Dec)
Canada	Manufacturing Orders (Nov) Manufacturing Shipments (Nov) Inventory-to-Shipment Ratio (Nov) Retail Sales (Nov)		Security Transactions (Nov) Employment Insurance (Nov) Composite Index (Dec)		
Europe					
ECB	**Euroland**: HCPI (Dec) **Germany:** Ifo Business survey (Dec) PPI (Dec) Import Prices (Dec) **Italy:** CPI (Jan)	**France:** Household Consumption (Dec) **Italy:** ISAE Consumer Confidence (Jan)	**Euroland:** Labor Cost (Q3) **France:** CPI (Final Dec)		**Euroland:** Trade Balance (Nov) **Italy:** Retail Sales (Nov)
U.K.			Minutes of MPC Meeting (held on 10/11 January) CBI Industrial Trends Survey (Jan)	Trade balance (Nov/Dec)	GDP (Q4 Prov.)
Japan	Tertiary Industry Activity Index (Nov)	Corp Service Price Index (Dec) Merchnds Trade Balance Total (Dec)		Crude Oil Imports (Dec)	Tokyo CPI (Jan) Nationwide CPI (Dec) Retail Sales (Dec)
Australia	Producer Input Prices (Q4)	Headline CPI (Q4)	Consumer Prices (Q3) New Motor Vehicle Registration (Dec)		
NZ		RBNZ Official Cash Rate (Jan)		Building Consents Issued (Dec)	
Singapore					Industrial Production (Nov) Consumer Prices (Dec)