



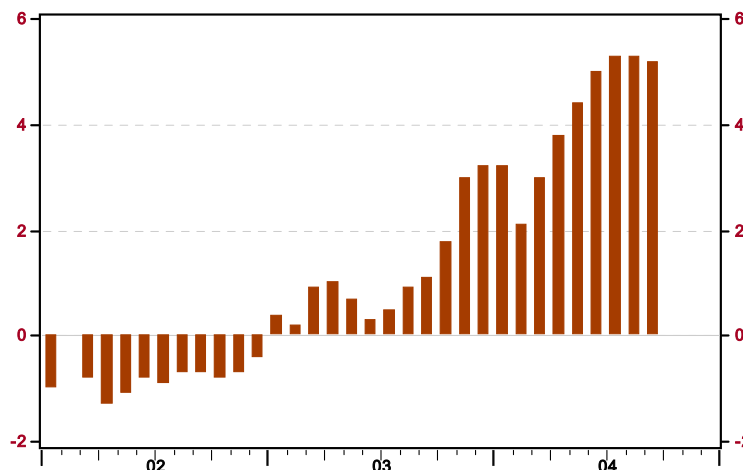
China's Surprise Monetary Policy Action – "Marriage of Convenience" Enters Rocky Phase

The People's Bank of China raised its one-year benchmark lending rate after nine years by 27 basis points to 5.58%, with the obvious intent to cool the pace of economic activity. This surprise rate hike has triggered sharp responses in all markets – commodities, currencies, bonds, and equities. A few weeks ago The Economist ran commentary about the China/Asia-U.S. economic relationship and termed it as a "marriage of convenience." This is a very fitting description and we now think that the marriage of convenience has entered a rocky phase.

A good starting point to understand the implications of this action is the benefits the marriage of convenience has conferred. China has financed a large part of the U.S. current account deficit along with other Asian central banks. The large current account deficit of the U.S. economy, 5.7% of nominal GDP, reflects inadequate household saving and a growing federal budget deficit. The extended willingness to purchase dollar assets, mostly U.S. Treasury securities, by China is effectively holding down bond yields in the U.S.; while at the same time, the low interest rate environment has promoted the borrowing and spending spree of U.S. households. Today's surprise rate hike is the beginning of the end of this convenient arrangement.

China: Consumer Price Index

NSA, year/year % chg



Source: China National Bureau of Statistics /Haver Analytics

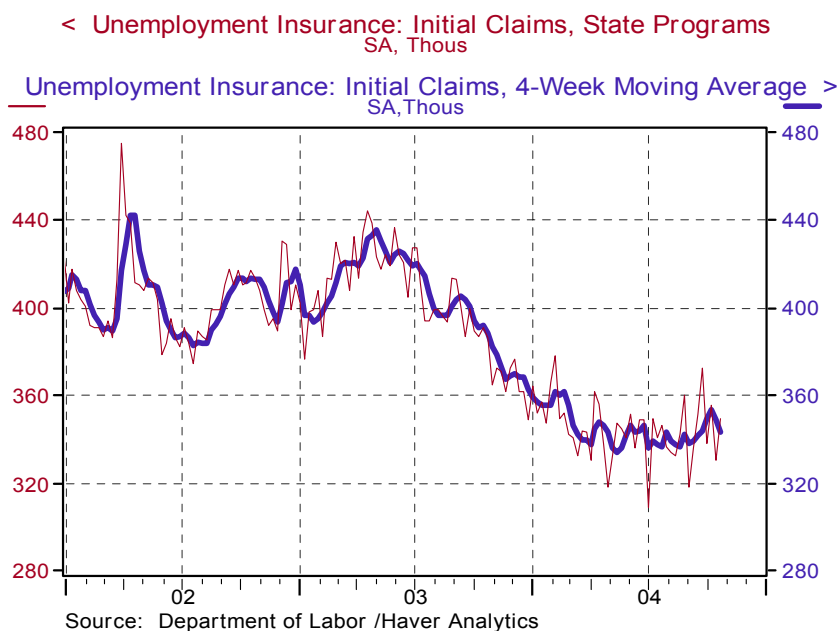
The pegged exchange rate of the yuan vis-à-vis the dollar translated into China importing consequences of easy monetary policy conditions of the U.S.. Rising foreign exchange reserves and capital inflows had resulted in rapid growth of money supply earlier in the year and continuing upward trend in inflation in China. Today's rate hike is a signal that China is no longer willing to import inflation from the U.S.. China cannot control both inflation and the exchange rate at the same time. There are favorable and unfavorable arguments for revaluation and raising interest rates. The People's Bank of China has fired the first salvo in favor of higher interest rates.

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Obviously, it is not its last attempt to rein in inflation and control the path of the economy. Additional action is nearly certain to follow. With access to enormous foreign exchange reserves, China has the wherewithal to defend the peg, but sooner or later they will have to consider a revaluation or create a new exchange rate arrangement. On this side of the world, the absence of the benefits of the marriage of convenience will hurt the U.S. financial markets and the economy.

Soft Labor Market Conditions Persist

Initial jobless claims increased 20,000 to 350,000 during the week ended October 23. Continuing claims, which lag initial claims by one week, rose 38,000 to 2.823 million and the insured unemployment rate held at 2.2% for the third straight week. Excluding distortions from the Columbus Day holiday, which contributed to the wide swings in the past two weeks, and the impact from hurricanes, jobless claims data still continue to send a message of soft demand for labor.



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