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WEEKLY ECONOMIC AND MONETARY REPORT

4 November 2011

The G20 Summit in Cannes, the crisis in Greece that has turned into an existential crisis for the eurozone, the US employment data... The continuing protests on Wall St and around the world. There is a real sense that everything is coalescing into one, giant crisis of globalisation. It has also been a week of wild fluctuations in sentiment on the global economy, on Europe, even on the banks. And, it is important to emphasise, nothing has really been settled.

I G20 SUMMIT

No surprise that the Summit (which concludes this evening) was hi-jacked by the Greek crisis. French President Sarkozy's hope was that the EU could present a united front at the Summit, and that he could use it to re-launch his faltering Presidential campaign. No such luck – though it did provide an opportunity to involve other players (notably China and the IMF) in an attempt to resolve the Greek crisis.

At the time of writing, the final Summit communiqué has not been published (though a draft has been circulating), and discussions are continuing on some of the key issues – notably on boosting IMF resources (and perhaps 'rebranding' some of its lending instruments). This is not quite as straightforward as it might appear. Although surplus countries, China in particular, would prefer to help the eurozone via the IMF (rather than, for instance, investing in the EFSF directly), other emerging countries are reluctant to see the IMF get sucked deeper and deeper into the eurozone mess. That also happens to be the UK's position – and PM Cameron may not be able to win a Parliamentary majority on increasing IMF resources if his party believes the increase will simply be recycled to Greece or Italy. Nevertheless, some deal to increase IMF resources will almost certainly have been agreed (even if it is not announced publicly).

It is expected that the communiqué will include a commitment to further (and more rapid) currency flexibility – though there is always a chance that this could be vetoed by the Chinese. After all, their clout has been enhanced by the Europeans' need to attract official money from capital surplus countries to support the eurozone. As we have said before, Chinese support comes at a price – probably official recognition of China as a market economy or (possibly) lifting of the post-Tiananmen arms embargo.

Other issues raised at the Summit:

- The Financial Stability Board: It is now "99% certain" that the Bank of Canada's governor, Mark Carney (46), will take over from Mario Draghi as chairman of the FSB. This is important since the FSB is the only regulatory body that brings together central banks, Treasuries and regulators Carney (who recently had a well-publicised row with JP Morgan's Jamie Dimon) spent 13 years with Goldman Sachs, before going to the BofC – where he has established an excellent reputation.
- The so-called "Tobin Tax": Bill Gates presented a paper to the Summit on financing development. It had been widely expected that he would build this around a *de minimis* tax on financial transactions – a so-called 'Tobin tax' or 'Robin Hood' tax. In fact, while he argues that such a tax is feasible, he appears to feel it should not be hypothecated to development. Nevertheless, France, in particular, is pushing for the EU to adopt some sort of Financial Transaction Tax.
- G-SIFIs: It is expected that the BIS's list of those globally significant banks that will be subject to a supplemental capital charge will be revealed at or just after the Summit. There will undoubtedly have been some haggling, though most of the names are known.
- Doha: Apparently (whether or not it appears in the communiqué), the sense of the Summit is that the Doha round is all but over, and that participants should try to get as many mini-deals settled bilaterally while abandoning hope of a global agreement.

- Italy: Clearly, one of the Summit's major concerns was to ensure that – whatever happens to Greece – Italy is, in some sense, quarantined. One possibility that was discussed was direct IMF surveillance – a sort of slimmed down version of what Greece is currently experiencing. (At present, there are around 370 foreign 'experts', under the control of a German economist, who are 'assisting' Greek ministers and government departments.) As of now, Berlusconi has not agreed to this surveillance.

All of this will, of course, be couched in the communiqué as part of an Action Plan for Growth.

II EUROZONE CRISIS

This evening may be crucial. Greek PM Papandreou has called a confidence vote on his handling of the crisis – but the vote may well not take place before midnight (Greek time).

If he wins, he will *probably* try (again) to put together a government of national unity – which *may* be easier now that the opposition leader, Antonis Samaras, has (controversially, and inexplicably) said he supports the bail-out package negotiated on October 26. If he loses, he may also try to put together a unity government – but it is more likely that there would be elections. Whatever happens, the extreme left parties (the Communists are the radical *Syriza* group) may well determine the outcome.

What seems most *unlikely* to happen is the referendum on the bailout package that Papandreou promised on Monday – to howls of shock and horror from Paris, Berlin and Brussels, who all felt that giving the Greek people a chance to express their views would be a democratic step too far.

What happened was extremely instructive. Out of the blue, Papandreou decided that the only way to resolve his political problems at home was to hold a referendum on the terms he had negotiated for the latest bailout. He never suggested a referendum on whether Greece should/should not remain in the eurozone; as has been repeatedly pointed out, the Treaties of Lisbon and Maastricht include no provision for anyone to exit the euro under any circumstances. (As in the American advertisement for the Roach Motel, "you check in, but you don't check out".) Nevertheless, Sarkozy and Merkel insisted that – if there were to be referendum – it must be on whether Greece wanted to stay in or get out of the eurozone. No other question would do. And they promised/threatened that Greece would not get the next €8 billion tranche of the (first) bailout package until the referendum had approved eurozone membership – and, implicitly, everything that goes with it.

In the end, Papandreou backed down – citing as an excuse that Samaras had said *Nea Dimokratia* would now support the bailout package. "If there is a political consensus" he said, "there is no need for a referendum".

So, there will (almost certainly) be no referendum – but that doesn't necessarily mean Greece will accept the terms of the bailout. Indeed, if there is a government of national unity or if ND takes over from PASOK (which only has around 15% support in the latest polls), there may well be an attempt to reopen negotiations – in which case, the apparent "relief rally" that boosted the markets last week could turn out to be premature. (The prospect of a renegotiation is not unreasonable: thanks to the austerity measures already imposed, Greek GDP is down 9% from 2008, industrial production is down 23% and unemployment currently stands at 17%.)

Plus, the crisis probably isn't really about Greece at all... Much more important is Italy, which has to refinance about €350 billion of its €1.7 trillion debt next year. This week the yield on Italian 10-year paper hit 6.4% - 440 basis points more than Germany is paying. Italy also had to pull a €3 billion bond auction on Wednesday, as a result of collapsing demand. That is despite the fact that Mario Draghi's first action as President of the ECB was to authorise it to step up its purchases of Italian government bonds.

This is what makes it so important to boost the resources of the EFSF/ESM. Even leveraging the Facility so that it can provide insurance cover for around €1 trillion in sovereign bonds may not be enough to impress the markets if Italy starts to wobble. Hence the efforts of the EFSF's head, Klaus Regling, to get China and Japan to invest – either directly, or through some sort of SPV. Or, if there is no other way, through the IMF. (There have been rumours today that China may be willing to invest €100 billion – though that may well be wishful thinking.) Hence, also, the deliberate humiliation that is being heaped on Italian PM Berlusconi by Sarkozy and Merkel – who believe that, if only he can be forced to step down, market sentiment will turn and that it will be much easier to keep Italy from following Greece.

A couple of other points:

- Wild-eyed optimists still insist that the crisis over Greece may yet turn out to be a good thing for Europe. German FM Schauble, for instance, insisted over the weekend that "the crisis opens the door to fiscal union".
- French banks (which are widely believed to be the most heavily exposed to the crisis) are starting to get real. BNP Paribas, for instance, announced yesterday that it is writing down its Greek exposure by 60%.
- The other 'peripheral' eurozone states (Ireland and Portugal, in particular) are taking every opportunity to disassociate themselves from Greece – and, so far, that seems to be working. (Ireland, for instance, has just announced a new €17 billion austerity programme.)

It is also worth noting that press reports today suggest that the big European banks are now openly running 'fire drills' on what would happen if Greece withdraws (or is expelled) from the eurozone. The result is said to be 'very, very messy'.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US**: Over the weekend, the OECD announced that it was cutting its forecast for US GDP growth this year from 3.1% to just 1.8% - which seems a bit harsh, given that the US economy looks in (slightly) better shape than Europe. That said, the Fed also announced this week that it is cutting its forecast for 2012 growth, from 3.5% to 2.7%. It also anticipates that US unemployment will remain above 8.5% through the end of next year.

That fits with the employment data for October, released today.

Non-farm payrolls for last month rose 80,000 – which was a bit less than expected, and only half what is required to make a significant dent in unemployment. Nevertheless, it wasn't all bad news. Factory employment, for instance, rose for the first time in several months, and the unemployment rate actually fell from 9.1% to 9.0% - though that probably reflects long-term unemployed dropping out of the labour force.

Other than that, US economic data this week has been mixed. On the (more or less) positive side, it was reported:

- that construction spending rose 0.2% in September, thanks to a 0.6% rise in private sector spending;
- that automobile sales surged in October, with the 'Big 3' reporting year-on-year gains of around 5%;
- that factory orders were up 0.3% in September; and
- that productivity rose at an annual rate of 3.1% in the third quarter.

In addition, although both the composite and services purchasing managers indices fell last month, they both remained above 50 – which means that the US economy has technically been expanding (albeit, slowly) for 27 months.

That said, the Fed is clearly worried. Although the FOMC left interest rates unchanged (with the funds rate at 0.25%) when it met on Wednesday, Bernanke gave a clear hint that he is in favour of more easing – possibly by having the Fed buy mortgage securities. With three voting members of the Committee now openly in favour of QE3, the market is pricing in Fed action – probably as early as next month.

Despite that, it is worth noting that – for the week though mid-day Friday – the Dow is down 3.0%, the S&P500 is off 3.3%, and the Nasdaq Composite is down 2.6%. This will be the first weekly drop for the S&P since September. At the same time, however, the problems in Europe have boosted US Treasuries, with the 10-year yield falling from 2.31% to 2.08% and the 30-year yield dropping from 3.35% to 3.12%.

<u>One other point</u>: A poll last weekend found that 59% of Americans agree with the aims of the "Occupy Wall St" movement – whatever they may be. (It is far easier to say what OWS is *against* than what it is *for*.) One reason that is frequently cited is that the richest 400 individuals in the US now have more wealth than the bottom 150 million.

B **<u>EUROPE</u>**: The economic knock-on effects of the eurozone crisis are becoming increasingly obvious. At the beginning of the week, as noted, the OECD published new economic forecasts. While it is now predicting 1.8% growth for the US next year, it cut its eurozone forecast from 2.0% to just 0.3%. Morgan Stanley has also cut its forecast – to 1.7% for this year, and to just 0.5% for 2012.

It certainly seems that the economy has hit a rock. Earlier today, Markit published composite October PMI data for the eurozone. For the zone as a whole, the index fell from 49.1 to a 28-month low of just 46.5. On top of that, eurozone unemployment has now reached its highest level since the launch of the euro. The total number of unemployed hit 16.2 million in September – or 10.2% of the labour force. In Spain, unemployment is now 22.6%. Even Germany is not immune; earlier today, it was reported that total factory orders fell 4.3% in September, far worse than expected. No surprise that the biggest contributor was a 12.1% drop in export orders to the rest of the eurozone.

No wonder that the ECB cut eurozone interest rates by 25 bp to 1.25% when its rate-setting Committee met yesterday. No wonder either that Draghi announced that the Bank would try to 'goose' the economy by buying a further €40 billion of covered bonds issued by eurozone banks. Despite that, the Xetra Dax has just closed down 6.2% for the week, while the CAC-40 is off 6.7%.

Not much relief in the UK either, where the FTSE-100 is down 3.3% for the week (despite not being a member of the eurozone).

True, there was some better than expected economic news in Britain. In particular, GDP was up 0.5% quarter-on-quarter (and year-on-year) in the third quarter. But it was also reported this week:

- that mortgage lending fell again in September; and
- that the CIPS manufacturing PMI dropped from 50.8 to a 2 1/2 year low of 47.4 in October, while the services PMI fell from 52.9 to 51.3.

As a result, the National Institute has warned that the UK faces a 50% chance of another recession – or 70% if the eurozone crisis is not resolved. (It did not define what a 'resolution' of the crisis would mean.)

C EMERGING MARKETS: The doom and gloom is no longer restricted to the US and Europe. This week has seen disappointing data from several other countries:

- China: It was reported this week that the official PMI (like the HSBC index) fell in October, from 51.2 to 50.4 – which suggests that the economy, though still growing, is slowing down.

- Argentina: Following Cristina Fernandez's landslide re-election, the anticipated flight into dollars has started. As a result, the government has imposed new controls on FX purchases; it won't work.
- Brazil: It was reported on Wednesday, that industrial production fell 2% in September – with durable goods production off 9%. Manufacturing is now down 1.6% year-on-year – largely due to the appreciation of the real against the US $.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the belief that Greece had committed itself to a tough reform programme, in return for a second bailout, gave the euro a big boost. Week-on-week, it was up 1.8% against the US dollar, 1.2% against the yen, and 1.0% against sterling. Meanwhile, the dollar fell 1.8% on a trade-weighted basis.

This week, the situation has been very different – with considerable intraday volatility in US $/euro depending on whether the markets decided whether Papandreou was/was not serious, whether there will/will not be a referendum, whether he will/will not win tonight's confidence vote, etc, etc. As a result, the euro closed last Friday at US $1.418/€ - and then fell as low as US $1.361 on Tuesday following the threat of a referendum. When Papandreou was forced to retract this commitment, the euro began to recover, hitting US $1.384 before scepticism set in again. It is currently trading around US $1.375 – down 3.0% for the week.

The euro has also followed much the same path against sterling. However, trading in the Japanese yen has been very different.

On Monday, the BoJ decided to intervene in the markets on a massive scale to check the steady appreciation of the yen. This caught traders by surprise since it was considered most unlikely that the authorities would move ahead of the G20 Summit. It is estimated that the BoJ and MoF sold anywhere up to US $80 billion – and the result was electric. From a post-War record of Y75.35/US $, the yen fell as low as Y79.51/US $ - though it closed on Monday evening at Y78.0. Since then, the yen has continued to trade in a fairly narrow range of Y78-78.5/US $; it is currently Y78.3 – which suggests that (as in the case of the Swiss franc) intervention worked.

All in all, the dollar has had a mixed week – up against the euro, down 0.4% against sterling, up sharply against the yen. It has also strengthened by 3.6% against the Australian dollar (which fell after the Reserve Bank cut Australian interest rates unexpectedly by 25 bp) and by 2.6% against the Canadian dollar (which was hit by poor jobs data).

Meanwhile, gold – which closed last week at US $1,744.50/oz – fell as low as US $1,714 this week, but has since recovered to US $1,755 on renewed uncertainties about Greece.

One currency to watch next week is the Swiss franc. This week, it has weakened slightly against the dollar, from SF0.863/US $ to SF0.889, while remaining virtually flat against the euro at around SF1.22/€. The SNB has again indicated that this is too strong, and that it is ready to push it down further.

IV OIL

Last week, front-month WTI rose US $5.92/barrel, to close at US $93.32. In contrast, Brent was up just 35 cents, to US $109.91. As a result, the spread in favour of Brent (which had been over US $28) narrowed to just US $16.59.

To some surprise, prices have risen again this week – despite concerns about global growth and about the situation in Europe. In late trading on Friday, December WTI is at US $93.83/barrel, up around 50 cents for the week, while Brent is at US $111.33, up US $1.42. That is despite a 1.83 million barrel increase in US crude inventories, and continuing progress in bringing Libyan production back on line. It has also pushed oil prices in general back up to a three-month high.

Will it last? It may be significant that the latest poll of oil traders by Bloomberg shows that 61% expect prices to fall next week.

V BANKING

The big story this week (overshadowed by the eurozone crisis) has been the collapse of MF Global – which put itself into Chapter 11 of the US bankruptcy code on Monday.

MF was one of the largest commodity brokers and broker/dealers in the US, with assets of US $41 billion. It was originally a spin-out from the UK's Man Group, but had been run (and owned) independently for some years. Controversially, its chairman/CEO was Jon Corzine – formerly a co-head of Goldman Sachs and former Governor of New Jersey, who had repeatedly been tipped as a potential Treasury Secretary.

What seems to have brought about MF's collapse was a net US $6.3 billion exposure to Italian, Belgian, Spanish, Portuguese and Irish sovereign debt – a position that Corzine himself is said to have promoted, on the grounds that the eurozone stood behind the debt. What has got the FBI involved is that there is some suggestion that – faced with enormous losses – MF Global may have started to dip into client accounts that should have been segregated. It appears that there is a potential shortfall of around US $600 million – the discovery of which meant that a last-minute sale of MF to Interactive Brokers Group fell through. Corzine has now resigned; many seem to think he could be in a lot of trouble. Whatever, this is the largest US financial collapse since Lehman Bros.

VI NEXT WEEK

Greece, Greece, Greece – and perhaps Italy. Eurogroup finance ministers are due to meet on Monday.

However, there are other things going on in the world. In <u>the US</u>, for instance, the markets will watch for:

- the Michigan sentiment index for November;
- the trade deficit for September; and
- consumer credit for September.

Elsewhere:

- APEC leaders meet on November 12-13, following a finance ministers meeting; and
- China's inflation data is released.

Regards,
Economic Evaluation (London) Ltd