WEEKLY ECONOMIC AND MONETARY REPORT

2 December 2011

The big story continues to be the eurozone – with attention now firmly focussed on the December 9 EU Summit. Despite repeated disappointments, the markets have once again convinced themselves that a resolution is near – in this case, a 'grand plan' for some sort of 'stability union', run by Germany and France, which will impose fiscal discipline on recalcitrant eurozone members in return for bailing out their bond markets via the ECB. It *could* happen; and there is no doubt that European elites (who seem to have abandoned any faith they once had in democracy) *want* it to happen. But – given all the disappointment of the last year or so (and the opposition of German public opinion to any bail-out of the South) – one would have to be a wild-eyed optimist to believe the crisis is almost over.

That said, there is another issue that really deserves more attention – the increased divergence in economic performance around the world. On the one hand, the US economy *appears* to be recovering; on the other hand, Europe appears to have hit a wall. And China (which many had seen as the 'locomotive' that would pull the West out of its problems) has suddenly started to slow down.

I THE EUROZONE CRISIS

The mood at the end of the week is much better than it was at the beginning – with attention focussed on: (a) the expected publication of plans by Merkel and Sarkozy on Monday for a 'stability union'; and (b) the December 9 EU Summit, at which it is hoped that all eurozone members will sign up to what ECB President Draghi has called a new "fiscal compact".

None of this seemed likely at the beginning of the week. Indeed, the big stories then were all negative. In particular, it was being reported:

- that non-eurozone banks (particularly US and Japanese banks) were cutting interbank lines to their eurozone peers;
- that both banks and corporates (significantly, including Siemens) were now making contingency plans for a euro breakup;
- that the ECB was having trouble finding buyers for the 7-day deposits it had been using to 'sterilize' its bond purchases;
- that Klaus Regling had given up trying to boost EFSF resources much beyond the €350 billion or so that is left in the pot (though it has been agreed that can be used to provide partial guarantees for around €750 billion of eurozone debt);
- that the pace of deposit withdrawals from Greek banks had accelerated in early November; and
- that French sovereign debt was now trading in the market as though France had already lost its triple-A rating.

Plus, eurozone bond yields were still very high. Italy, in particular, was paying 7.89% for three-year money and 7.56% for 10 years. Given that it has to raise €220 billion in 2012, that is clearly unsustainable. Even Germany was starting to be affected. On Tuesday, for instance, the yield on 10-year UK gilts fell to 2.25% - despite a budget deficit amounting to 8.4% of British GDP. This compared with 2.31% on comparable German *bunds* – the first time UK rates had been below German rates since 2009.

Of all these problems, the most pressing was the danger that eurozone banks were being shut out of the interbank market. That prompted a coordinated move on Wednesday by the Fed, the Bank of England, the ECB, the Bank of Canada, the Bank of Japan and the SNB – all of which slashed the cost of interbank dollar liquidity by 50 basis points. In the case of the Fed, that meant that it cut the cost of short-term dollar loans from 1.1% to 0.6%. At the same time, China and Brazil also cut bank reserve requirements to encourage local bank lending (though China, at least, denied that this was coordinated with the Fed).

The effect of this move (which caught the markets off-guard) was electrifying: Stock markets in Europe jumped 3-5% on Wednesday, while the DJIA, S&P500 and Nasdaq were all up over 4% for the day – and seem likely to close the week with their strongest gain for two years. Plus, the 10-year *bund* yield fell from 2.31% to 2.28%, and the one-year German interest rate briefly turned negative. Other eurozone interest rates followed. On Thursday, for instance France and Spain both held well-received Treasury auctions, with the French 10-year rate falling to a one-month low of 3.11% and the Spanish 10-year rate falling to 5.74%. Italy's 10-year yield also dropped to 6.67% (it had been over 7.8% last week).

What impressed the markets was not just the central bank action (though it was emphasised that there was 'no limit' to the liquidity the banks were prepared to put in). It was the growing belief that Germany, France and the ECB were finally developing a common policy to 'save' the eurozone.

This is much more controversial territory, and we are not sure that the markets are right to be so upbeat. Nevertheless, they have taken their cue from a speech that the new ECB President, Mario Draghi, gave to the European Parliament on Thursday morning. In this, he emphasised that "a new fiscal compact" is the key to restoring eurozone credibility – and promised that, when this has been agreed, the ECB would be willing to play a more pro-active role. He has still not committed the ECB to being the lender of last resort for the eurozone, or to buying up unlimited bonds from eurozone sovereigns. But – despite the fact (emphasised by former Vice-president of the ECB, Otmar Issing, in today's *FT*) that both these would be illegal under the Treaties of Lisbon and Maastricht – that seems to be what is now on the table, even though Merkel reiterated today that so-called "eurobonds" are still "unthinkable".

Apparently, Merkel and Sarkozy are to present a joint proposal for a 'stability union' on Monday. This will (it is said) include provisions for stricter budgetary rules, sanctions for non-compliance, and surveillance – everything (a cynic might point out) that was already in the Treaty of Maastricht. In addition, they hope to give a bigger role to the IMF –

which should help to defray the financial burden package. This if a bailout of Italy or Spain is required, is then to be debated (and agreed) by all eurozone leaders at the subsequent Summit.

This *may* happen. However, Merkel has already begun to pour cold water on her more enthusiastic supporters; as she pointed out, a real solution to the eurozone crisis will take years.

Other reasons for pessimism abound. For instance:

- It was reported this week that – far from getting better - Greece's fiscal problems are actually getting worse as the tax base shrinks. On its own statistics, it looks as if Greece's deficit this year will be over 15% of GDP – perhaps as high as 18-19% - compared with 10.5% in 2010. (Perhaps not coincidentally, it was also reported this week that the Greek authorities are now suing the head of the government's statistical agency, who used to work for the IMF, for 'betraying the country's interests' by exaggerating the 2009 budget deficit.)
- While France and Germany share the belief that 'something must be done', their approaches may well turn out to be fundamentally incompatible. In particular, Merkel wants to give Brussels the power automatically to penalise eurozone member states who break the proposed budgetary rules; Sarkozy wants this to remain a domestic political decision (presumably because France is almost certain to be one of the first to break any budget rule).
- Anti-German feeling continues to grow in the debtor countries of the South. This was emphasised over the weekend by the (German) head of the *troika*'s task force in Greece, who demanded that a date be set for him to leave the country because of anti-German hostility. "I was surprised at the degree to which being German was a factor", he said – presumably forgetting Germany's brutal occupation of Greece from 1941 to 1944.

On the other hand, the Polish Foreign Minister, Radek Sikorski (whose country has suffered more than any other at the hands of the Germans), argued this week that Germany is the only country that can save the EU from "a crisis of apocalyptic proportions". For many in Southern Europe, the choice between disaster and being saved by the Germans is not very appealing.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

Janet Yellen, the Vice-chairman of the US Fed, summed up the problem this week. The global economy, she said, faces three big issues:

- the absence of forceful action in Europe to resolve the crisis of the euro;
- the "dysfunctionality" of the US housing market, which continues to hold the US recovery back; and
- China's reluctance to boost domestic consumption.

To that, it is worth adding the danger of protectionism. The EU's trade Commissioner, Karel de Gucht, warned this week that more and more countries are ignoring the WTO and imposing unilateral trade restrictions.

Yellen is certainly right that prospects for the global economy have deteriorated. Indeed, this week, the OECD released its latest semi-annual *Economic Outlook*, which cut its growth forecast for the Organisation as a whole for 2011 from 2.3% to 1.9%, and for 2012 from 2.8% to just 1.6%. However, what is as interesting as the aggregate figure is the country-by-country breakdown:

OECD: Economic Outlook (GDP growth rate)

	2011	2012
US	1.7%	2.0%
Germany	3.0%	0.6%
UK	0.9%	0.5%
Eurozone	1.6%	0.2%
France	1.6%	0.3%
Italy	0.7%	-0.5%
OECD-34	1.9%	1.6%

In other words, Europe looks like being much harder hit than the US.

A **THE US**: This week's economic data reinforces this view – and, indeed, Citigroup's economic 'surprise' index (which measures the extent to which economic releases exceed market expectations) is now at its highest level since March 9. That said, today's payrolls number for November was actually a little on the disappointing side.

At the beginning of the week, the prediction for the increase in non-farm payrolls in November was around 125,000 – pretty much in line with the 120,000 increase that was actually announced today. However, in the meantime, ADP reported a 206,000 increase in private sector jobs last month – leading some to anticipate a monthly gain of around 200,000 in total jobs. Nevertheless, given that the overall unemployment rate (which is calculated separately) fell from 9.0% to 8.6%, the markets seem likely to react fairly positively, especially given that September and October payrolls were also revised upwards by 72,000.

Plus, and more importantly, most of the other US data released this week has been positive. In particular:

- the Conference Board's consumer confidence index for November rose from 40.9 to a five month high of 56.0;
- the Chicago purchasing managers index rose from 58.4 to 62.6 in November;
- pending home sales jumped 10.4% to their highest level of the year last month;
- the manufacturing ISM purchasing managers index rose last month from 50.7 to 52.7 – with the new orders component jumping to 56.7;
- November same-store retail sales were up a better than expected 3.1% in November; and
- construction spending was up 0.8% in October.

"Black Friday" – ie the day after Thanksgiving, when shops effectively begin their Christmas sales season – was also strong, with preliminary reports putting sales up 6.6% year-on-year.

Just about the only negative this week was a 0.6% drop in the Case-Shiller housing index, though that was for September. Even the Fed's 'Beige Book' survey of business conditions was positive, with 11 out of 12 regions reporting an increase in activity since October – though from a low base.

The combination of a stronger US economy and more central bank liquidity (if only to bail out the eurozone) gave equity markets a significant boost this week. Last week, the DJIA was off 4.8% and the S&P500 was down 4.6%; in the first four days of this week, the Dow was up 7.0% and the S&P was up 7.4%. In early trade Friday, both are up around 1%. At the same time, however, fear of inflation has increased, pushing the yield on the 10-year Treasury up from 1.97% last Friday to 2.12%.

Politically, the drop in the jobless rate is obviously good news for Obama. However, he still faces a stand-off with Republicans in Congress over deficit reduction. That said, there are reports that Rep. Eric Cantor is trying to broker a deal that would stop the automatic imposition of US $1.2 trillion in spending cuts that is supposed to come in starting in 2013. (Cantor's concern is to stop any cuts in military spending – something that would be anathema to Republicans.)

B **EUROPE**: There isn't much good news as far as the eurozone economy is concerned. This week, for instance, it was reported:

- that the Commission's own economic sentiment indicator for the eurozone fell last month from 94.8 to 93.7;
- that the industrial confidence index for the eurozone fell from -6.5 to -7.3, while consumer confidence fell from -19.9 to -20.4;

- that eurozone unemployment rose from 10.2% to 10.3% in October – hitting a euro-era high; and
- that the Markit PMI for November hit a 28-month low of 46.4, down from 47.1.

Under these circumstances, the almost inescapable conclusion is that the eurozone is falling back into recession.

There is, however, one exception – Germany. This week, it was reported:

- that the CRS's consumer sentiment index rose in November from 5.3 to 5.4 – with a prediction that it will hit 5.6 in December;
- that the overall German unemployment rate fell from 7.0% to 6.9% last month;
- that retail sales were up 0.7% month-on-month in October; and
- that the BGA exporters association now expects German exports to rise a further 6% next year – though how, given the collapse of export markets in Southern Europe, seems unclear.

The problem is that (as with everything else) Germany is an outlier. In Italy, for instance, it was reported this week that unemployment rose unexpectedly from 8.3% to 8.5%; in France, the jobless rate is now nudging 10%.

As for the UK, the outlook is almost as grim as within the eurozone. The (independent) Office of Budget Responsibility issued new economic forecasts this week, cutting its growth projection for this year from 1.7% to 0.9%, and for 2012 from 2.5% to just 0.7%. Moreover, it now expects unemployment to rise from 8.1% to 8.7% by end-2012 – and the outcome could be worse than that, based on the picture of continued austerity painted by the Chancellor, George Osborne, in his Autumn Statement on Tuesday. Even though the government is promising extra spending on public infrastructure, the prospect is for at least five years of low growth and constrained public finances. According to the *FT*, "no government has made such deep cuts – or expected such hard

times". That may be an exaggeration – particularly since many of the projected cuts don't kick in until after the next election. But the outlook is pretty grim.

Despite that, some things never change. First, a general strike on Wednesday by public sector workers appears to have led to a sharp increase in retail spending as workers had more time to go shopping. Second, UK house prices have started to rise again. According to the Nationwide, they were up 0.4% last month – the third straight increase.

C **CHINA**: As noted earlier, the PBoC announced an easing of bank reserve requirements by 0.5% on Wednesday – the first such move in over two years. The key issue is whether this was part of the globally coordinated push to bail out European banks, or whether it was dictated by domestic Chinese considerations.

Of the two, the latter explanation seems more likely – not least, because it was also reported this week that the manufacturing PMI fell below 50 last month, dropping from 51.4 to 49. The *Wall St Journal* is not alone in predicting that China faces a hard landing. Property prices are already falling, the most recent PMIs suggest that the economy may actually have contracted last month, and China's main export markets are slowing down.

The Chinese policy response is still cautious. But it is significant that, on Monday, the authorities announced a shift of policy on the internationalisation of the renminbi. They will now allow foreign firms to invest renminbi accumulated overseas in mainland China's securities markets, and they will permit trading of renminbi against the Australian and Canadian dollars.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week was a strong one for the dollar. It gained 1.8% against the euro (to close at US $1.327/€) and 2.0% against sterling (to close at US $1.548/GBP). However, it fell 0.3% against the yen (to Y77.68/US $).

This week, the pattern has been reversed:

- US $/euro: At the close last week, the euro was trading at US $1.327. It then strengthened to US $1.347 on optimism that the eurozone crisis may take a turn for the better. Even though it has eased a little today to US $1.338/€, it is still up 0.8% for the week.
- US $/sterling: The pound closed last week at US $1.548. It then rose to US $1.573, before easing slightly yesterday. It is currently trading at US $1.558 – up just 0.6% for the week.
- Yen/US $: The dollar closed last week at Y77.7/US $. It strengthened briefly to Y78.1, but has since settled back down at around Y77.9 – up 0.3% for the week. Despite this, Japanese industrialists are pushing hard for the BoJ to do something about the yen; Nissan's Carlos Ghosn has been particularly vocal.

It has generally been a 'risk on' week (though the 'risk on/risk off' cycle has been getting shorter and shorter) – which has meant strong capital flows into the Australian and Canadian dollars. Indeed, the Australian dollar broke parity, firming from A$1.025/US $ to A$0.973, before weakening slightly today. The Canadian dollar also strengthened, from C$1.047/US $ to C$1.016.

One problem that concerns the Swiss franc in particular is what a break-up of the euro might do. At the close last Friday, the franc – which is the safe haven of choice for many Europeans – was trading at SF1.238/€; it firmed to SF1.225 before easing to SF1.234/€ at the present time on reports that the SNB is considering the imposition of negative interest rates.

As for gold, it lost almost US $31/oz last week, but has gained US $57.40 this week, and is currently trading at US $1,752.30. Whatever politicians might be saying about a eurozone deal, it would appear that traders are far from confident. There is also the problem of the Indian rupee – which has lost 18% of its value against the US dollar since

the beginning of August (and 6% in the last month). Indians are natural gold buyers, and their declining confidence in the rupee has underpinned the gold price.

IV OIL

Last week, front month WTI fell 90 cents to close at US $96.77 a barrel, while January Brent fell US $1.16 to close at US $106.40 – pushing the spread in favour of Brent down to just US $9.63. It was more than twice that before reports of a new pipeline out of Cushing, OK hit the market.

This week, the main factors in the oil market have probably been:

- the possibility of an EU embargo on Iranian crude imports as part of Europe's response to the trashing of the UK economy in Tehran;
- a sharp rise in US crude inventories, up 3.93 million barrels in the latest week (after a drop of 6.2 million); and
- an increasingly tight market in Europe for higher sulphur, low quality sour oil – which has seen the price of Russian Urals jump ahead of Brent.

Whatever, January WTI is currently trading at US $100.20/barrel (up 3.5% for the week), while Brent is at US $109.28 (up 2.7%). As a result, we seem certain to see the first weekly gain in five for both marker crudes.

Looking ahead, the EU has taken no decision on Iranian imports – and it is unlikely to move quickly, given that Greece, Spain and Italy are all substantial buyers. (Turkey is the main European buyer, but would presumably not participate in a boycott.) Certainly, European refiners would find it hard to replace Iranian crude if they did impose an embargo. Longer term, it may be significant that Goldman Sachs has actually increased its price forecast for Brent. It is now predicting US $127.50/barrel by end-2012.

V BANKING

A **S&P DOWNGRADE**: At the beginning of this week, S&P introduced a new ratings model, incorporating (so it said) lessons learned from the post-2007 crisis. This involved 37 global banks – of which it decided to downgrade 17 and to upgrade two (both Chinese). Of eight US banks, seven were downgraded. Among the adjustments:

- Bank of America A → A-
- Morgan Stanley A →A-
- RBS A →A-
- Lloyds Banking Group A →A-
- Barclays A+→A
- HSBC AA→A+
- Bank of China A-→A
- China Construction BankA-→A.

The general feeling is that the changed ratings are appropriate.

B UK: The new Financial Policy Committee announced this week that it expects UK banks to apply new leverage ratios in 2013, not 2015 as had been originally intended. There is a fine line between applying appropriate rules and pushing banks over the edge, but BofE Governor King has made it very clear that dividends and bonuses must be restricted while capital and liquidity are being built up.

VI NEXT WEEK

As noted, Sarkozy and Merkel meet on Monday, ahead of a crucial EU Summit at the end of the week. The ECB also meets next Thursday; what is important is what Draghi says afterwards. The BofE's MPC also meets; no change in interest rates or in its policy on QE is expected until January.

In the US, the focus will be on whether the unemployment benefits and payroll tax cuts are extended. Most observers assume they will be extended for at least another year. Other US economic releases due next week include:

- factory orders for October;
- the services PMI for November;
- the trade deficit for October; and
- the preliminary Michigan sentiment index for December.

Regards,
Economic Evaluation (London) Ltd