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WEEKLY ECONOMIC AND MONETARY REPORT

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The apparently never-ending cycle of hope and despair over the eurozone crisis is in one of its more optimistic phases – which means that the markets can concentrate on the *real* problem. That is the growing danger that the problems of Europe and the US could pull the wider global economy back into recession – a danger that the IMF's Christine Lagarde will be emphasising on her current trip through Asia. What she wants is for China and Japan to act aggressively to boost their economies to offset the policy paralysis in Europe and the US.

I GLOBAL ECONOMY

Yesterday, the OECD reported that its indices of leading economic indicators for China, India, Brazil, Canada, the UK and the eurozone had all fallen below 100 – implying that virtually all the major economies are now seeing a sharp economic slowdown. That followed a warning from Mark Carney, the Governor of the Bank of Canada (who has just taken over the chairmanship of the Financial Stability Board), that "we are on the cusp of another recession". More apocalyptically, it followed a comment from the IMF's former chief economist, Simon Johnson, that the world is "looking straight into the face of a Great Depression".

II EUROZONE CRISIS

As discussed below, the deteriorating economic prospects for the EU are part of the wider global problem of failing growth. However, for once, there is modest optimism (albeit, probably misplaced) about the political problems of the eurozone.

That certainly wasn't the case at the beginning of the week. Indeed, on Monday, the eurozone was described as being on a "cliff edge". The EFSF did manage to raise €3 billion in the markets – but the 5-year spread over German *bunds* that it had to pay

widened from 52 basis points to 163 bp. More worrying, the interest rate on Italian 10-year bonds hit 6.7% (or almost 500 bp over *bunds*), which most observers believe is unsustainable given that Italy has to refinance about €350 billion in the next 12 months. To go on paying this sort of interest rate, Italy would have to run a primary budget surplus of more than 4% of GDP – indefinitely.

Unfortunately, things got worse. By Wednesday, Italy was having to pay 7.48% on 10-year bonds, while Greek yields were over 32%. There were even rumblings about France, where the 10-year yield hit 3.2%, compared with only 1.71% in Germany. The European Commission also warned that Spain is likely to miss its 6% target for this year's budget deficit – a warning that pushed Spanish 10-year yields over 5.8%.

In the last couple of days, however, things *appear* to have changed – politically, if not economically.

The main reason is that Greek PM Papandreou (whom French President Sarkozy was overheard called a "madman" and a "depressive") has stepped down, to be replaced by a government of national unity headed by Loukas Papademos, 64.

Papademos is the eurocrats' favourite. A contemporary of new ECB President Draghi at MIT (where they both got their doctorates), he is a former Governor of the Bank of Greece and Vice-President of the ECB who has absolutely no experience of real politics. His job, before national elections which are said to be set for February 19, is to push through the tough austerity measures that are being imposed on Greece as the price for the October 26 bailout package. In return, the "troika" will release the next €8 billion tranche of the first €110 billion bailout package, so that the government can pay salaries through year-end.

Can he succeed where Papandreou failed? Maybe – but it will be difficult to keep the Opposition leader, Antonis Samaras, onside. His (self-contradictory) position is that, while he supports the austerity package, he won't commit his party by formally signing

up to it. (As a result, the Finance Minister will continue to be PASOK's Evangelos Venizelos, while New Democracy's deputy leader, Stavros Dimas, will take the far less controversial Foreign Affairs portfolio.) Plus, it was reported this week that Greek unemployment is now 18.4% - with the youth unemployment rate more than double that. Given that EU officials are now effectively running most of the government ministries, there is almost certain to be a violent political backlash in Greece as the austerity measures start to bite. However, for the moment, the markets seem to feel that Papademos is good news.

The markets also seem to feel that it is good news that Italian PM Berlusconi is finally on the way out – despite the fact that Berlusconi has been the longest-serving Italian PM since the War. (Before he came to power, Italian governments, on average, lasted less than a year.)

The Italian Senate approved the latest austerity package (which includes an increase in VAT, a freeze on public sector salaries, a rise in the retirement age, and a new energy tax) today; the lower house is likely to follow over the weekend. Thereafter, Berlusconi has pledged to step down. As in Greece, what Brussels and the other EU leaders want is a non-political bureaucrat – in this case, Mario Monti, a former EU Commissioner who was appointed a "Senator-for-life" by Italian President Napolitano at the beginning of the week. It is widely expected that Monti will be appointed early next week – though he may face some competition from ex-PM Giuliano Amato and/or Berlusconi's protégé, Angelino Alfano. If he does get the job, his finance minister is likely to be the present D-G of the Banca d'Italia, Fabrizio Saccomanni.

The markets may like this (Greek and Italian bond yields have both fallen sharply, and the euro got a brief bounce) – but it is fundamentally undemocratic. Neither Papademos nor Monti has any political legitimacy – which could leave a political opening in both Greece and Italy for the extreme left or right.

What seems to be happening is that political power in the eurozone is now being exercised almost exclusively by Germany and France. There is talk of a 'Frankfurt Group', or of a 'Union within the Union'; there has even been talk that France has been considering a breakaway eurozone.

It is important to appreciate that, although the political changes in Greece and Italy might make passage of the agreed austerity packages more likely, nothing fundamental has changed. Southern Europe's problem remains its loss of competitiveness vis-à-vis Germany, which is not addressed by spending cuts or by creditor 'haircuts'. Nor would boosting the resources of the EFSF or getting the IMF more deeply involved provide a lasting solution. There are many economists (including NYU's Nouriel Roubini) who argue that the only lasting solution would be for the ECB to become the unlimited lender of last resort to all eurozone governments (ie the buyer of government debt without limit). But it is hard to see how even that would work: piling more debt on to government whose problem is that they already have too much debt seems intuitively stupid. Plus, it is expressly forbidden by Articles 101 and 103 of the Maastricht Treaty (though that hasn't stopped the ECB buying large amounts of Italian and Greek paper in the secondary market).

As a result, the current 'relief rally' may well be short-lived. Italy has to sell €3 billion in 5-year bonds on Monday; that auction is now likely to go quite well, but it is hard to see Italian (or Greek) yields continuing to fall.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: Last week, the DJIA lost almost 1.9%, while the S&P500 was down 2.5%. In the first four days of this week (today is Veterans' Day, which means trading is likely to be thinner than usual), the Dow was down a further 0.7%, while the S&P500 was off 1.0% and the Nasdaq Composite was down 2.3%. That is despite a pick-up yesterday after better political news from Greece and Italy. The mood in the markets remains tense – which is underpinning the 'safe haven' role of US Treasuries. The 10-

year Treasury yield, for instance, remains only just over 2%, while the 30-year yield is around 3.10%.

It has been a generally slow week for US economic data. The only releases of note have been:

- the trade deficit for September, which came in at US $43.1 billion, its lowest level since December largely because of higher than expected exports;
- department store sales for October, which appear to have been stronger than expected (Ralph Lauren, for instance, was up 24% year-on-year);
- first-time jobless claims, which fell 10,000 in the latest week; and
- the preliminary reading for this month's Michigan confidence index, which rose unexpectedly from 60.9 to 64.2.

On balance, this was a bit better than expected. However, it has also been reported this week that Congress's so-called 'Super-Committee' – which is tasked with producing a budget reduction plan by November 23 – is making little or no progress. If that is the case, automatic spending cuts will hit – which could well tip the US back into recession.

Meanwhile, the political situation in the US is starting to favour Obama – though not because of anything he has done. In a series of state-wide referendums last week (on union rights, on 'right-to-life' issues etc), the right-wing generally did badly. Moreover, the latest television debate among Republican presidential hopefuls was little short of a disaster for the party. It still looks as though the Republican candidate will be the 'smarmy', multi-millionaire, Mormon, wooden Mitt Romney; at the moment, his most likely rival would seem to be the ethically-challenged former Speaker, Newt Gingrich, who has virtually zero cross-over 'appeal' to Democrats. So, Obama should win. However, dissatisfaction with the entire US political class is rife. As the *Wall St. Journal* reported on Monday, for instance, 54% of Americans now identify with either the Tea Party (right-wing) or the Occupy Wall St. movement (left wing).

B **EUROPE**: The economic outlook is even bleaker in Europe than it is in the US. This week, for instance, the Commission released new growth projections – which were, almost across the board, substantially lower than in the Spring:

European Commission: Autumn GDP growth forecasts

	(Spring)	**2011**	(Spring)	**2012**
Germany	(2.6%)	2.9%	(1.9%)	0.8%
France	(1.8%)	1.6%	(2.0%)	0.6%
Italy	(1.0%)	0.5%	(1.3%)	0.1%
Greece	(-3.5%)	-5.5%	(1.1%)	-2.8%
EZ-17	(1.6%)	1.5%	(1.8%)	0.5%
UK	(1.7%)	0.7%	(2.1%)	0.6%

Even that could be over-optimistic. It was also reported this week that eurozone retail sales were off 0.7% month-on-month in September, and for many eurozone countries other data was also depressing:

- Germany: It was reported this week that industrial production was down a hefty 2.7% month-on-month in September (though it was up 1.7% for the third quarter as a whole). Meanwhile, consumer price inflation is now running at 2.5%, which constrains the ECB's room to reflate.
- France: Industrial production was off 1.7% in September, while inflation is now around 2.3%. Insée's industry sentiment index also fell, from 97 to 96, last month, while the services index dropped from 96 to 95. The government now acknowledges that there is likely to be zero growth in the fourth quarter. Despite that, Sarkozy is pressing ahead with a new austerity package designed to ensure that France does not lose its prized triple-A rating. This is intended to raise €6-8 billion next year, and involves an increase in the lower VAT band, levies on dividend and interest payments and a temporary tax increase for high revenue companies.
- Italy: The final straw for Berlusconi's supporters was probably news that industrial production had fallen 4.8% month-on-month (and 2.7% year-on-year) in September.

One piece of good news (at least, for Sarkozy): After months of semi-public arm-twisting by the French, Lorenzo Bini Smaghi – the remaining Italian member of the ECB's Executive Board – has agreed to step down in January, to go to Harvard. That leaves one seat open on the ECB's Board – a seat that France (which had been unrepresented since Trichet stepped down as President) will be quick to fill.

As for the UK, it may be outside the eurozone, but the Coalition government is emphasising (perhaps, over-emphasising) its vulnerability to the euro crisis. True, more than half British exports go to the eurozone, but the UK is – by virtue of position and historic trading links – far better placed to benefit from the growth of Asian markets than eurozone members. Nevertheless, the British economy is clearly in some difficulty. Thus, it was reported this week:

- that like-for-like retail sales were down 0.6% year-on-year in October;
- that the RICS house price index fell from -23 to -24; and
- that the trade deficit on goods hit a record £9.8 billion in September, up from £8.6 billion in August.

Under these circumstances, there was little that the BofE's MPC could do when it met yesterday. To no surprise, it held UK interest rates at a record low of 0.5%, while maintaining its bond buying programme at £2.75 billion.

It is worth noting that (no matter what Cameron *et al* say about the UK's dependence on the eurozone) sterling is increasingly coming to be seen as a safe haven from eurozone turbulence. The 10-year gilt yield, for instance, actually fell as low as 2.11% yesterday – its lowest level since the 1950s. It is currently trading at about 2.25%, compared with 1.79% for the comparable *bund*.

C **JAPAN**: Last week, the Nikkei-225 fell almost 2.8%; this week, it has just closed off another 3.3%. The reason is the increasingly obvious economic slowdown in Japan. It was reported this week, for instance:

- that machinery orders were off 3.7% month-on-month (and 8.2% year-on-year) in October; and
- that the large company diffusion index for the Reuters *tankan* survey fell this month from 6 to 1 – a very sharp slowdown.

No surprise that Lagarde is pressing the government to do more to boost the economy.

D **CHINA**: Same with China – where the IMF's emphasis is on trying to get the government to shift its focus from exports to domestic consumption. It may be pushing at a (slightly) open door, in that Chinese trade data released yesterday showed imports up 28.7% year-on-year in October (up from 20.9% in September), while exports were up 'only' 15.9% (compared with 17.1% in September).

In addition, there is evidence that house prices are now flat or falling in most of China's cities, with the overall house price index off 0.23% last month.

The catch is that China's policy-makers may not respond to these challenges as foreigners would like. Indeed, earlier this week, the chief economist of the State Information Centre was quoted as urging the PBoC to let the renminbi *depreciate* – along with other emerging market currencies – as a way of getting the economy going again. That is hardly what the US wants.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the big winner was the US dollar – which was up 3.0% against the euro, 0.7% against sterling and 3.2% against the yen. This week, the dollar's strength has generally continued, albeit not against the yen:

- US $/euro: At the close last Friday, the euro was trading at US $1.376/€. By Tuesday, it had strengthened to US $1.381 on news that Berlusconi would step down as soon as Italy's austerity package had been passed. However, it then eased back, and it is currently trading around US $1.368. That means the dollar is up around 0.6% for the week. Despite that, most observers are still puzzled by the euro's relative strength. For the year-to-date, it is up over 3% - despite the near-collapse of the eurozone and the economic slowdown in Europe.
- US $/sterling: The pound closed last week at US $1.603. It fell as low as US $1.588 yesterday, but has since recovered to US $1.595 on what appears to be its new-found 'safe haven' status. Week-on-week, that means the dollar is up just 0.5%.
- Yen/US $: The dollar closed last week at Y78.2/US$. It fell to Y77.5 yesterday, and has continued to weaken. It is currently trading at Y77.34 – down 1.1% for the week.

The US dollar is up 1.7% against the Australian dollar for the week, and by 0.1% against the Canadian dollar. It has also risen 1.8% against the Swiss franc, to SF0.904/US $. The Swiss franc has also eased against the euro, from SF1.222/€ to SF1.236 – prompting more speculation that the SNB might introduce a new ceiling for the currency around SF1.24/€.

Meanwhile, spot gold closed last Friday at US $1,763/oz (up US $25 on the week). It fell as low as US $1,754 – but then bounced to US $1,795. It is currently trading around US $1,766 – basically, flat for the week. However, it is worth noticing that 21 out of 22 gold bullion traders polled by Bloomberg today expect the gold price to rise next week.

V OIL

Last week, the price of front-month WTI rose 94 cents to close at US $94.26/barrel, while front-month Brent was up US $2.06, to close at US $111.97. As a result, the spread in favour of Brent widened to US $17.71. More significant, oil prices were generally at or close to a seven-week high as a result of nervousness provoked by the imminent release of the IAEA's report on Iran's nuclear ambitions – and speculation about an imminent Israeli attack.

That has remained a concern this week. In mid-day trading Friday, December WTI is at US $98.58/barrel (up 4.6% for the week), while Brent is at US $114.30 (up 2.1%). Aside from the uncertainties over an attack on Iran (a low probability/high salience event, which might have catastrophic implications), the main factors in the market this week appear to have been:

- An increased demand forecast from OPEC in its latest *World Oil Outlook*. It is now projecting an extra 1.9 million b/d of demand through 2015. It has also upgraded its reference price range for this decade from US $75-85/barrel to US $85-95.
- A sharply higher price forecast from the IEA in its *Annual Energy Outlook*. It is now warning that oil prices could go up to US $150 a barrel by 2015, in part because oil inventories in Europe are now at a 9-year low and in part because of product shortages in non-OPEC producers like the North Sea, China, Syria and Yemen.
- An unexpected 1.37 million barrel fall in US crude inventories in the latest week.

Whatever, prices are up about 17-18% since early October – despite growing concerns about the health of the global economy and despite a steady fall in commodity prices more generally. (The R/J CRB index, for instance, has fallen from 320.2 to 319.5 this week.) <u>There seems no reason to expect that this will change</u>.

VI NEXT WEEK

Berlusconi should be gone and the new Greek government will be in place by Thursday, when the next eurozone Finance Ministers meeting is scheduled. However, although the markets may still be enthusiastic, it is important to emphasise that nothing fundamental has changed; the eurozone is still in serious trouble. A good pointer will be Italy's €3 billion five-year auction on Monday; what interest rate will it have to pay?

As far as economic releases are concerned, the major ones to watch for in the US are:

- producer and consumer price inflation for October;
- the Empire State (NY) manufacturing index for November;
- industrial production and capacity utilization for October;
- housing starts for October;
- leading economic indicators for October; and
- the Philadelphia Fed index for November.

Elsewhere, the CDU holds its party Congress in Germany; Merkel may well find herself under pressure on how far the ECB can go towards a so-called 'transfer union'. The EU is also expected to publish its (highly controversial) proposals for regulating ratings agencies.

Key European and Japanese data that is due next week includes:

- ECB purchases of sovereign debt;
- eurozone GDP data for the third quarter;
- Japanese industrial production for September; and
- eurozone industrial production for September.

Regards,
Economic Evaluation (London) Ltd