GLOBAL MARKETS MONITOR

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Country Risk and Foreign Exchange
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Executive Summary

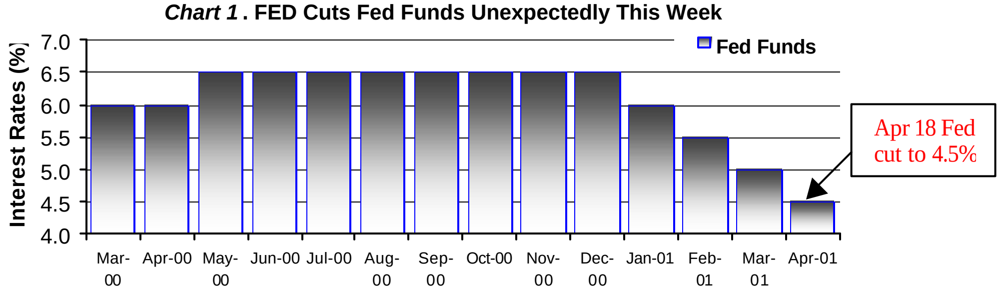
- **US: Fed slashes another 50 bps in a surprise, inter-meeting move on concerns about softening capital investment and profit erosion. Stocks and bonds rally in response. What does the Fed move suggest about the prospects for a U.S. economic recovery this year?**
- **Canada: Reflecting the underlying strength of domestic demand, Bank of Canada trimmed interest rates by only 25 bp this week at its regularly scheduled meeting. The BOC is poised to continue its easing cycle while uncertainty remains over a U.S. rebound. BOC expects a U.S. recovery in 2H01.**
- **Europe: The euro vis-à-vis the U.S. dollar showed renewed strength this week as interest rate and growth differentials favor Europe. ECB likely to sit out a rate cut again this week, despite calls from many quarters, as inflation in March at 2.6 percent steadily hovered well above the ECB target of 2.0 percent.**
- **UK: MPC voted unanimously to cut rates 25 bp at its meeting in early April. Three members wanted a steeper reduction.**
- **Japan: Problem loans in Japanese banking system larger than thought. Miyazawa intends to resign.**
- **Country Update – Argentina: Economy Minister proposes adding euro to 10-year old U.S. Dollar peg, adding uncertainty to political and economic instability, which threatens to widen spreads in advance of next week's $750 million Treasury auction and drain local market liquidity.**
- **Country Update – Turkey: Despite announcement of a new economic program to cut expenditures, raise government revenue and reform the weak banking sector, a concrete monetary and foreign exchange rate policy is absent, as is the finalization of the external financing rescue package. S&P downgrades Turkey's sovereign credit rating for the second time in as many months. Heightened political and implementation risk could lead to further currency weakness.**

Economic and Central Bank Monitor

North America

- **Fed Delivers Another Surprise 50 bp Rate Cut As Economic Outlook Worsens:** The slowdown in the U.S. economy is clearly sharper than the Fed thought. In response to a dim capital investment outlook, a deterioration in equity wealth that could have adverse effects on consumer spending, and the risk of slower growth abroad, the Fed acted this week between meetings to reduce borrowing costs in the U.S by slashing its target for the fed funds rates (rate at which banks borrow from each other to meet reserve requirements) to 4.5 percent from 5.0 percent in the Fed's fourth interest rate cut, and its second move between meetings, this year. Despite stronger than expected U.S. industrial production results in March (up 0.4 percent after dropping 0.3 percent in February and 0.6 percent in January), as well as a reduction in excess inventories and consumption and housing expenditures that "have held up well," the Fed clearly fears that the internal and external pressures threaten to keep the pace of U.S. economic activity "unacceptably weak." The Fed has reduced borrowing costs by 200 bp since the beginning of January (*see Chart 1*). The FOMC's next formal meeting is scheduled for May 15.

***Chart 1*. FED Cuts Fed Funds Unexpectedly This Week**



- **Fed's Surprise Move Sparks Stock and Bond Market Rally:** Believing the worst of the economic downturn to be over and that the Fed is now poised to deliver the needed stimulus to strengthen investment spending whose weakness has crippled corporate profits, the U.S. equity markets rebounded on Wednesday after the Fed decision. The NASDAQ gained 13.3 percent this week, while the Dow industrials rose over 4 percent. Bond prices also rallied after the surprise cut was announced, as many traders did not expect another move until the next official meeting in May. Despite Wednesday's rally, investors may be waiting to clarify whether the worst of the slowdown, both at home and abroad, is over. With Japan's economy weak and the outlook even bleaker, the U.S. economy is not yet out of the woods.
- **U.S. Economic Outlook – Does the Fed Move Cloud or Clarify the Outlook for a 2H01 Rebound?** In its press statement, the Fed reported that a significant reduction in excess inventories "seems well advanced." Industrial production results in March, driven primarily by the auto sector and other durables, validate that the inventory adjustment process is proceeding. Yet, a large part of the sharp deceleration in U.S. economic growth in the latter half of 2000 was due to production cuts following excessive inventory accumulation in anticipation of industrial and consumer demand that didn't materialize. Now that the process of inventory depletion is underway, the Fed appears to have shifted its concerns from inventories to corporate profitability, which has suffered from the slowdown in demand at home and abroad. Most economists agree that interest rate cuts take at least six months to have a measurable impact on spending decisions. As consumers over borrowed during the boom and companies over invested in technology and equipment, they may now take the opportunity to pay down debt rather than spend. Also, deteriorating credit quality and a rise in problem loans have hurt banks' earnings (Bank One, FleetBoston and Comerica all reported lower earnings in 1Q01) and forced them to tighten lending standards. It is capital deepening that lead to the productivity enhancements that have raised the U.S.' economic growth rate potential. Thus, it is clear the Fed's easing cycle will continue, but just when the U.S. economy will rebound is not clear. Fed Vice Chairman Ferguson said this week that reports that businesses have been postponing capital improvements are widespread and that he thinks, "It is too early to have a strong conviction that the economy is reaching the end of this period of quite slow growth."
- **Bank of Canada (BOC) Cuts Again:** Canada continues to be at risk due to a U.S. slowdown. Thirty-five percent of Canadian GDP depends on exports to the U.S. and the Canadian and U.S. manufacturing sectors are closing integrated. Although final domestic demand has maintained its underlying momentum, the BOC stated the "marked easing in the pace of U.S. economic growth" has continued to dampen Canadian economic growth. The BOC expects the Canadian economy to strengthen in 2H01 and in 2002, which reflects completion of the current inventory adjustment, continuing investment in technology, recent tax cuts, lower interest rates and most importantly the resumption of stronger U.S. economic growth. Total CPI, at 2.5 percent as of March, is expected to move down to 2 percent by the end of 2001.

Europe

- **Bank of England's MPC Unanimous in Support of Recent Rate Cut But Several Wanted More:** In response to a weaker global outlook than at its March meeting and falling equity prices that would restrain demand, all MPC members were in agreement to trim rates by 25 bp to 5.5 percent on April 5. But 3 members voted for a steeper 50 bp cut, arguing that with inflation under control, significant downside risks such as a deterioration in confidence, pessimism about the global economy, the foot and mouth epidemic's effect on tourism and financial market slides warrant a steeper cut in borrowing costs. The BOE is poised to cut again, even "in the absence of further downside news," the MPC minutes revealed. In other BOE news, the chief economist of the Confederation of British Industry (CBI), Kate Barker, will replace DeAnne Julius on the BOE's MPC on June 1. Barker was the chief economist at Ford Europe before joining the CBI.

- **Euro Rebounds on Favorable Growth & Interest Rate Differentials:** The reduction U.S. fed funds to 4.5 percent on Wednesday drops U.S. nominal short-term benchmark interest rates below Europe's refi rate of 4.75 percent for the first time since the euro's inception in January 1999. The euro gained 2 U.S. cents during Wednesday's trading, jumping from $0.8700 to $0.8900 before settling back at $0.8850 in late trading. The euro closed up 1.5 percent this week at $0.9022. With the ECB more concerned about price stability than growth, and the Fed's policy concerns exactly the reverse, the question is whether interest rate and growth differentials that favor the euro will more than offset the flight to safety the U.S. offers in an environment of slowing global economic growth.
- **ECB Likely To Sit Out A Rate Cut As March Inflation Fails to Subside:** The ECB has little reason this week to embark on an easing cycle adopted by the world's other major central banks because of its unwavering mandate of price stability. Harmonized inflation (HICP) held steady at 2.6 percent in March, well in excess of the ECB's target of 2.0 percent. However, inflation is on a downward trend in both Germany and Italy, the euro has retraced some of its earlier losses and oil prices have retreated this week to around $25/bbl. Yet, until the harmonized index across Europe subsides closer to 2.0, or the ECB convinces itself that the hangover from high oil/weak euro from last year is fading, the ECB is unlikely to cave into outside pressure to cut rates. Also providing the ECB some cushion to keep rates steady were industrial production results in February: production rose 0.4 percent after declining a revised 1.7 percent in January, according to the European Commission.

Asia/Pacific

- **Japan's Loan Problem More Severe Than Originally Thought:** According to the Democratic Party of Japan (DPJ), problem loans in Japan have reached Y150,000bn ($1,200bn), or 25 percent of the country's GDP. By contrast, the usual government estimate based upon FSA data say banks hold Y33,000bn of clearly bad loans. However, in addition to these clearly bad loans, the banks hold an additional Y117,000bn of "category two" loans, credit which requires "careful monitoring." The DPJ argues that many more of these category two loans are going sour than the banks or the FSA admit.
- **LDP Presidential Race to be Decided This Week:** ex-PM Hashimoto, head of the LDP's largest faction, leads among the 346 Diet members, but ex-Health Minister Koizumi appears to be favored in opinion polls. If Hashimoto fails to win an outright majority this week, more rounds of voting in the LDP will take place in the coming weeks. Both uncertainty surrounding election of the new prime minister and announcements that Minister of Finance Kiichi Miyazawa plans to retire will contribute to investor concerns.

Country Update: Argentina

- **Economy Minister Cavallo Signals Suddenly A Change to Currency Regime:** Cavallo plans to integrate the euro into Argentina's currency regime once the euro reaches parity with the U.S. dollar. In theory, a basket of euros and dollars would allow Argentina's economy to become less dependent on the U.S. dollar, increase Argentina's export competitiveness and structure a currency regime that is more closely aligned with capital and trade flows (Europe is the number one destination for Argentine exports). This implies that all pesos in circulation in Argentina would be fully backed by an equal amount of euro- and dollar-denominated foreign exchange reserves. The economy ministry has emphasized the importance of exchange rate stability in avoiding deflation. A strong U.S. dollar has generated deflation in Argentina, which hurts borrowers and consumer spending. Cavallo took a first step toward integrating the euro into the economy by allowing Argentines to open euro-denominated bank accounts and carry out financial transactions in the euro. Clearly there is a bone of contention between Cavallo and the central bank governor Pou over Cavallo's proposal to cut bank's reserve requirements in order to boost domestic liquidity.

- **Adding Uncertainty to Political Instability and Economic Imbalances:** Yet, why introduce the regime change now? If the Argentine government would decide to diversify its external debt resources as part of an overall economic recovery-financing plan, which portends increased euro-denominated debt, while trying to disentangle itself from a strong U.S. dollar, this policy shift seems logical. Also, the 50-50 split of euros-dollars would give the central bank greater flexibility in monetary policy to remedy internal imbalances in response to external shocks. However, it is not inconceivable that the euro could strengthen once parity with the U.S. dollar is reached. It is risky to bank the currency regime on a downward bet on the euro. This strategy shift has created confusion as the Argentine economy continues to perform poorly. Argentina is expected to miss its first-quarter 2001 fiscal deficit target of $2.1 billion by $1.0 billion. Tax revenues fell by 12.9 percent in March, which largely depressed the fiscal deficit. Exports fell by 7.1 percent in February while imports fell by 10.1 percent. Automobile production fell for a sixth straight month in March, declining 26 percent year-on-year. Congressional elections slated for October 2001 could undermine the government's effort to build consensus needed to reduce the fiscal deficit and avoid a debt crisis.

Country Update: Turkey

- **Some Legislative Progress But Uncertainty Over External Financing and Monetary Policy Persists**: Since the Turkish government decided to abandon the lira crawling peg system on 22 February 2001, the lira has depreciated 44.5 percent on a nominal basis (closing at TRL1251050 per U.S. dollar on 19 April, down sharply from TRL694000 on 21 February). In response to the financial crisis that began late last year, the Turkish government and the IMF have been working toward structuring a new economic revitalization program to address the economy's fiscal and monetary imbalances (budget and progress of privatization are key concerns) and the weak banking sector. A series of measures announced within the past week to cut expenditures, raise revenues and reform the banking sector are aimed at securing additional external funding from official lenders, such as the IMF, and other foreign creditors, such as G-7 countries or private lenders. Thus far, some progress has been made on the legislative front, but important announcements regarding external financing and the monetary and exchange rate regime are still absent from official government statements about the economic program.
- **Turkish Sovereign Credit Rating Downgraded:** On 16 April 2001, just after the new economic program announcement by Turkish Economy Minister Dervis, S&P downgraded Turkey's long-term sovereign credit ratings to "B-" from "B" on concerns about the Turkish government's ability to secure budget financing on terms adequate to stabilize public debt stock, inflation and the lira. This was the second cut in Turkey's sovereign credit rating by S&P in two months and takes the country to 6 notches below investment grade.
- **Political and Implementation Risk:** Winning political support for Dervis' reforms is an essential first step to achieving currency stability. Implementation of the new economic reforms is paramount to Turkey's success in restoring investor confidence, reducing investor's risk premium, lowering interest rates, controlling inflation and managing a spiraling public sector debt. Thus, implementation risk is heightened by the current situation. Arguments this week between Agriculture Minister Gokalp and Dervis over agricultural subsidies reveals the delicate political balance.

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	4.50	19 Dec 00 (-200 bps)	18 Apr 01 (-50 bps)	15 May 2001
Canada	Overnight rate	4.75	23 Jan 01 (-100 bps)	17 Apr 01 (-25 bps)	29 May 01
Europe					
ECB	ECB rate	4.75	4 Nov 99 (+225 bps)	5 Oct 00 (+25 bps)	26 Apr 2001
U.K.	Base rate	5.50	11 Jan 01 (-50 bps)	5 Apr 01 (-25 bps)	9-10 May 2001
Asia/Pacific					
Australia	RBA Cash rate	5.00	6 Feb 01 (-125 bps)	4 Apr 01 (-50 bps)	June 2001
New Zealand	Official cash rate	6.25	13 Mar 01 (-25 bps)	13 Mar 01 (-25 bps)	15 May 2001
Japan	Overnight call rate	0.00	28 Feb 01 (-25 bps)	19 Mar 01 (-25 bps)	25 Apr 2001

Economic Calendar – April 16 to April 20, 2001					**(all times are CST)**
Country	**Mon. April 23**	**Tues. April 24**	**Wed. April 25**	**Thurs. April 26**	**Fri. April 27**
The Americas					
U.S.		Redbook Conf Bd Consumer Confidence (Apr) Richmond Fed President Broaddus to speak Revisions to ECI data	Mortgage Applications (Apr 20) Durable Goods (Mar) New Home Sales (Mar) Existing Home Sales (Mar)	Jobless Claims (Apr 21) Employment Cost Index (Q1) Help-Wanted Index Kansas Fed president Hoenig in New York San Francisco Fed President Parry to speak Fed Vice Chairman Ferguson in New York	Real GDP (Q1) Chain-Weight Price Index (Q1) U of Michigan Confidence (Apr-F) Fed Chairman Greenspan to speak at Bond Market Association annual meeting
Canada		Retail Sales (Feb)	Security Transactions (Feb) Composite Index (Mar)	Employment Insurance (Feb)	Average Weekly Earnings (Feb)
Europe					
ECB	**Germany:** 6 State CPI (Apr-P) PPI (Mar) Import Prices (Mar) IFO Business Survey (Mar) **Italy**: 20 City CPI (Apr)	**France:** CPI (Mar-F) Consumption of Manufactured Products (Mar) **Italy:** Trade Balance (Feb)	**France:** Housing Indicators (Mar)	**Euroland:** Trade Balance (Feb) **France:** INSEE Industrial Survey (Apr) **Italy:** Retail Sales (Feb) ECB Meeting	**Euroland:** Labor Costs (Q4) **France:** PPI (Mar) Unemployment (Mar) Real GDP (Q4-F) **Italy:** Contractual Wages (Mar) CPI (Apr-P)
U.K.	Money Supply (Mar) Trade Balance (Feb/Mar) Public Finances (Mar) PSNB (Mar) PSNCR (Mar) Housing Turnover (Mar)		CBI Industrial Trends Survey (Apr)		GDP (Q1-P)
Asia-Pacific					
Japan	Tertiary Industry Activity Index (Feb)	Corp Service Price Index (Mar)	Large Scale Retail Sales (Mar) Crude Oil Imports (Mar)	Unemployment Rate (Mar) Tokyo CPI (Apr) Nationwd CPI (Mar)	Household Survey (Mar) Industrial Production (Mar)
Australia	CPI (Q1)			New Motor Vehicle Registration (Mar)	
Singapore				IP (Mar) CPI (Mar)	