



The Chinese Renminbi -- From Draggin' Anchor to Dragon Anchor?

Everyone from Fed Chairman Greenspan to Treasury Secretary Snow seems to be offering advice to the Chinese monetary authorities as to how they should manage their currency. So, I will add to the unsolicited advice – anchor the renminbi to gold. The Chinese monetary authorities give stability as one rationalization for pegging the renminbi to the U.S. dollar. But is the dollar a stable anchor? Hardly. Chart 1 shows the behavior of the U.S. Consumer Price Index from 1921 through 2004 on a semi-log scale. A basket of consumer goods that cost \$100 to buy in 1921 cost over \$1000 to buy in 2004. Notice that the slope of CPI steepened dramatically starting in the second half of the 1960s. That's when our guns and butter fiscal policies started. The U.S. abandoned convertibility of the dollar into gold in August 1971. It is interesting, and I don't think coincidental, that the highest 10-year compound annual rate of growth in the CPI, 8.7%, occurred in the 10 years following the severing of the U.S. dollar – gold link (see Chart 2).

Chart 1

U.S. Consumer Price Index
(1921 = 100)

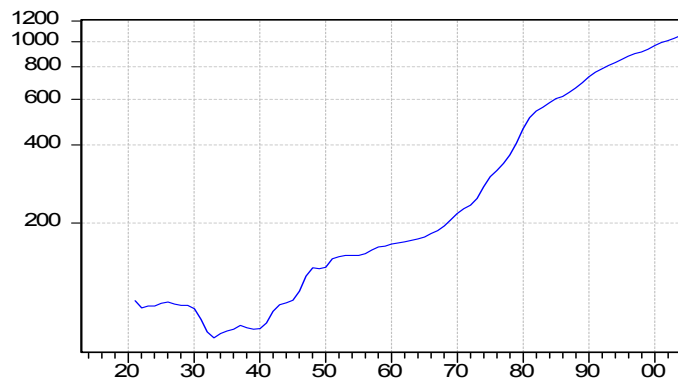
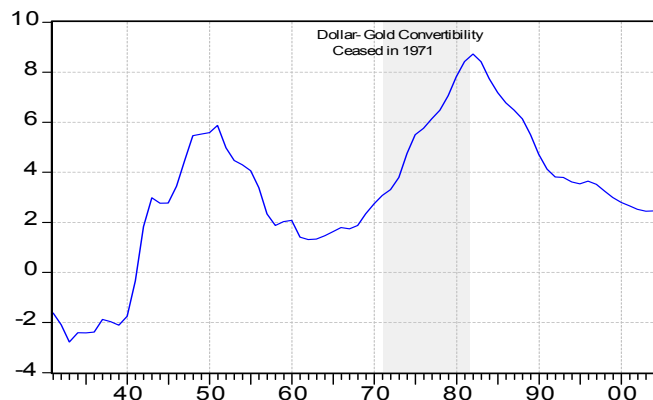


Chart 2

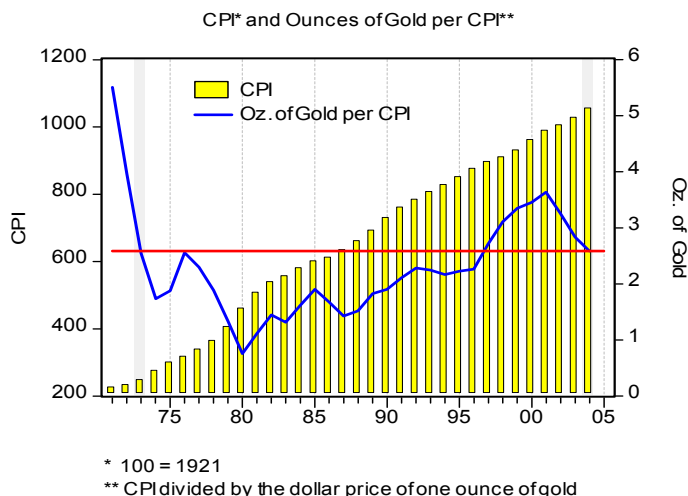
U.S. Consumer Price Index
(10-Yr. Compound Annual Growth, %)



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Would anchoring a currency to gold provide longer-run price stability? That is, would anchoring a currency to gold preserve the purchasing power of that currency? Chart 3 suggests it would. Although U.S. dollar – gold convertibility ceased in 1971, it was not until November 0f 1973 that major central banks stopped intervening in the gold market to keep its dollar price from rising to a free-market level. The line in Chart 3 is the CPI (100 = 1921) divided by the U.S. dollar price of an ounce of gold. In a sense, then, it is the number of ounces of gold needed to “buy” the CPI basket of goods and services. The bars in Chart 3 are the levels of the CPI. As you can see, the CPI marches inexorably higher and higher, meaning that it takes more and more dollars to buy the CPI basket of goods and services. Does it take more and more ounces of gold to buy the CPI basket? No. In 2004, it took 2.58 ounces of gold to buy the CPI basket – about the same as it took in 1997, 1976 and 1973. Not shown on the chart, but it also took about the same number of ounces of gold to buy the CPI basket in 2004 as it did in 1942. The CPI in 2004 was 1059 percent higher than it was in 1942!

Chart 3



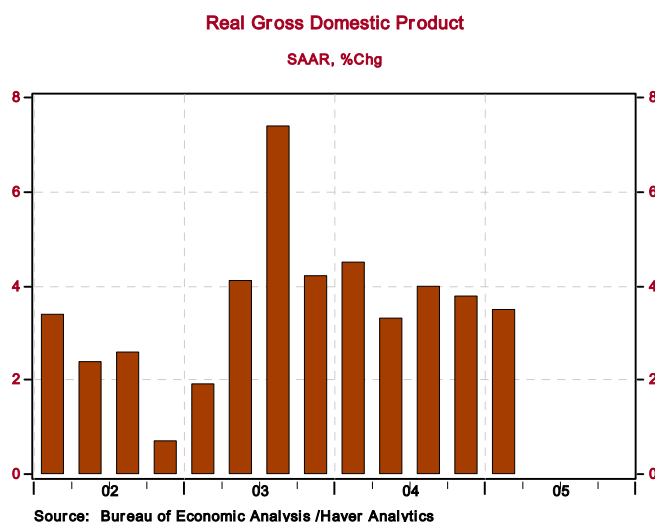
The sum and substance of all this is that anchoring the renminbi to the dollar is a recipe for Chinese inflation. Anchoring the renminbi to gold is a recipe for long-run price stability. And long-run price stability may be an important ingredient in the recipe for social stability, something the Chinese leadership is striving to preserve. Perhaps the current Chinese Communist Party leaders ought to reread the writings of the founding father of their movement, V.I. Lenin, and his fellow traveler, J.M. Keynes. To wit:

- Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. **By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.** By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become 'profiteers,' who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery. Lenin was certainly right. **There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.**
 - *Economic Consequences of the Peace* (1919)

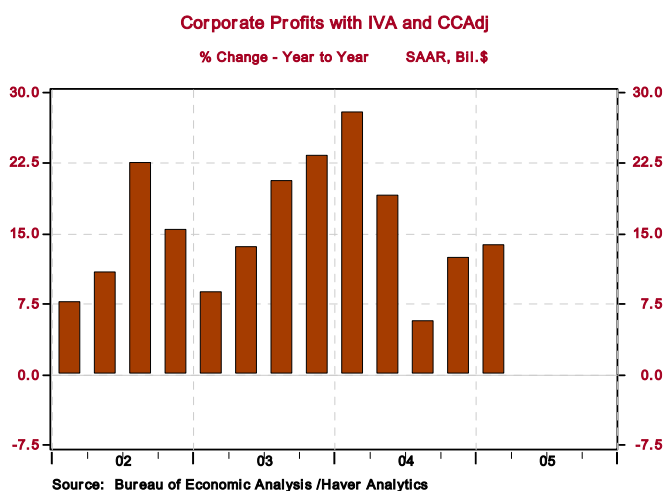
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Upward Revision of Q1 Real GDP

Real gross domestic product of the U.S. economy grew at an annual rate of 3.5% in the first quarter, slightly higher than the advance estimate of 3.1% annualized increase. An upward revision of consumer spending to 3.6% vs. the earlier estimate of a 3.5% gain, faster growth in residential investment expenditures (+8.8% vs. +5.7% in the advance estimate), and a significantly smaller trade gap (\$640 billion vs. \$663.2 billion in the advance estimate) accounted for the upward revision. Equipment and software spending is now estimated to have risen at an annual rate of 5.6% vs. the prior estimate of a 6.9% increase. Outlays on structures were much weaker than the advance estimate (-3.3% vs. -2.6%). The reduction in the accumulation of inventories (\$68.4 billion vs. \$80.2 billion) in the preliminary estimate compared with the advance estimate implies a smaller correction in the second quarter. Growth in final domestic demand, that is, growth in final sales to domestic purchasers was the same in the advance report as the preliminary report – 3.2%. This was down from 4.5% in Q4:2004. The revisions to the price deflators were insignificant.



Corporate profits with inventory valuation and capital consumption adjustments increased 13.8% year over year in the first quarter. The upward trend of unit labor costs and projected moderation of economic growth suggest that corporate profits may not post double digit gains during the rest of 2005.



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Growth in the second and third quarters of 2005 are predicted to be slightly slower, reflecting the impact of the 200 basis point increase in the federal funds rate. The FOMC is expected to raise the federal funds rate 25 basis points to 3.25% at the June 30 meeting.

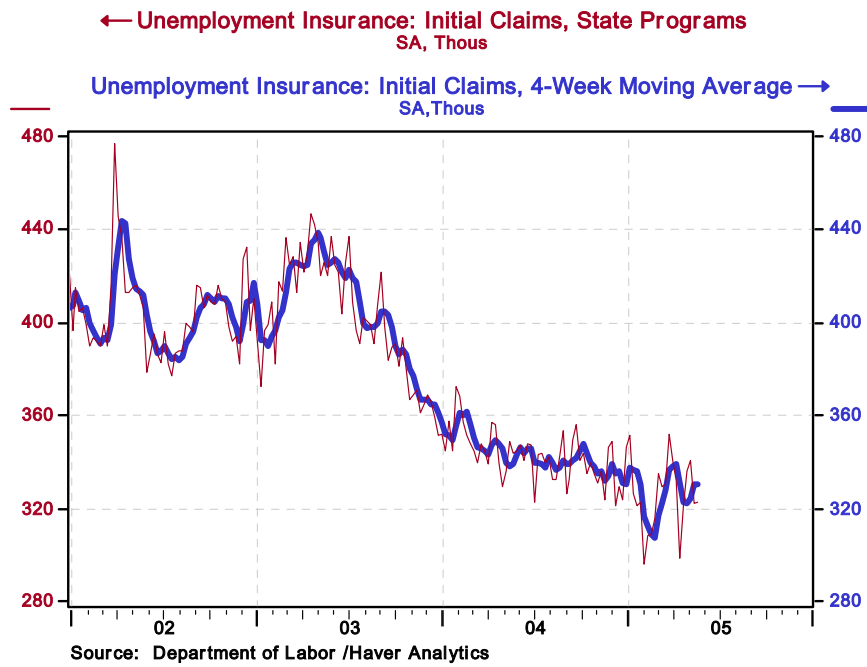
REAL GROSS DOMESTIC PRODUCT – PRELIMINARY ESTIMATE 2005:Q1

| | (2000 chained dollars) | | | | Percent Change (SAAR) | | | |
|--------------------------|------------------------|---------|---------|----------------|-----------------------|----------|----------|-------------|
| | 04:3 | 04:4 | 05:1 | 05:1 | from prior quarter | | | |
| | Final | Final | Advance | Preliminary | 04:3 Fin | 04:4 Fin | 05:1 Adv | 05:1 Prel. |
| GDP | 10891.0 | 10994.3 | 11078.2 | 11088.8 | 4.0 | 3.8 | 3.1 | 3.5 |
| CONSUMPTION | 7667.8 | 7747.0 | 7814.2 | 7816.5 | 5.1 | 4.2 | 3.5 | 3.6 |
| DURABLE GOODS | 1118.3 | 1129.0 | 1129.0 | 1133.8 | 17.2 | 3.9 | 0.0 | 1.7 |
| NONDURABLE GOODS | 2213.2 | 2245.3 | 2272.2 | 2275.2 | 4.7 | 5.9 | 4.9 | 5.4 |
| SERVICES | 4352.4 | 4389.2 | 4427.8 | 4423.4 | 3.0 | 3.4 | 3.6 | 3.2 |
| INVESTMENT | 1853.9 | 1912.6 | 1969.7 | 1958.8 | 2.4 | 13.3 | 12.5 | 10.0 |
| FIXED INVESTMENT | 1816.1 | 1861.9 | 1884.9 | 1886.3 | 8.8 | 10.5 | 5.0 | 5.3 |
| NONRESIDENTIAL | 1245.3 | 1288.3 | 1303.0 | 1299.5 | 13.0 | 14.5 | 4.7 | 3.5 |
| STRUCTURES | 241.0 | 242.3 | 240.7 | 240.3 | -1.1 | 2.1 | -2.6 | -3.3 |
| EQUIPM. & SOFTWARE | 1015.6 | 1059.5 | 1077.2 | 1074.0 | 17.5 | 18.4 | 6.9 | 5.6 |
| RESIDENTIAL | 565.9 | 570.6 | 578.6 | 582.7 | 1.6 | 3.4 | 5.7 | 8.8 |
| CHG. BUS. INVENT. | 34.5 | 47.2 | 80.2 | 68.4 | | | | |
| NET EXPORTS | -583.2 | -621.1 | -663.2 | -640.0 | | | | |
| EXPORTS | 1131.1 | 1140.0 | 1159.5 | 1159.9 | 6.0 | 3.2 | 7.0 | 7.2 |
| IMPORTS | 1714.3 | 1761.2 | 1822.7 | 1799.9 | 4.6 | 11.4 | 14.7 | 9.1 |
| GOVERNMENT (C & I) | 1949.9 | 1954.0 | 1956.7 | 1953.2 | 0.7 | 0.9 | 0.6 | -0.2 |
| FEDERAL | 726.6 | 728.8 | 729.8 | 729.6 | 4.8 | 1.2 | 0.6 | 0.4 |
| DEFENSE | 491.5 | 490.7 | 491.0 | 491.1 | 10.1 | -0.6 | 0.2 | 0.3 |
| OTHER | 234.7 | 237.7 | 238.5 | 238.1 | -5.3 | 5.3 | 1.3 | 0.7 |
| STATE AND LOCAL | 1223.2 | 1225.1 | 1226.8 | 1223.5 | -1.7 | 0.6 | 0.5 | -0.5 |
| DISP. PERS. INC. | 7990.2 | 8170.9 | 8165.6 | 8193.1 | 2.0 | 8.3 | -0.3 | -1.2 |
| FINAL SALES | 10854.7 | 10945.5 | 10996.2 | 11018.8 | 5.0 | 3.4 | 1.9 | 2.7 |
| GROSS DOMESTIC PURCHASES | 11430.9 | 11558.6 | 11650.6 | 11650.5 | 4.9 | 4.5 | 3.2 | 3.2 |
| PRICE DEFLATORS: | | | | | | | | |
| GDP CHAIN TYPE | 108.6 | 109.2 | 110.0 | 110.0 | 1.4 | 2.3 | 3.3 | 3.2 |
| GDP EX. FOOD & ENERGY | | | | | 1.8 | 2.1 | 3.2 | 3.0 |
| PCE CHAIN TYPE | 108.0 | 108.7 | 109.3 | 109.3 | 1.3 | 2.7 | 2.1 | 2.1 |
| PCE EX. FOOD & ENERGY | 106.8 | 107.2 | 107.8 | 107.8 | 0.9 | 1.7 | 2.2 | 2.2 |

Initial Jobless Claims – Nothing New, Yet

Initial jobless claims rose 1,000 to 323,000 during the week ended May 21. Continuing claims, which lag initial claims by one week, dropped 22,000 to 2.574 million and the insured unemployment rate held at 2.0% for the fifth straight week. The brief improvement in the labor market implied by the drop in the number of new applicants for unemployment insurance during April appears to be transitory. Additional weekly declines will be necessary to make it meaningful.

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