Αρχείο

WEEKLY ECONOMIC AND MONETARY REPORT

9 September 2011

G7 Finance Ministers are meeting today and tomorrow in Marseilles. The IMF's Christine Lagarde (who will also participate) set the tone with a speech in London today in which she warned that the global economy is entering a "dangerous new phase" – a crisis of confidence about the economic outlook, sovereign debt and the banks. Like many individual economists, the Fund is generally supportive of more short-term stimulus – albeit coupled with longer-term fiscal consolidation. Although there will be no formal communiqué after the FMs' meeting, that approach will undoubtedly get majority support; the only dissenters are likely to be the ECB (which is still emphasising the fight against inflation) and the UK (though the Coalition government's commitment to the tough austerity programme it has recently launched is coming under massive strain).

It certainly accords with the approach being followed in the US by the Obama Administration. The US $450 billion, three year jobs programme launched by the President last night is far bigger than almost anyone had predicted. Since it consists of tax cuts now (mostly of payroll taxes), to be funded by spending cuts in the (ill-defined) future, there is a chance that enough Republicans will support it to ensure that much of it gets passed. However, there are plenty of sceptics (particularly on Wall St) who believe it is "Keynesianism gone wild" – and that the government's priority should be to cut the deficit, now.

Meanwhile, the eurozone crisis goes from bad to worse... German FM Schauble (who will also be at Marseilles) warned today that Greece's membership of the euro is "on a knife-edge", and insisted that Greece will not get the €8 billion it needs from the ECB and IMF to meet the next debt call later this month unless it has actually made progress towards implementing the deficit/debt reduction programme to which it agreed. So far, the one thing Greece's creditors can agree on is that – for whatever reason – there has been virtually no progress at all.

I GENERAL ECONOMIC SITUATION

One of the key inputs to the Marseilles Summit is the OECD's latest update of the economic outlook, released yesterday.

This shows a marked deterioration from May, with the recovery coming virtually to a halt in many OECD economies and with growth slowing sharply among non-OECD countries. It points in particular to:

- a weakening of global trade in the second quarter, only partly due to Japan's supply chain problems;
- a widening of global imbalances;
- a softening of global labour markets;
- a collapse of consumer and business confidence in many OECD economies; and
- heightened risk aversion in financial markets.

For 2011 as a whole, the OECD is now projecting GDP growth well down on 2011:

OECD: GDP growth 2011

US	2.7%	- France	2.2%	China	9.0%
Japan	-0.9%	- Italy	1.1%	India	8.5%
Eurozone	2.0%	UK	1.4%		
- Germany	3.4%	Canada	3.0%		

Even that may prove too optimistic. World Bank President Zoellick has made a number of speeches in the last couple of weeks in which he has made the same points as Lagarde: the world is in a "new danger zone" from which the US and Europe cannot extricate themselves unless China cooperates. What 'cooperation' means, he suggested, is that Beijing must speed up its economic reforms and accelerate the shift away from export-led growth to domestic consumption.

II EUROZONE CRISIS

The problem as far as Europe is concerned is that – even if politicians could agree on what had to be done (and, as in the US and elsewhere, they are split between those who want more stimulus and those who prioritise deficit reduction) – the whole decision-making process is paralysed by the crisis over Greece. Today's revelation that ECB Board member Jürgen Stark resigned earlier this week, because he strongly disagreed with Trichet's support of bond-buying by the Bank indicates just how deep the differences are.

It is, of course, good news of a sort that markets are focussing on Greece – rather than on Ireland, Portugal, Spain, or (most dangerous) Italy. Unfortunately, Greece's situation seems intractable.

Last week's decision by the 'troika' (the ECB, Commission and IMF) to quit Greece for 12 days was precipitated by its belief that the Greek government cannot push through the reforms it has promised. In particular, the asset sales programme has barely started, and no public sector workers have yet been laid off (though some have gone into a labour reserve on 60% of salary). Moreover, unions have blocked all attempts to open up the professions, and tax receipts are nowhere near projected levels.

New Finance Minister Venizelos has defended the Greek government's commitment – but even he has said he is not prepared to make further cuts this year, partly given the latest statistics which show GDP fell at an annual rate of 7.3% in the second quarter. Central Bank Governor Provopoulos appears to have given up; over the weekend, he called the situation in Greece "truly dismal".

As a result, there is now a strong possibility that Greece will not get the next tranche of ECB/IMF money – and that it will, therefore, not be able to meet the debt payments falling due this month. Even though there are press reports that Germany is prepared to offer Greek banks liquidity assistance if that happens, the Greek two-year yield is now around 56%, the 10-year yield is over 20% and CDS cover costs 3,238 basis points – implying a 92% probability of default. In contrast, the ECB's bond purchase programme (which caused Stark's resignation) has helped drive Spanish and Italian rates down. The Spanish 10-year yield, for instance, is around 5.25% and Italian paper is now yielding only about 5.50% - notwithstanding the chaos that has attended Berlusconi's attempt to push a new austerity budget through.

So, what will happen?

Well, the good news is that ratification of an expanded EFSF is going ahead. Germany's Constitutional Court gave its expected (if reluctant) approval on Wednesday, and the Bundestag is expected to vote before month-end. The Slovak Cabinet also agreed – though expansion of the EFSF has not yet been approved by Parliament. In addition, there is a bit more optimism this week that as many as 60-70% of eligible banks will sign up for the IIF-designed debt swap programme for Greece. Expressions of (non-binding) interest were due today.

On top of that, Chancellor Merkel has also given her most categorical assurance yet that "the euro will not fail" – though the idea of bailing Greece out yet again is so unpopular with German voters that her freedom of action is severely constrained. A group of former EU leaders also issued a call this week for more economic unity, specifically for €-bonds, a bigger EFSF/ESM and more focus on coordinated stimulus. In addition, former Chancellor Schröder urged a softer line on Greece – warning (with justification) that current policies could generate serious social unrest.

On the other hand, there continue to be serious concerns about eurozone banks – and not just Greek banks. Deutsche Bank's ceo, Josef Ackermann, gave a speech on Monday, in which he warned that "some" European banks are close to collapse – and that "many" could not cope with writing down their sovereign debt exposure to market value. According to Deutsche, EU banks as a whole need to find €2 trillion over the next five years – and they don't seem likely to get it. The big banks most obviously in the frame appear to be BNP Paribas (though it has denied any short-term funding problems), SocGen and Intesa.

Plus, more and more mainstream European politicians are beginning to wonder whether there isn't a better way to handle the problem of countries like Greece. One possibility, of course, is that pressure will mount irresistibly for the €-bond approach, ie for a fiscal/transfer union. However, the Dutch PM this week proposed an alternative: that the eurozone should appoint a "Commissioner for budgetary discipline", who would:

- have a power of veto over national budgets; and
- have the authority to expel from the common currency member states who ignored his findings.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: Yesterday's speech by Obama to Congress, in which he put forward a US $450 billion in job creation plan, was (it is generally accepted) a clever attempt to craft a plan that the Republicans will find difficult to reject. It offers a short-term stimulus plan (more than half of which takes the form of tax cuts, though there is also a US $105 billion infrastructure package), offset by longer-term cuts to entitlements. The formal bill will go to Congress next week; at least parts of it seem likely to pass – though it is worrying that some Republicans are already insisting it is dead in the water.

The urgency of this is political; it is a Washington axiom that no President gets re-elected if the unemployment rate is over 7% (it is currently 9%).

Plus, the Administration may not be able to count on much more help from the Fed. Before Obama spoke yesterday, Bernanke also spoke – insisting that the Fed still had tools at its disposal. His speech is being interpreted as support for more QE, but there must be some doubt that he could get that through the FOMC. One of the Committee's "hawks", the Richmond Fed's Jeff Lacker, warned earlier in the week that – in the view of a substantial minority on the FOMC – "more monetary stimulus will just mean higher inflation".

In the meantime, economic data reported this week was, on balance, better than anticipated. In particular:

- the ISM services index improved slightly in August, from 52.7 to 53.3 – which was a modest surprise;
- the Fed's Beige Book survey of regional business conditions found activity on the East Coast to be falling, while growth was positive (though subdued) everywhere else; and
- the trade deficit for July came in at US $44.8 billion – substantially lower than June's (revised) US $51.6 billion.

That may be the reason equity markets have been stronger than anticipated this week. Through Thursday, for instance, the DJIA was up 0.5%, the S&P500 was up 1.0% and the Nasdaq Composite 2.0%. Markets are down in early trade on Friday, but still seem likely to close up for the week. However, it is worth noting that, traditionally, <u>September is the worst month of the year for US equities</u>.

As for US Treasuries, the key continues to be the feeling that capital has nowhere else to go – particularly since the SNB's attempt to cap the Swiss franc *appears* to have succeeded. Last week, the yield on the benchmark 10-year Treasury fell, sharply – from 2.19% to 2.00%. This week, it briefly dropped as low as 1.91% - close to a 60-year low. Although it has since backed up to 2.00%, it is still extremely low. This has prompted speculation that the Fed may engage in what it calls maturity extension – what the markets call 'Operation Twist'. This involves issuing lots of short-term paper, and using the proceeds to buy back longer-dated securities – thereby flattening the yield curve and giving the economy a boost. That may be a more acceptable form of stimulus for Fed "hawks" like Lacker.

B **EUROPE**: Yesterday's meeting of the ECB's Council left eurozone interest rates unchanged at 1.5%. No surprise, there. However, the subsequent briefing by Trichet was important. First, he defended the Bank's inflation record – and attacked the Bundesbank for its recent criticism. (The ferocity of this attack, which was unexplained at the time, clearly reflected his earlier row with Stark.) Second, he insisted (against considerable evidence) that there is no liquidity crisis for eurozone banks. Third, he hinted – strongly – that, given "particularly high uncertainty", the ECB may consider lower interest rates in the next couple of months. As a result, the market is now pricing an interest rate cut by the ECB in November at over 90%.

As far as the eurozone economy is concerned, the only important economic release this week was the Services PMI for August, which fell marginally from 51.6 to 51.5. However, at the national level, there has been a lot going on:

- Germany: As noted Merkel's stance on Greece is exceptionally unpopular at home – and it appears to have hurt her badly in her home state of Mecklenburg-Vorpommern. In local elections, the CDU's share of the vote fell from 29% to 23%, while the SDP's share rose from 30% to 36%, and the Greens from 3% to 8%. She blamed the loss on local issues, but there is growing dissatisfaction with her leadership. Meanwhile, economic data has been mixed. On the positive side, industrial production jumped 4% in July – far better than the 0.5% that had been expected. On the other hand, industrial orders fell 2.8% - which suggests strongly that the German economy is about the slow down.
- France: Aside from DS-K's return from the US (which is unlikely to have much impact on the Socialists' challenge for the Presidency), the big news this week was PM Fillon's backtracking on the tax increases that underpinned his austerity package. There is also speculation that Sarkozy will (formally or otherwise) drop his commitment to balance the budget within three years.

- Italy: U-turn has followed U-turn on Berlusconi's commitment to austerity. First, he proposed a wealth tax, cuts in aid to regional governments and an increase in VAT. Then, he dropped them all in favour of a nebulous commitment to stop tax evasion. Now, at the last minute, he has reintroduced a new higher rate of VAT and a 3% wealth tax on incomes over €500,000; on Wednesday, this package cleared the Senate.

Outside the eurozone, the situation in the UK is pretty dire – and there are signs that the government may decide to go slow on its austerity programme. In particular, it was reported this week:

- that UK retail sales were down 2.2% year-on-year in August, largely as a result of the urban riots;
- that the Services PMI fell in August from 55.4 to 51.1 – the biggest drop in 10 years;
- that, according to the Halifax, UK house prices fell 1.2% in August (and were down 2.6% year-on-year); and
- that industrial output fell 0,2% in July (though manufacturing output was up 0.1%).

The National Institute also estimated that the UK economy grew just 0.2% in the June-August quarter, down from 0.6% in May-July. And one of the country's leading supermarket chains warned yesterday that it is experiencing the biggest fall in sales since 1980-83.

What can be done? The Institute of Directors has now joined other trade bodies in calling for more stimulus – and more QE. However, the BofE's MPC, which met yesterday, left UK interest rates unchanged at 0.5% and indicated no change in its asset purchase programme.

In the meantime, a (fairly) influential group of UK economists published an open letter to the PM this week, demanding that he end the "temporary" 50% tax rate on top earners, on the grounds that it is driving wealth-creators abroad. Cameron is broadly sympathetic to this argument, but it is strongly opposed by his LibDem Coalition colleagues; it will go nowhere.

C **JAPAN**: PM Noda and the new FM, Jun Azumi, are currently drafting a (third) supplementary budget to help recovery from the March earthquake/tsunami. This is expected to total Y10 trillion – far bigger than the first two – and will be presented in October.

The need is pretty obvious. It was reported this week:

- that GDP fell at a 2.1% annual rate in the second quarter (worse than the 1.3% rate that was originally suggested);
- that machinery orders fell sharply in July; and
- that capital spending was down 0.9% in the second quarter.

Plus, there really isn't much that the BoJ can do given that Japanese interest rates are already effectively zero. Indeed, the two day MPC meeting held this weekend appears to have focussed on the overvaluation of the yen, rather than on the possibility of more monetary stimulus.

That said, so far Noda is getting pretty good reviews – not least for his Cabinet appointees. He also seems keen to repair relations with the DPJ's 'kingmaker', Ichiro Ozawa - whose followers have got a couple of Cabinet posts.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

The big story this week was the dramatic announcement by the SNB on Tuesday that it will intervene in the markets as much as necessary to 'cap' the Swiss franc/euro rate at SF1.20.

This commitment – which came from the SNB's President, Philip Hildebrand (a Harvard and Oxford-educated economist, who has spent time working with a hedge fund in London) – came out of the blue, though it was precipitated by fears that the recent strengthening of the SF would kill Swiss industry. Between November 2010 and August, the franc was up almost 30% against the euro – and it had recently started to appreciate again. Indeed, last week, it strengthened from SF 1.16/€ to SF1.11, and on Monday it strengthened further to SF1.10.

Within minutes of Hildebrand's announcement, the Swiss franc weakened by over 8% - and it closed on Tuesday up 9.7%, at SF1.202/€. Since then, it has remained within a tight trading range, and is currently around SF1.206.

This is a formidable achievement. Given that the Swiss franc is often seen as a proxy for gold, it has also taken the gold price down with it. From US $1,903/oz on Monday, the price has now fallen to US $1,856 – a drop of US $47. But will it last?

The conventional wisdom is that markets love a target to aim at. That, however, usually means they are trying to push the value of a currency *down*, not up – and the central bank's ability to fight them is limited by its FX reserves. In this case, if the markets decide to fight the SNB, it can just print as much money as it wants – provided that it is prepared to accept the inflationary consequences, which may become severe. That is the key question: Will the SNB go on expanding the domestic money supply to drive the franc lower?

As noted, the markets are not fighting back – yet. However, it is worth noting that, although the SNB said it "informed" the ECB of its decision, it is acting unilaterally. The ECB is not assisting. Nor (to some surprise) has the BoJ decided to do the same – which may lead to friction if capital flows are diverted from the Swiss franc into the yen.

That poses another question: If 'footloose' money cannot go into the SF, where will it go? One possibility is the Scandinavian currencies – and, indeed, both the Norwegian krone and Swedish krona rose sharply after the Swiss move. However, they have since settled back. Another possibility is the commodity currencies – notably the Canadian and Australian dollars. However, the Can $ actually took a hit today after Canada reported an unexpected jump in domestic unemployment.

As for other key currency pairs, the dollar has had a pretty strong week:

- US $/euro: Last week, the euro weakened slightly from US $1.436/US $ to US $1.421 – primarily on expectations of a doveish tone from the ECB. This week, it has weakened further – not least on the initially positive response to Obama's Congressional speech, but also (and perhaps more significant) as a reaction to Juergen Stark's unexpected resignation from the ECB. It is currently trading at US $1.366/€ - down almost 4% for the week.
- US $/sterling: The dollar has also strengthened against the pound. Last week, it was broadly unchanged, closing at US $1.620/GBP. This week, it has strengthened steadily and is currently trading at US $1.587 – up 2.0% for the week.
- Yen/US$: Last week, the dollar was broadly unchanged at around Y76.8/US $. This week, it has strengthened 0.5%, and is currently trading around Y77.15. (The yen has therefore strengthened against the euro, from Y109.1/€ to Y105.4.) What stops the yen from falling further is clearly the Swiss example. Nevertheless, as Japanese FM Azumi said on Wednesday, "Switzerland is Switzerland – Japan will not follow."

Looking to the future, Trichet's hints that the ECB's tightening is over appear likely to underpin the dollar. The euro seems on track for its biggest weekly decline since May, and it could well continue for a while.

V OIL

Stark's resignation and growing fears about the global economy have hit oil prices hard in the last couple of days, and there have been stories in the press about traders buying protection against an out-and-out pride collapse such as occurred in 2008. So far, the average Wall St estimate for the price of front-month WTI in the fourth quarter is US $97 a barrel – well up on current levels. But there has been big interest in US $50 puts – which is a bit worrying.

Last week, the price of October WTI rose US $1.08 a barrel, to close at US $86.45. October Brent rose 97 cents, to US $112.30 – meaning the spread shrank to US $25.85. This week:

- front-month WTI has fallen 57 cents, and is currently trading at US $85.88; while
- October Brent has fallen 73 cents, to US $111.60.

However, it is important to stress that all of that fall has come about today. Through Thursday, WTI was up US $2.75 and Brent was up US $2.25.

What supported prices earlier in the week were stories out of Libya that it would take until late-2012 or 2013 to rebuild production, plus a 3.96 million barrel drop in US crude inventories in the latest week. Reports that 'La Nina' had returned to disrupt weather patterns also boosted commodity prides across the board. In contrast, today's sell-off appears to reflect growing pessimism about the global economy – and, in particular, about the Fed's ability to do anything.

VI BANKING

A VICKERS COMMISSION: On Monday, the UK's Independent Commission on Banking will release its final report. This is likely to maintain its recommendation that the retail operations of British banks should be 'ring-fenced' from their investment banking operations. This 'ring-fencing' would take the form of separate, dedicated capital – which could not be used to back trading activities.

The principle is clear, but the details are not. Moreover, the opposition of UK banks has been vociferous and it is increasingly likely that the Coalition government will decide to delay implementation until (well) after the next election.

B FHFA: More details have been released on the 17 suits that the FHFA is planning against individual banks relating to the mortgage-backed securities that they packaged and sold to Fannie Mae and Freddie Mac. Apparently, the suits (which differ by bank) allege failures:

- of process (in that banks are accused of illegally cutting corners);
- of affordability (in that the MBS included loans made to customers who obviously couldn't afford them); and
- of misselling (in that the creditworthiness of the securities was overstated).

The volume of MBS involved is impressive. BofA, for instance, sold US $57 billion to Fannie and Freddie, JP Morgan sold US $33 billion, RBS sold US $30 billion, Deutsche Bank and Credit Suisse sold US $14 billion, and Goldman Sachs and Morgan Stanley each sold US $11 billion. That said, the *FT* has estimated that all of the banks involved could afford to lose the suit. Nevertheless, bank stocks were devastated on Monday, with RBS down 12%.

VII NEXT WEEK

In the US, the key releases next week are:

- retail sales for August;
- consumer price inflation for August;
- industrial production for August; and
- the Philadelphia Fed sentiment index for September.

Elsewhere, markets will look for eurozone and Japanese industrial production, and the eurozone's current account.

Regards,
GISE