

CAD-USD \$1.0084 ▲ \$0.51 0.51% S&P TSX 13272.30 ▼ 39.37 -0.30% S&P 500 1271.50 ▼ 2.35 -0.18% OIL \$88.48 ▲ \$0.10 0.11% GOLD \$1369.70 ▼ \$2.00 -0.15%

## The Boy Who Cried "Dragon" BY DAVID MONUS

The United States is presently dealing with a number of financial and economic aftershocks that were either created or magnified by the 2008 financial crisis. Specifically: the anemic pace of economic growth, flagging capacity utilization, continued growth in both trade and current account deficits, and most importantly, domestic unemployment that remains stubbornly high with little prospect of near term improvement. As time has progressed, it has become apparent that the U.S. is unable to regain its economic momentum internally through fiscal and monetary policy alone. It has recently turned its focus externally on the world's other major economy — China, and has argued that China's fixed currency policy is a major cause of the current U.S. economic situation.

The impact of the 2008 financial crisis is quite profound given the result of recent and unprecedented back-to-back economic stimulus programs. President Obama's \$700 billion fiscal stimulus program, announced in early 2009, has done little, if anything, in terms of U.S. job creation.

The first stage of quantitative easing (QE-1), over US \$1.7 trillion, that saw the Federal Reserve's balance sheet balloon from approximately \$200 billion to \$2 trillion between 2007 and 2010 has likewise done little in terms of economic improvement. Although QE-1 led to lower interest rates, it did not result in a level of bank loan creation that was sufficient in lifting the pace of domestic economic growth. This stems from a number of issues. First, banks' diminished capital positions and subsequent reticence have heightened the level of concern regarding the current credit worthiness of U.S. borrowers. Second, consumers have restrained themselves and are either unwilling or unable to take on additional debt.

Many market participants remain equally dubious that the recently



announced QE-2 program (amounting to \$600 billion) will provide any additional substantive benefits given QE-1's lacklustre impact. During the first week of QE-2 in early November, the Federal Reserve reached the distinction that China was the largest holder of U.S. treasury securities (at approximately \$870 billion) in the world. How much longer can/should the U.S. government rely on these two sources of long term funding?

Given the dismal effect of both U.S. fiscal stimulus and quantitative easing, the Obama administration has turned to a third 'tool' — exerting political pressure on China since it views China's foreign exchange policy as both a major cause of, and potential solution to, the current U.S. economic situation.

The official currency of the People's Republic of China, the renminbi (RMB or Yuan) has been permitted for use only in Chinese domestic commercial transactions and is not a freely-floating currency. Since its creation in July 2005, the RMB has been tied or 'pegged' to the USD. Over the past five years, the RMB has seen only modest appreciation despite China's phenomenal economic growth both in absolute and relative terms. Specifically, it has appreciated from 6.99 RMB/USD in April 2008 to a level of 6.66 RMB/USD currently — a cumulative appreciation of only three percent.

Under this fixed foreign exchange rate mechanism, the People's Bank of China (PBoC) purchases USD from Chinese exporters at the fixed exchange rate in exchange for RMB.

This process coupled with the ever-growing China-US net export trade balance has resulted in the PBoC currently accumulating over \$2.7 trillion in USD reserves. Clearly, this is not a trend that can continue indefinitely.

The Obama administration has made their case numerous times over the past six months — that a major portion of America's current domestic economic woes are attributable to an unfair trade advantage for China as a result of this fixed exchange rate mechanism not being representative of the true terms of trade between the two economies. The U.S. rhetoric has strengthened recently and the level of U.S. frustration has escalated with the Chinese insistence on making any RMB-related changes on their own terms and timing.

Of course, this fixed exchange rate mechanism has not permitted the U.S. to realize any improvement in its trading balance with China despite the USD's steady depreciation over the past year. Additionally, the pressure continues to mount on China as other countries are starting to 'chime in' on this same RMB-value concern. Particularly, other Asian countries with floating exchange rate mechanisms have generally seen a diminishment in their export competitiveness during this period of USD and RMB depreciation.

Presently, The US is pursuing a two-tiered strategy in its attempt at battling the current economic situation. Despite its potential inflationary risks, further quantitative easing has been implemented in order to encourage bank lending and a more active

consumer. Meanwhile, RMB revaluation does carry limited potential to both reduce the trade imbalance and current account deficit. It is difficult to quantify how much of the U.S.-China balance of trade would change with various amounts of RMB appreciation. Due to its market size, scale of production capacity, low wage rates and number of other factors, a material RMB revaluation may still leave China in a relatively competitive position.

However, one thing is very clear — that trade and economic issues between the U.S. and China will likely not be resolved easily or in the near term.

## Extending the Bush Tax Cuts

BY JOSH NYE

On Monday December 6, President Obama announced a tentative agreement with House Republicans to extend the Bush tax cuts across all income brackets for the next two years. While the move has put an end to speculation about whether the cuts would be extended,

ardize the current economic recovery.

The so-called Bush tax cuts refer to two tax bills passed by George W. Bush in his first term as president. The first, the Economic Growth and Tax Relief Reconciliation Act of 2001, reduced income taxes across all brackets. This encouraged Americans to work more by letting them keep a larger portion of their paycheck. The second, the Jobs and Growth Tax Relief Reconciliation Act of 2003, rewarded savings and investment by lowering taxes on capital gains and dividends. When these tax cuts were passed they were not government stimulus; both were made to promote long-term economic growth. But quite a bit has changed since then. The global economy went through the worst recession since the Great Depression and is only now on it's way to recovery. With the Bush tax cuts set to expire on December 31, 2010, they now play a much different role. The government is more concerned with bolstering the economy in the short-term than achieving long-term growth. Extending the tax cuts amounts to further fiscal stimulus,

left-wing economist, would allow the cuts to expire and replace them with extra stimulus in the form of transfers to state and local governments. Meanwhile, others worry that extending the tax cuts would only serve to deepen the large deficit that the U.S. government currently faces. They argue that the government cannot afford to extend the cuts without commensurate decreases in federal spending. However, many are weary of this alternative as a significant decline in government spending could further slow the unstable economic recovery.

While Congress can agree that the Bush tax cuts should not be allowed to expire, exactly how to extend them is a divisive issue. House Republicans want to see the cuts extended across all income brackets while Democrats are adamant about allowing cuts for the highest bracket to expire. They argue that tax cuts for top earners are saved rather than spent and thus do little to help the economy. Most Republicans, however, are not willing to compromise on the issue. This leaves Democrats with the choice of allowing the cuts to expire or extending them in their entirety. This was just what President Obama faced when negotiating the extension with House Republicans. In the end, despite his convictions, he agreed to extend the cuts even to the highest income bracket rather than let them expire altogether.

But while the agreement is largely seen as a Republican victory, Obama was able to get some extra stimulus out of the negotiations. The \$900 billion package will also include a payroll tax cut and an extension of unemployment benefits, among other things. Although Democrats are not happy with the tax cuts for the rich, for them this package makes the best out of a bad situation. With Republicans set to take over Congress in the new year, they should be happy with any extra spending they can get. The reality is that extending the Bush tax cuts was the easiest way to get economic stimulus through Congress in the near future — even if it's not exactly what the Democrats wanted.



it has certainly not quieted debate on the subject. Obama is being highly criticized by Democrats for extending tax cuts for the rich, something he had vowed not to do when running for office. But while some say he is bowing to Republican pressure, he is really just attempting to navigate a highly partisan political landscape. Obama was forced to choose the lesser of two evils: extending the cuts in their entirety rather than allowing them to expire. Whether Democrats agree with them or not, the Bush tax cuts represent an important fiscal stimulus whose removal would jeop-

something the economy is certainly in need of.

Although most lawmakers are in favour of extending the Bush tax cuts, many critics outside of government are not so eager to see them renewed. Some argue that while stimulus is needed to boost economic growth, extending the Bush tax cuts is one of the least effective ways to achieve this. Most observers agree that the controversial tax cuts for the rich will do nothing to stimulate the economy. But some go even further, arguing none of the cuts should be extended. Paul Krugman, an influential



## Big Money in American Politics

BY KUNAL KAPOOR

It is no startling fact that over 90% of candidates who won seats in the last American elections spent more money than their opponents in doing so. This is a trend that has carried on in election cycles for decades, igniting debates over the democratic process and the money that finances it. Deep pocketed interest groups have generally been able to hold more sway in political outcomes than the average citizens who have only small contributions to spare for their favourite candidate. Limiting that sway has long been the reasoning behind bans on corporate spending to influence elections. In early 2010, these limits changed when the Supreme Court ruled on the case of *Citizens United v. Federal Election Commission (FEC)*. In a landmark decision, they ruled that limitations on corporations and unions to launch independent and explicit ads about a candidate was unfairly restricting First Amendment rights of free speech.

While the limit on direct corporate contributions to political parties remains unchanged, the new ruling has lifted restrictions on how corporations can independently spend to influence elections. Before *Citizens United v. FEC*, corporations were unable to run advertisements and media spots explicitly advocating or attacking a political candidate. Today, they face no such restrictions and can finance their efforts directly from corporate treasuries. Corporations can now spend as much money as they wish, in the form of explicit political messages, in order to garner a win for their favourite candidate. Many critics, including President Obama, argue that the weight of power in American democracy has shifted over to corporations and unions that are will-

ing to inject enough money to vastly influence the outcomes of elections.

There is an inherent chicken and egg question at play. Do money and advertisements grab voters or do voters and corporate contributions freely allocate money to supporting the best candidate? Applying free market economics to political outcomes is a shaky process. Large corporations could easily outspend their political opponents in crucial elections; and not necessarily to support the best candidate, but the one who serves the corporation's interests on a single issue. It becomes a question of whether an extreme scenario such as a 7 to 1 outspending will truly affect the outcome of elections or not and this is by no means an irrational fear. Exxon, for example, can spend more than the top 20 political action committees in America with less than 2% of a single quarter's earnings. Obama was able to privately raise 745.7 million dollars in contrast to McCain's 84.1 million and went on to a highly successful campaign. For every idea that an opposing politician can communicate, a corporation can now do several times more and in better form, simply through sheer purchasing power. While the correlation between money spent and candidate wins is strong, the financial leverage is not always cause alone.

**“Exxon, for example, can spend more than the top 20 political action committees in America with less than 2% of a single quarter's earnings.”**

Corporations are now in a position to truly hold sway over the future of their businesses. Industries threatened by public policy in the wake of climate change legislation, such as greenhouse emitters and oil, now have the greatest incentive to spend their treasuries on taking a political stance. Politicians who were elected because of considerable industry backing will likely push for protectionism when these corporations are threatened. Corporate influences are not necessarily all bad either. Pushing for the creation of trade boards and opening up investment in emerging markets that were previously undervalued can drive economic growth, for example.

While this ruling provides significant benefits to corporations, it also poses the danger of drowning out smaller political voices. Single voters can only provide a fraction of the in-

dependent support to candidates that large companies can. Single voters can even form groups and committees as they have done in the past, but the bottom line is that these groups cannot compete with the financial capabilities of revenue generating businesses. Essentially, this new form of political competition threatens to belittle the voice of many by purchasing the mode of electioneering communication.

As political candidates poise themselves for their campaign down the road, so too will the corporations that now wield significant influence in the electioneering process.

## A Golden Opportunity

BY DAVID EDWARDS

Gold has been an investor's dream over the past decade. Nothing, not stocks, bonds, real estate or emerging markets have even come close. If you had bought gold at its lows in 2001 – at around \$250 an ounce – you would have seen gains exceeding 450%. With gold now trading around \$1400, the question that needs to be asked is: Is gold a bubble about to burst?

To answer this question, it is important to understand what has caused the significant run-up of gold prices over the past decade.

The value of paper currency can be quite volatile due to several social and economic factors such as political unrest, economic recessions, inflation, etc. In times of uncertainty, gold provides a safe haven to investors since it is viewed as a currency with a tangible value. Gold is easily traded worldwide and is not tied to any single country. Since gold is a safe asset to protect against fear and uncertainty, a portion of the price increase must be justified. Over the past few years, the world economy has seen a variety of potential problems. There have been fears of the next Great Depression, the collapse of the world's financial system, a series of potential national defaults in Europe and more recently a double-dip recession in North America. While none of these problems have materialized, the uncertainty that surrounded each event has continually pushed gold – the safe haven – to higher levels.

On the other side, many people on Wall Street believe that the run-up in gold prices has reached the speculative stage and has completely strayed from the underlying fundamentals.



George Soros, a world famous investor, declared gold to be “the ultimate asset bubble”, yet still continued to add gold to his hedge fund’s portfolio. While this seems like a contradiction, people in the investing community know that the most money will always be made right at the end of a bubble, when frenzied speculation has set in. The idea of speculative investing is well represented by the Greater Fool Theory. The Greater Fool Theory is when someone buys an asset at a price above its underlying value, simply because they believe that they can sell it to someone else (“the greater fool”) for a higher price. This is equivalent to paying \$3 for something worth \$1, because you think someone will buy it from you for \$5. Eventually, all bubbles run out of “greater fools” and the bubble bursts, causing prices to crash.

While gold has continued to push higher, the current price levels may still not be enough to consider gold a bubble about to burst. In 1980, gold reached a price of \$850 an ounce, which corresponds to a price of about \$2250 an ounce in 2010 dollars with inflation factored in.

Predicting the future of gold is difficult, yet continued uncertainty in the world economy or the onset of greater fools in pure speculation could potentially push gold to higher levels. The gold rush may be far from over.

## A WINDOW OF OPPORTUNITY

BY KADEEM ROBINSON

If a consumer thought that choosing a cell phone was hard, that decision has just become even more difficult. On November 8, 2010 Microsoft launched their line of phones running Windows Phone 7 across North America, making them the fourth big player in the mobile market joining Google, RIM, and Apple.

At first glance, such news seems insignificant due to Microsoft’s struggles to create a revolutionary mobile operation system since 2000. Within that time they have released 8 different versions, not including Windows Phone 7. Their most recent software disappointment came in May 2009 when they released Windows Mobile 6.5. The new Windows Phone 7, however, brings a totally different look from its predecessors. The new operating system uses tiles to navigate the home page while boasting flawless email syncing and a useful Microsoft office that allows for creation, viewing and editing of PowerPoint, Word, and Excel.

This leads to the following question, what is the significance of having one more competitor in a mobile market that seems to already have an abundance of players?

The emergence of Microsoft in the mobile OS market has the potential for a massive shift in the competitive landscape as Windows Phone 7 poses reliable document and email functions. This provides many businesses with a mobile option that does not require the extra hassle and cost of registering and building an OS to cater to the business programs when it is much more natural with a phone running

Windows. As a result, Microsoft offers a perfect substitute for BlackBerrys, making them a serious threat to RIM. This seems to be the beginning of a new rivalry; Dell, an early supporter of the Microsoft OS and aiming to push their own piece of hardware has equipped their business professionals with their new Venue-Pro device that supports Windows Phone 7 – swapping away 25,000 BlackBerrys in the process. This may simply be a cost cutting measure, however, if Dell reports success in the switch then it will only encourage and harvest device change within other organizations.

The majority of the business world runs on Windows. Running a mobile OS that is readily integrated with a company’s IT infrastructure is both easy and affordable. It is also important to keep in mind that there has been a growth in the ability to complete daily tasks through a phone and it is evident that Microsoft realizes this through its platform development. It will be interesting to see what the future holds for Microsoft as they could potentially achieve great success by obtaining a large portion, if not the majority, of business consumers over time. Let the battle begin.

### THE ECONOMIC OUTLOOK

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