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America's income-short, consumer-led recovery is the aberration — not the norm — in this Brave New World. It is all about ever-declining saving rates, ever-widening current account deficits, mounting debt burdens and increasingly wealth-dependent consumers. It personifies what I believe is one of the most precarious macro models that has ever existed for a major economic power.

— Stephen Roach, Morgan Stanley Economist, April 4, 2005

APPROACHING THE TURNING POINT

Entering 2007, the current expansion of the U.S. economy is now a little more than five years old. After an unusually slow start, it gained some vigor over the following three years from mid-2003 though mid-2006. Nevertheless, it has remained the U.S. economy's most anemic postwar recovery by any measure. Its weakest growth components, by far, have been employment and wage and salary incomes.

Private households in the United States embarked on their greatest borrowing binge of all time, fostered and facilitated by the rampant house price inflation and a most aggressive financial system. Over the five recovery years since the end of 2001, their overall indebtedness surged by 66%. This compares with a much slower debt increase in the prior recovery years from 1995–2000 by 43.9%.

What developed in the balance sheets of private households was a race between booming "wealth creation" through rising house prices, soaring indebtedness and increases in liquidity.

The outstanding winner among the three components was the first. The net worth of private households — comparing the aggregate rise in house values with the simultaneous rise in indebtedness — soared 40% between 2002–late 2006 to about $54,100 billion.

Liabilities rose even faster in percentage terms, actually, by 48.2%, to $13 billion. The much higher level of asset values still provided the private households with the biggest wealth gains of all time. Nonetheless, owners' equity as a percentage of household real estate has significantly fallen, from 57.6% to 53.6% lately, even with the unprecedented wealth gains of recent years.

This was only possible through persistent heavy net selling from their equity portfolios. For many years, private households have reaped abundant profits in the housing market. But in the equity markets, they have been large net sellers, in comparison with much smaller net purchases of mutual fund shares.

The turn of the calendar year is always a convenient time for taking stock — looking back on the events in the past year that has just ended and pondering what major changes the new year will portend for the future. On the surface, 2006 appears to have been a time of splendid global economic performance.

World economic growth has generally accelerated, except for one great exception, and that is its former locomotive — the U.S. economy running a current account deficit that has been exploding from year to year. While the growth rate of real U.S. GDP has steadily fallen from an annualized rate of 5.6% in the first quarter of 2006 to 2.6% in the second and further down to 2.0% in the third quarter, the trade deficit has continued to beat new records.

Outstanding dramatic deteriorations occurred during 2006 in the three asset and credit bubbles: housing, automotive and commodities. Of these three bubbles, the bursting housing bubble has definitely been the single most important event, because homeowners used the sharply rising market values to embark on their greatest borrowing-and-spending binge of all time, financing higher consumer spending through soaring equity withdrawals, even though personal savings are negative in the aggregate.

In the commodity area, the two most shocking plunges have happened in oil and copper. Both speculative bubbles have been living by the U.S. housing bubble, and now, they are dying by its bursting.

As to be expected, the U.S. dollar, in response to the accumulating bad news about the U.S. economy, has promptly weakened against the European currencies, while better-looking recent housing news has just as promptly strengthened it again. To be sure, the final outcome of the U.S. housing bubble will, in the course of 2007, also determine the final outcome of the dollar bubble.

The big three economies of the eurozone — Germany, France and Italy — experienced a sudden jump in growth that is sure to slow soon. As a result, the euro area's real growth rate accelerated from 1.5% to 2.7% in 2006. In contrast, the yen's extraordinary weakness against the dollar and other major currencies has its particular cause in heavy use of yen carry trade, offering extremely cheap yen credit to purchase high-yielding assets in other currencies.

Reading quite a bit of recent Wall Street research and articles in the financial press, the common positive underlying tone is stunning, considering the great uncertainties about the bursting U.S. housing bubble. Last year, the rise in U.S. stock prices — Dow up 15.4%, Nasdaq up 9.5% and S&P up 13.1% — had generally exceeded earlier modest expectations. This year, not one of a panel of nine Wall Street strategists polled by *Barron's* (Dec. 9, 2006) considered the possibility of a decline in stock prices in 2007.

Plainly reflecting the same general absence of worry, the panel of strategists has predicted that the yield on 10-year U.S. Treasuries will finish 2007 at between 4.5–5.1%. Note the extremely tight range.

To quote Marc Faber's *Gloom Boom & Doom Report* of January 2007: *"Not entirely surprisingly, the panel wasn't asked what the dollar exchange rate would be against foreign currencies and against gold at the end of 2007. After all, you wouldn't want the public to know that, whereas the S&P is in 2006 up 13% against the dollar, it's only up 1% against the euro and is down significantly in gold and silver terms."*

THE "SERIAL BUBBLE BLOWER"

In a recent speech in Atlanta, Donald L. Kohn, vice chairman of the Federal Reserve Board, made some quipping remark about the economic situation in the United States and its outlook:

> *Before venturing some guesses on these questions, I need to issue two caveats. First, events will probably unfold differently than currently seems likely, and the range of uncertainty around any forecast is considerable. That uncertainty does not, however, diminish the value of having and discussing an outlook. Monetary policy must be based on our best estimate of future developments, and the effectiveness of policy is aided when the public understands the outlook of policymakers.*

Mr. Kohn made other stunning remarks, such as:

> *Our uncertainty about what pushed home prices and sales to those elevated levels raises questions about how the market will adjust now that expectations of the rate of house price appreciation are being trimmed. And changes in the organization of the construction industry, with activity more concentrated in the hands of large, publicly traded corporations, may also affect the dynamics of prices and activity in response to the inventory overhang.*

Please note his explicit remark on *"our uncertainty about what pushed home prices and sales to those elevated levels."* The Fed slashed its federal funds rate with unprecedented speed to 1% and accommodated America's greatest credit inflation, yet Mr. Bernanke stresses the uncertainties in the Fed about what truly pushed homes and sales of housing to those elevated levels.

There never was a secret about what exactly has been fueling the U.S. asset-inflation bubbles — above all, equities, bonds and the boom in housing. First of all, the Federal Reserve — with Messrs. Greenspan and Bernanke at its helm — played a key role in the late 1990s both with extremely loose monetary policies and highly encouraging public remarks to foster the stock market boom.

Nevertheless, both the economy's and equities' boom went bust in 2000 and the following years. While the government and the Federal Reserve opened their fiscal and monetary spigots as never before, the economy started its most anemic postwar recovery, most anemic in particular in employment and income generation. The main support for economic growth came from the developing residential housing bubble offering homeowners soaring collateral for borrowing through soaring home mortgage refinancing.

To quote Stephen Roach of Morgan Stanley: *"The Fed, in effect, had become a serial bubble blower."* By the time the equity bubble popped in early 2000, consumers had moved on to a new strain of wealth effects — taking advantage of possible equity withdrawals from rising housing values to extract newfound purchasing power. As property prices started to flatten out in 2002, the bond bubble kicked in with a sharp decline in 10-year Treasury yields, to a temporary record low of 3.1% in 2003.

According to the Fed's Flow of Funds Accounts of the United States, mortgage borrowing by private households peaked in the third quarter of 2005 to an annual rate of $1,223.6 billion. One year later, its growth sharply slumped to $672.7 billion, marking a decline by 45% within just one year. Retrenchment in mortgage borrowing and lending over this brief period has been dramatic.

Manifestly, the name of the world's *"serial bubble blower"* is well known around the world. It is the Federal Reserve in Washington. The immediate effects took place in the United States in two ways: Credit expansion and the current account deficit abruptly exploded, while domestic savings literally imploded.

The U.S. economy is one of the very cases in the world in which all three main sectors — government, businesses and private households — keep borrowing and spending heavily in excess of their current income growth. In 2005, they together borrowed $3.35 trillion, of which the nonfinancial sector borrowed $2.3 trillion and the financial sector another $1 trillion. This compared with a total credit expansion by $1.6 trillion in 2000. This coincided with a collapse in national saving from $582.7 billion to $7.2 billion.

CHINA VERSUS THE UNITED STATES

In the third quarter of 2006, the U.S. economy ran its highest-ever current account deficit, $902 billion, annualized. This compared with a deficit of $733.6 billion year over year and one of $415.1 billion in 2000. Manifestly, for the U.S. economy it has been a dramatic development over these years that had its counterparts in exploding domestic credit and imploding savings.

Particular events in other countries, for sure, also played an important role in boosting the U.S. external deficit, above all China's decision to keep its currency strictly pegged to the dollar. Nevertheless, these climatic changes in U.S. credit and savings unquestionably played the vastly overriding role in determining the continuous rise in the U.S. current account deficit.

The Chinese yuan closed 2006 under 7.81 to the dollar. It increased 3.4% against the dollar last year, compared with less than 0.5% in the last four months of the prior year. While exports continue to rise at stellar growth of close to 30%, imports keep disappointing the ambitious forecasts of an import surge. As many commodity prices sharply declined, imports increasingly lagged. A growing trade surplus accrues far more from slowing import growth than from increasing exports.

At the end of September 2006, China's foreign indebtedness was 8.5% higher year on year, at $305 billion, while the central bank's foreign exchange reserves were 28.5% higher, at $988 billion. Reserves have since exceeded $1 trillion, adding more than $200 billion each year.

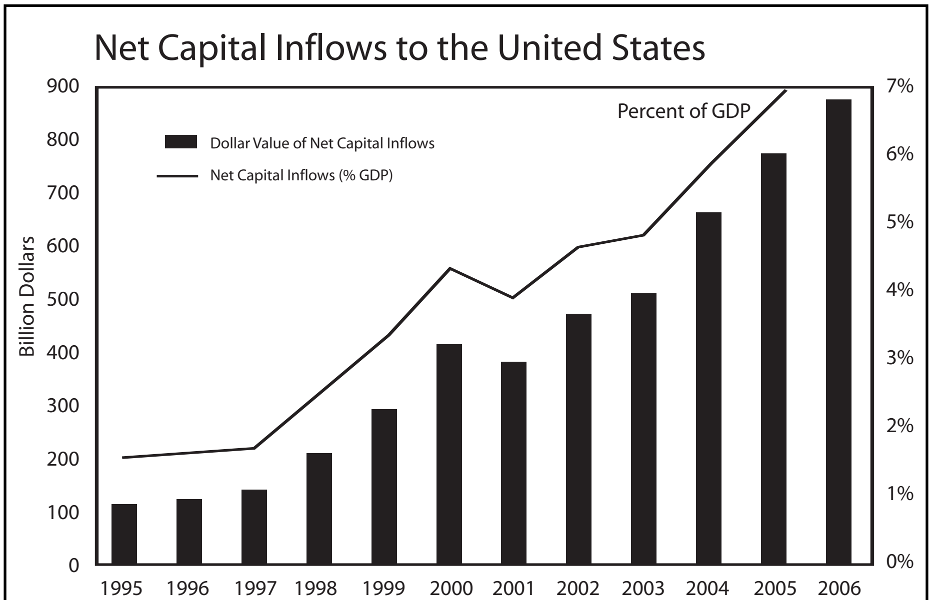
WHAT MAKES FOR A TRADE SURPLUS?

The Economic Report of the President to Congress for 2006 further stresses that an analysis of U.S. capital inflows requires a strict distinction between "market-driven" and "policy-driven" inflows. Recent capital inflows from Germany, for example, have largely reflected market forces and private sector behavior. In contrast, China's recent capital outflows largely reflect policy decisions by the government. In the case of the United States, capital inflows reflect a combination of market forces and policy behavior.

As recently as 1985, the United States still had more assets than liabilities abroad. Since then, the U.S. external financial position has dramatically deteriorated, due to virtually uninterrupted U.S. trade deficit growth. Analyzing the development of international capital flows, it strikes the eye that the large capital flows have concentrated among a small and shrinking number of countries.

Most of the changes in the past reflected soaring U.S. net capital inflows. In 1995, the United States received 33% of global net capital flows. It was up to 61% in 2000 and to 70% in 2004. Other much smaller recipients were Spain, Britain and Australia. Plainly, the U.S. case is extraordinary in size and importance.

If the United States has provided the predominant change among capital-importing countries, China has been predominant on the side of capital exporters. In 2000, China's central bank registered an increase in its foreign exchange reserve by $10.9 billion. Recently, this rise is running at an annual rate of slightly above $200 billion.



Note: Includes net inflows on the capital-financial accounts. Net statistical discrepancies in the financial account.
Source: Department of Commerce (Bureau of Economic Analysis)

This vastly beats the reserve gains by the net oil export countries, which have soared from $31.9 billion in 2000 to $83.1 billion in 2005. During this year, China's central bank accounted for 80% of the increase in reserves in Asia ex-Japan. Among single countries, the main capital exporters are Japan and Germany.

It brings us back to the familiar main question: What makes for a persistent trade surplus?

American policymakers and economists have a precise answer. In their view, it is typical of countries with slow economic growth. Look at Japan and Germany. Trade deficits, in contrast, are typical of countries with strong economic growth. See the United States.

The fact is that this question has never been seriously posed and has also never been seriously investigated because after a few years large trade deficits regularly ended in a bust of the economy and the currency. It has to be realized that the United States and the dollar are the great exception from the normal rule, because the dollar is the key currency for a large part of the world. Its financial markets, moreover, are the largest, and probably also the most efficient, in the world. Therefore, we assume a strong global interest to maintain this global dollar standard, even though Europe has opted out. It is difficult to say what will follow when it crashes.

What, then, ultimately determines a country's trade balance and the strength of its currency? Principally, there are two different possibilities. One assumption focuses on the economy's rate of growth. By this measure, a high rate of economic growth attracts imports, translating into a trade deficit and weak currency, while slow growth implies a trade surplus by deterring imports and a strong currency.

The second assumption fixates, instead, on the composition of economic growth, mainly the relationship between investment spending and available domestic savings. If the latter is on the higher side, foreign trade will be in surplus with a strong currency. This has been the long experience of Japan and Germany over the whole postwar period.

As to Japan, its real GDP growth during its bubble years of 1987–90 averaged a little less than 5% per annum, against about 3.5% in the years before. Its ratio of fixed capital investment accelerated from a level of 30–31% to 33–34% of GDP. Gross national savings hit a peak of 33.5% in 1989, compared with a rate of 14.1% for the United States, 16.5% for Britain and 25.6% for Germany. Net national savings in Japan came close to 20% of GDP. At the time, there was nothing in sight to prepare the authorities for the coming economic and financial disaster.

Yet Japan experienced a precipitous change in its pattern of saving. While corporations generally had stagnating or falling real incomes during the bubble years, personal saving has virtually collapsed recently, to 2.4% of disposable income. The key source of its rising savings-investment balance is its corporate sector. Between 1995–2004, it went from being a net borrower of funds (investing more than they saved) between 2–3% of GDP to a net lender of funds (saving more than they invest) equivalent to nearly 15% of GDP. At the same time, the government is running a chronic deficit of around 5% of GDP.

Germany, the second extraordinary case during this period, had met its financial "Golgotha" with the unexpected, abrupt arrival of East-West unification in 1989–90. It hit a financially very strong economy. Personal savings hovered around 12–13% of disposable income. Lately, they are down to around 10.5% of disposable income. As the last letter explained, the gross difference with the development in the United States is that the return to stronger economic growth did not come from the consumer. It arose from the business sector, that is, from stronger exports and capital investment associated with booming profits and corporate savings.

Decisive for both countries is that domestic savings have kept in excess of domestic capital investment, as reflected in soaring export surpluses. In the case of Japan, such export surpluses jumped from $88.7 billion in 2001 to around $195 billion. Germany over the same period staged a surge in its export surplus from close to zero in 2001 to about $160 billion.

We posed the question, what makes for a trade surplus? Is it the economy's rate of growth? Or is it the relationship between domestic savings and domestic investment? What matters exclusively is the latter. Saving out of current income implies a corresponding reduction in consumer spending. During the bubble years of the late 1980s, consumers and corporations saved virtually one-third of their current income. While investment boomed, it remained below this level of savings. As a result, the export surplus even rose.

What the United States plainly lacks for a stronger current account is domestic savings, providing the physical resources for domestic investment spending. Absent such savings, these resources have to be borrowed abroad, as partly reflected in the surging trade deficit.

If you want to know whether the economic and financial development in the United States is healthy and sustainable, you have to make one single calculation: Compare the increase in U.S. foreign indebtedness with the simultaneous increase in U.S. domestic capital investment.

According to the latest calculations for the third quarter of 2006, the U.S. current account deficit amounted to $902 billion at annual rate, implying a corresponding net inflow of capital. Over the same period, U.S. private fixed investment slightly declined because the spending losses through the slumping housing bubble exceeded the increases in business fixed investment. We expect this pattern to continue for some time to come.

THE GLOBAL TROUBLEMAKER

Earlier, we distinguished between "market-driven" and "policy-driven" global capital flows. It is a most important, although highly inaccurate, division. "Market-driven" implies that decisions about capital flows are exclusively determined by interest rates derived from market forces, while "policy-driven" flows are directly determined by decisions of central banks about the use of their foreign exchange reserves. The overriding example is, of course, their decisions to add to their dollar reserves.

The big dubious interim case is global carry trade funded by extremely cheap Japanese yen or Swiss francs. In both cases, it is clear that the decisions about extremely low national interest rates have been made by the competent central banks. The decisions, however, to borrow these low-cost currencies in order to buy higher-yielding assets and currencies in other countries are generally made by private investors, particularly hedge funds.

There is no question that two central banks know perfectly about this close connection between their interest rate policies and the global carry trade, funded by the two currencies. We take it for granted that domestic economic requirements are their main criterion for their interest rate decisions. But they certainly do not dislike that the associated global carry trade is weakening their currencies, and thus supporting their exports. Both countries are running a soaring current account surplus.

The yen dropped to a near-four-year-low against the dollar as the Bank of Japan faced a volley of criticism over the handling of its decision to hold its benchmark interest rate at 0.25%. The bank's policy board had voted 6-3 for this decision. During the day, the yen hit its lowest level since March 2003, after a long decline against the dollar and the euro.

From the global monetary perspective, the most important, and also the most dangerous, part of global capital flows is the "policy-driven" component, referring to the dollars that foreign central banks purchase and recycle into U.S. bonds.

It started in 1971, when President Nixon suspended the convertibility of dollars against gold at a fixed rate of $35 per ounce of gold. Looking back, it strikes the eye that central banks began to accumulate dollar reserves in the late 1960s, even though dollar convertibility on the part of the Federal Reserve to foreign central banks was still in full force. From then on, the United States was to run more and more trade deficits, which foreign central banks had to swallow at quasi-fixed rates or allow their currencies to rise against the dollar.

Particularly under the leadership of the German Bundesbank, the central banks of Europe began to develop a common policy against the dollar. Over the four decades since the collapse of Bretton Woods, the United States has incurred a cumulative current account deficit of more than $5 trillion.

What's worse, this debt accumulation has rapidly accelerated. Of the $5 trillion, more than $4 trillion has ended up with foreign central banks. China's central bank alone is sitting on foreign exchange reserves equivalent to more than $1 trillion. Next comes the Bank of Japan, with foreign exchange reserves around $828 billion. The euro area holds around $167 billion.

Spending in the United States definitely continues to lack any monetary restraint. True, mortgage borrowing has sharply slowed, but its immediate reason is not tight money. The decisive influence has been the disappearance of the previous wealth effects provided by rising house prices. Highly liquid banks and other lenders appear all too willing to expand their outstanding loans. Yet the fact is that overall nonfinancial borrowing and lending has sharply slowed over the course of 2006.

Manifestly, the permanent large spending outflows through the U.S. trade deficit to foreign producers correspondingly diminish U.S. domestic spending and income flows in line with U.S. economic growth. But this rapidly growing income and liquidity leakage in the economy has so far been offset by additional alternative credit creation, as strikingly reflected in the persistent sharp acceleration of overall domestic credit expansion relative to GDP.

Over the first three decades after the end of World War II, it had taken an increase in outstanding debt by about $1.40 to add $1 to GDP. Today, that aggregate credit-to-income ratio is well above $3. One, though by no means the only, reason is the U.S. trade deficit. Put bluntly, the trade deficit increasingly changes the resource allocation in the U.S. economy. Manufacturing is the big loser, while services gain.

The second highly important effect of the trade deficit is that the foreign central banks promptly recycle the dollars they purchase into the U.S. financial system by buying U.S. bonds in order to slow or to prevent a rise of their currencies against the dollar. Considering the large amounts involved, there can be no question that this helps to lower the level of U.S. interest rates. In this way, the U.S. economy has become the world's perpetual motion of apparently unlimited liquidity creation.

"POLICY-DRIVEN" CAPITAL FLOWS

Much less appreciated is the monetary impact of this rampant international liquidity creation through the exploding U.S. trade deficit on the economies and financial systems of the countries whose central banks are the main dollar buyers. The most spectacular case is, of course, Japan's bubble economy during the second half of the 1980s.

Having, essentially, no use for the dollars they receive, Japan's exporters sold them to their commercial bank, which generally sold them further to the Bank of Japan, the central bank.

In the course of these two dollar sales, two things have happened from the monetary perspective. The exporter has gained a bank deposit covering his costs and profits.

Far more important, though, is the second monetary effect on the banks and the banking system. Each dollar they sell to the central bank increases their highly liquid deposit holdings by the same amount. The trouble is that these deposits act for the commercial banks as "high-powered" money, permitting a larger credit expansion.

During those "bubble years," the Bank of Japan faced two major disturbances. One was a soaring yen against the dollar, and the other was unprecedented dollar purchases by the central bank. After all, an economy of unprecedented vigor was quickly destroyed for many years to come. More than 15 years after those bubble years, the Bank of Japan is still afraid to raise its rock-bottom rate of 0.25%, apparently fearful of thereby endangering the economy's ongoing very modest recovery.

Meanwhile, Japan's central bank has no worries about possible capital inflows, because the present record-low yen interest rates in the world are fostering massive yen carry trade. Foreign investors are borrowing the ultra-cheap yen to purchase high-yielding assets in foreign currencies. Nevertheless, we keep wondering what will happen to currencies and asset prices when Japan returns to normal interest rates. It is a dangerous game for all participants, Japan most of all.

At the time, the numbers reported for the dollar purchases by the Bank of Japan shocked the world. Over the three bubble years of 1986–88, they altogether amounted to $71 billion. Over 2000–05, the central bank of the much smaller Chinese economy increased its foreign exchange reserves by $1 trillion.

Japan's asset and credit bubbles popped in 1990 because excessive investment in industrial capacity and commercial real estate had created overcapacity throughout the economy. Excess capacity exerted general downward pressure on prices. Rather abruptly, the former asset and credit bubbles turned into savage deflation of asset values and conventional price indexes. U.S. stock prices fell by a maximum of 70% and property prices by more than 80%.

In a study of Japan's painful bubble aftermath (*"Preventing Deflation: Lessons From Japan's Experience* *in the 1990s,"* published by the Federal Reserve in 2002), the authors express their strict conclusion that *"Either easier monetary policy or easier fiscal policy would have been helpful in preventing deflation and a protracted slump in Japan."* In the United States, of course, that is precisely the established consensus view about the causes of the Great Depression in the 1930s. Implicitly, it boils down to the question of whether the central bank has made its decisive policy mistakes during the prior boom phase or during the following economic and financial slump.

TWO FED WARNINGS

Under Mr. Greenspan, the Federal Reserve was constantly in the news. Apparently, he was keen to let the markets know his particular views about anything of some economic or financial interest. The most popular argument against the use of monetary policy to restrain a developing asset and credit bubble is the widely asserted difficulty to identify a bubble.

In a recent speech about this question, Fed Governor Frederic S. Mishkin stated:

> *First, one must assume that a central bank can identify a bubble in progress. I find this assumption highly dubious because it is hard to believe that the central bank has such an informational advantage over private markets. Indeed, the view that government officials know better than the markets has been proved wrong over and over again. If the central bank has no informational advantage, and if it knows that a bubble has developed, the market will know this too, and the bubble will burst.*

This argument is as common as it is stupid. Major asset bubbles have always developed in times of low inflation, overly loose monetary policy and capital inflows. Exploding credit is at an all-time high. In the United States, runaway credit escalation began to develop after 1992. Remember that the Fed reduced its interest rates in 1998, even though the U.S. economy was booming. After the sharp rate cuts in 2001, credit generally exploded. The decisive fact to see about the U.S. economy is that its credit expansion has run completely out of control in relation to economic activity.

Fed Chairman Ben Bernanke expressed severe warnings about fiscal policy. His theme was long-term fiscal challenges facing the United States. He was rather quick in making a highly satirical remark: *"Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade."*

His explanation for the projected large increases in entitlement spending was categorical and compelling. Like other developed countries, the United States has entered what is likely to be a long period of demographic transition. He gave three main reasons: *first*, a sharp decline in fertility; *second*, longer life expectancies; and *third*, a major shift in the relationship between going into retirement and people entering the work force.

Presently, people of retirement age, over 65 years of age, make up about 12% of the U.S. population, and there are about five people between 20–64 for each person 65 and older. According to official projection, retired people in 2030 will amount to 19% of the population, matched by about three working people per retired person.

Chairman Bernanke warns of the danger that rising budget deficits would drain funds away from private capital formation and thus slow the growth rate of real incomes and living standards over time.

During the past six years, there have actually been three dramatic changes in the U.S. pattern of national domestic savings. It amounted in 2000, the last boom year, to 5.8% of gross national income. In 2005, it was down to 0.1% of GNI. But in the third quarter of 2006, it was up again to 1.7%.

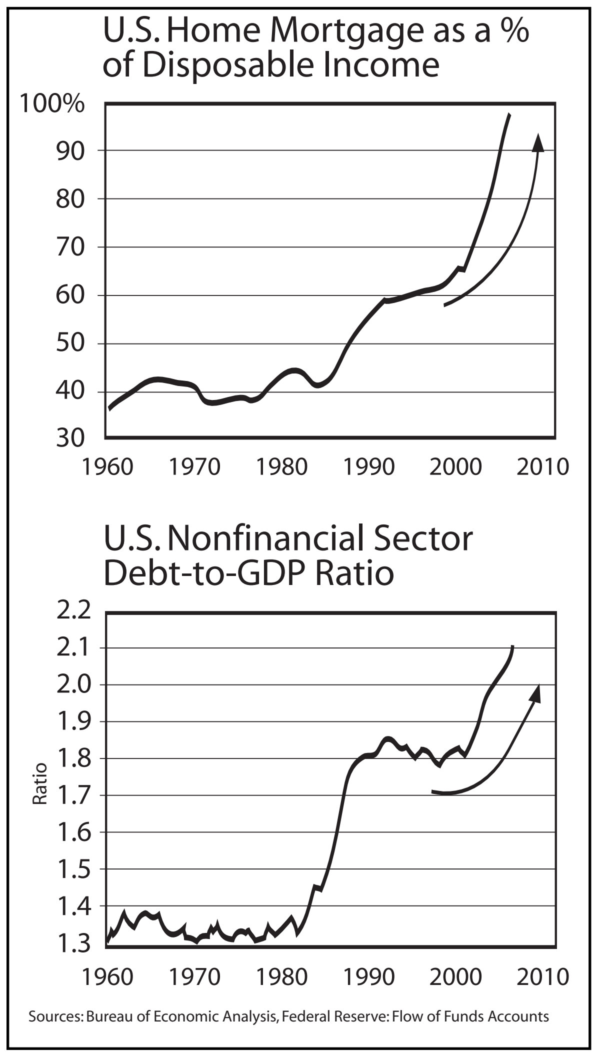
The chief positive factor over the years was soaring undistributed business profits. They surged without any interim dip from $130.3 billion in 2000 to $713 billion in the third quarter of 2006. At the same time, the net savings of the government sector changed over the same period from a surplus of $239.4 billion to a deficit of $175.8 billion. Personal saving switched simultaneously from a surplus of $168.5 billion to a deficit of $111.7 billion. What prevented an outright disaster was the boom in undistributed corporate profits.

SCARED OF ASSET AND CREDIT BUBBLES

Arguments between bulls and bears about the further prospects of the economy and the financial markets are focused more than ever before on one aggregate: excess liquidity. Long ago, until the late 1960s, credit growth was closely tied to economic growth, as measured by gross national product. But this formerly close relationship between the two aggregates went completely bust in the 1980s. Ever since, credit has been expanding in excess of GDP growth. The main reason has been exploding leveraged financial activity. In the United States, a second main reason is the trade deficit.

The chart to the right rather understates the actual credit explosion because it confines to nonfinancial credit. Since the 1980s, though, financial credits have grown much faster.

During 2005, total credit grew in that single year by $3.35 trillion. Compared with nominal GDP growth by $0.74 billion, this resulted in a relationship of 4.5–1. In other words, it required $4.50 of new credit to add $1 to GDP. This contrasts with a former relationship of 1.4–1 between the two aggregates.



Bulls believe that the existing global excess liquidity originates primarily in a radical change in corporate financial behavior. In the past, the Fed tightened its reins until banks and other institutions slashed their lending, typically associated with sharp falls in asset prices. During the 1991 recession, businesses repaid credit. Over the last few years, while the Fed raised its federal funds rate 17 times, by a total of 4.25%, corporations have been hoarding cash from undistributed profits as never before.

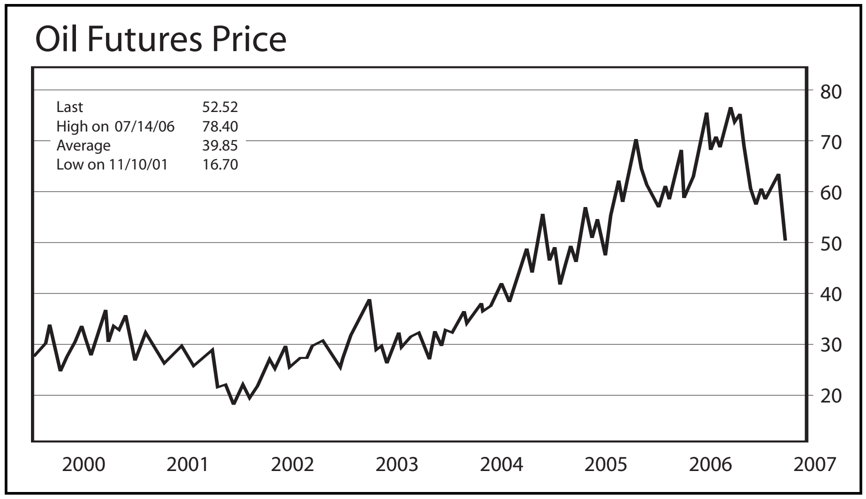
The Fed started its rate hikes in mid-2004. Yet it took until the third quarter of 2005 for the first signs of actual credit restraint to appear. Commercial banks started their first sharp slowdown in lending and liabilities in the third quarter of 2006.

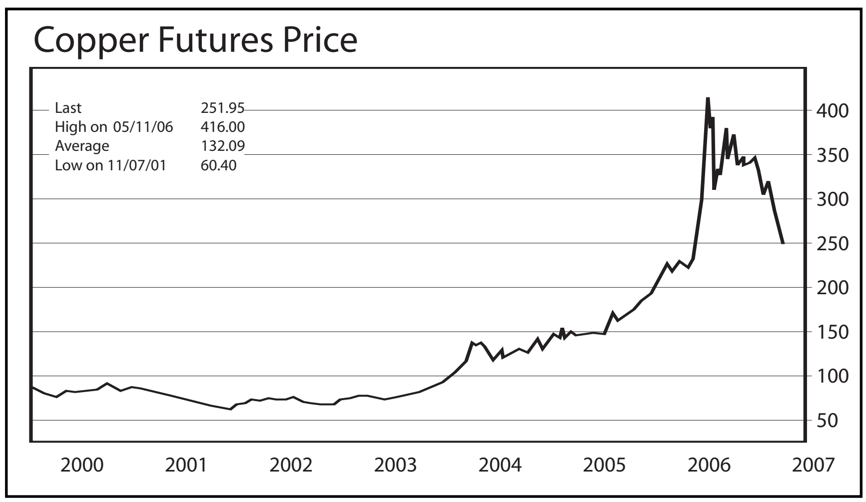
As to liquidity, it is a fact that each major economic and financial crisis was preceded by “excess” liquidity. Just think of America’s New Era during the 1920s and of Japan’s famous bubble years in the late 1980s. In both cases, prior excess liquidity vanished in no time when the existing asset bubbles began to burst. If growing asset bubbles are the channels to excess liquidity, bursting asset bubbles are the channels to liquidity destruction and excess debt.

WHITHER COMMODITY PRICES?

Among the various surprises that the last year brought about, the sudden sharp reversal in commodity prices certainly belonged to the worst part. As usual, it raises two customary questions: *first*, its causes; and *second*, its economic and financial implications for the U.S. economy and the rest of the world.

The most reasonable explanation of the sudden falls is the weakening U.S. economy. The oil price is down from $78.40 per gallon on July 14 to around $50 recently. This is a pretty sharp decline of about 36%. Copper had its last high on Nov. 5, at $416, and is lately down to about $252. This represents a steep 39% decline in a very short period of time. The apparent main cause is heavy oil purchases by "commercials," followed by heavy sales.





Opinions are strongly split. The optimists are betting that according to the latest data, the U.S. housing bubble has passed its worst point and a brief soft landing is assured to be followed by customary economic growth of close to 3%. In our view, the housing bubble, with all its implications for consumer spending, was much too big for such a comfortable outcome.

We strongly believe in a decisive role of the weakening U.S. economy behind the reversal in commodity prices. There is, moreover, nothing in sight to suggest that a strong business investment recovery will take over the baton from the consumer. The great question is whether or not the Asian countries possess sufficient internal staying power to offset and overcome the import shock from America.

IMPONDERABLES

Frankly speaking, observing the rather languid global stock markets around the world during recent days, we have some difficulty reconciling their behavior with all the Goldilocks reports that ended last year. But there are far more days to come this year. Our focus is mainly on three countries — the United States, Germany and China. The United States is decisive for the world; Germany is decisive for Europe; and China is decisive for Asia.

As to the United States, we belong to the small group that expects deeper and longer recession than is generally expected. Yet the next three to six months will provide the answer. There is much talk of the economy's inherent strength. Looking for this strength, we identify two diametrically different sectors.

On the one hand, there is the business sector, with its balance sheets immensely bolstered during the past few years by an unprecedented surge in undistributed profits. Available liquidity is at record levels, while net new fixed investments are at a record low.

It was always the great hope that in due time stronger business fixed investment would take over for the housing bubble to feed future economic growth. So far, nothing of that is in sight. Commercial real estate investment has accelerated, but business investment in plant and equipment has, in contrast, decelerated. Judging by the latest figures, it looks more like an impending general downturn in business fixed investment.

Merger and acquisition activity and stock buybacks have been running at a record pace and are expected to increase with further weakness in business capital investment as their counterpart. Considering in the same vein the burgeoning corporate cash holdings, one has to conclude that their opportunities for organic growth through new investment are not overwhelmingly in the view of corporate management. Once mergers and acquisitions are completed, the manifest key to profits is through rationalization of existing plant and equipment.

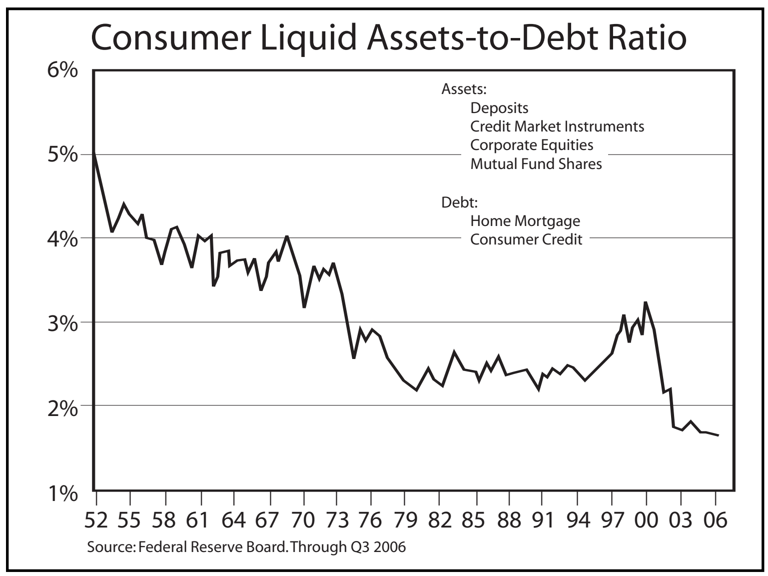
On the other hand, we observe with a very critical eye the sector of private households. For the consensus, their balance sheets are in excellent shape because asset values, mainly equity and housing, have soared in value for years, altogether by about $19 trillion — or almost 40% — since recession year 2001.

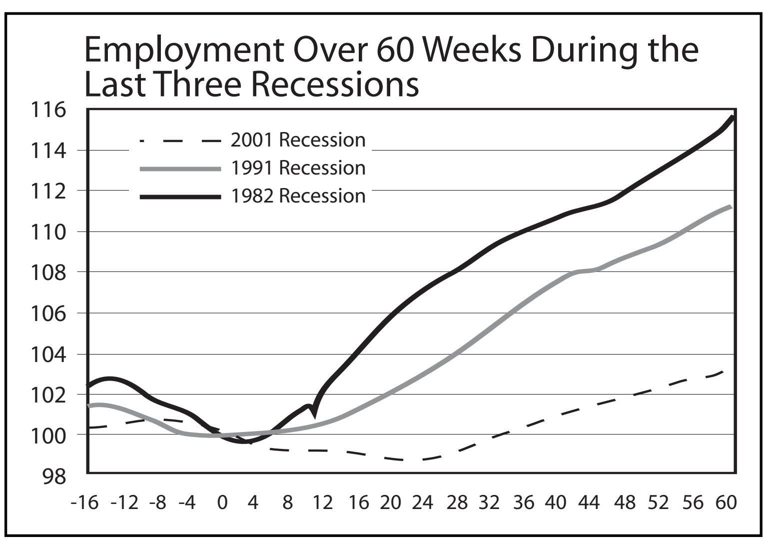
But the bulk of these gains has been entirely in illiquid assets, mainly equity and housing. Liquidity, measuring existing cash against overall liabilities, is at its lowest ratio in postwar history. To us, consumer balance sheets in the aggregate look more like a house of cards.

The great question is whether there is anything in the pipeline that might shake this house of cards.

In our view, the economic and financial situation in the United States is more complicated than ever before. First of all, the famous imbalances have continuously deteriorated. The current account deficit, national savings and debt levels are all at their worst thanks to a national and international credit machine that has been eagerly financing any income gap. Falling house prices have been pulling the first major leak into this credit system. At the same time, we wonder about the future effects of the reversals in oil prices and manufacturing raw materials. An unusually big contributor to U.S. GDP growth in 2006 was real inventory investments, with an amount of $68 billion over the past four quarters. Absent his large buildup of inventories, real GDP would have risen 2.3%, instead of the reported 3%.

In hindsight, the U.S. economy's recovery





from the brief 2001 recession suffered from two major deficiencies. *First*, it was by any measure the most anemic postwar recovery; and *second*, its composition was unbalanced as never before. We are sure that it has peaked, because the alternative investment-led growth, taking the lead from the housing-led recovery, is not in sight.

Net nonresidential fixed investment held in 2005 with $205.9 billion, little more than half its level of 2000. The second-biggest laggard in the recovery was employment and income growth. With an increase by a little less than 4%, it contributed the lowest employment growth during the whole postwar period, compared with an average growth rate of about 16% for postwar recoveries. Another big handicap is that one third of this weak employment growth arose directly or indirectly from the housing bubble.

Germany's real GDP is expected to have risen by 2.5% year over year in 2006. It was the economy's fastest increase since 2000. The strongest impetus came from exports, which contributed 0.7 percentage points to GDP growth. The second-biggest contributor to the economy's GDP growth was business fixed investment with 0.5 percentage points. Private consumption is estimated to have added 0.4 percentage points and building investment another 0.3 percentage points. Government added 0.3 percentage points and inventories 0.1 percentage points. Here again, the great question is the size of the U.S. economy's downturn and its repercussions on the rest of the world.

CONCLUSIONS:

It is no big secret that for several years the American consumer, with his unprecedented borrowing and spending excesses, translating into record-sized U.S. current account deficits, has played a key role in driving global economic growth.

Measured by the associated credit expansion, it was the world's greatest asset and credit bubble in history. The fact is that unusually warm weather in large parts of the United States led to considerable statistical distortions through seasonal adjustments, which will soon be corrected.

Right now, there exists enormous faith in the ability of the Federal Reserve to keep the various asset and credit bubbles inflated. Inflationists fail to see that much of the credit being borrowed can never be repaid, because debt service depends on capitalizing unpaid interest.

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