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WEEKLY ECONOMIC AND MONETARY REPORT

22 July 2011

Yesterday's eurozone Summit – at which it was agreed to bail out Greece (again) and to expand the remit of the European Financial Stability Facility – is clearly the big news of the week, and it has certainly had a positive impact on the markets. But the continuing impasse over the US debt limit remains a serious threat. At the moment, it looks likely that a compromise deal will be worked out (though there may not be enough time to write up all the necessary legislation, and get it passed by Congress, before August 2) – but it is worth emphasising that neither Republicans nor Democrats are happy with the package. It could still unravel – leaving the US at the point of default.

I EUROZONE CRISIS

Yesterday's meeting of heads of government was officially described as a "Summit to save the euro" – and it seems to have succeeded in that. At least for the moment. Stock markets around the world are up, the euro is about to end the week up against the dollar, and European interest rates are significantly lower. In particular, the Greek 2-year yield has fallen almost 600 basis points – albeit, it is still an astronomic 28%.

So, what was agreed?

The first thing to appreciate is that analysts are still combing through the communiqué, which was short of details in some important areas. As a result, there is still considerable confusion about the exact numbers. However, the key points appear to be the following:

- Greece will receive €109 billion in new official assistance from the EFSF and the IMF. Surprisingly (since this is the core of the package) there is very little detail on this. In particular, there is no breakdown of how much will be real new money, and how much will come from adjusting the conditions of existing loans. The latter is important. The Summit agreed that existing official loans to Greece (and to Ireland and Portugal as well) should have their interest rate cut to around 3.5% and their term extended from 7½ years to 15-30 years.

- Greece *should* get somewhere between €37 billion and €60 billion (most estimates are around €47 billion) in debt relief from private creditors. This programme is, however, 'voluntary', so the exact amount of relief is uncertain. Private creditors (mostly banks and insurance companies) will be offered a "menu" of options, including longer maturities and lower interest rates – offset by 'enhancements' which will include some sort of guarantee by the EFSF. According to Sarkozy, the intention is to cut the NPV of Greece's existing debt burden by around 21% - which seems rather low, given that most observers felt Greece needed to cut its debt burden by at least 50%.

This is also reference to the possibility of a buy-back of Greek debt in the secondary market, presumably through the EFSF. This could reduce the total debt outstanding by up to €12.6 billion.

Implicit in all of this is an enormous increase in the remit of the EFSF (which was scheduled to become the European Stability Mechanism next year). The EFSF/ESM will be given the power to offer 'precautionary' lines of credit to eurozone members before they actually get into trouble. It will also be able to recapitalise any bank in the eurozone, and (with the prior approval of the ECB) it will be able to buy sovereign eurozone bonds in the secondary market. All of this implies a huge increase in its resources (currently capped at €440 billion).

<u>Those are the main points</u> – but there are some other points that deserve attention.

First, the package is not absolutely a done deal. In some countries, it may require Parliamentary approval; it has also been suggested (though it seems unlikely) that the expansion of the EFSF's role could need a Treaty change. Whatever, there is bound to be a political backlash in the North (apparently, the Finnish PM suggested – half-jokingly

– that Greece should be forced to put up the Parthenon, the Acropolis and some of its islands as collateral).

Second, although the lower official interest rates and longer tenor apply to Ireland and Portugal as well, the rest of the package (particularly the 'haircut' for private sector lenders) applies only to Greece. All the other suspects swear blind that they will meet all their obligations in full. In the words of the communiqué, "Greece is in a uniquely grave situation... it requires an exceptional solution". The intention is not to create a precedent.

Third, the communiqué refers to a special 'Task Force' that will be set up to ensure that the Greeks stick to their commitments, particularly on privatisation. The danger is (presumably) that – now that they have been bailed out again – the Greeks will lose any taste for austerity, and will revert to their old spendthrift ways. How that Task Force will operate is anyone's guess: one commentator was reminded of Germany's wartime occupation of Greece ("*panzers* start your engines").

Fourth, in return for having the interest rate cut on its existing bail-out loans, Ireland has, apparently, agreed to talk about dropping its very low 12% corporate tax rate in favour of a common eurozone tax rate. If the Irish government is serious (which it may well not be), it would face strong opposition at home to this since the low tax rate is crucial to attracting multinationals.

There is also an assumption – though it is not spelled out in the communiqué – that despite what Trichet has been saying, the ECB will continue to accept Greek government paper as collateral for bank liquidity, even if Greece is formally (if temporarily) in default. This is extremely important for the survival of the Greek banking sector.

Whatever, the initial reaction of the markets to the package as a whole has been strongly positive – though some second thoughts must be expected.

Regardless of those second thoughts, the Summit was a genuine success. The crisis had been getting steadily worse, and had begun to threaten European unity, not just the euro. On Monday, for instance, Greek two-year bond yields hit 36% - and they increased to 39% on Tuesday. At the same time, Portugal's 10-year yield was over 20%, and the markets were starting to target Spain and Italy as well. There was also an important story in the *FT*, suggesting that the IMF was "looking for a way out" of the Greek crisis because of the risk to its reputation, and there were also rumours that Cyprus was gong to be next in line for a bail-out. (Its banks are very heavily exposed to Greece.) The agreement that was reached yesterday is far from perfect – and Fitch (one of the three big rating agencies) has already decided that it constitutes a 'restricted default'. And it will still leave Greece with an unsustainable debt burden of around 150% of GDP. Moreover, critics are right that it may well weaken the will of the Greek electorate to pursue further austerity. But it is also a major step forward – perhaps towards a single fiscal policy within the eurozone.

II US FISCAL DEADLOCK

As we noted last week, the other potential disaster is the failure of the Obama Administration to win Congressional approval for an increase in the Federal debt ceiling, which is currently US $14.29 trillion. If it is not increased by August 2, the conventional wisdom is that the US will be in default – a situation that might cause chaos in global financial markets.

This week, the news on the debt ceiling has see-sawed. However, at the moment, there is real hope that a deal can be struck in time – or, if it cannot be struck in time (and it may already be too late to draft all the necessary legislation), with sufficient certainty that both sides will agree to a temporary deal that would raise the debt limit for a brief period while details are worked out.

The deal that seems to be on the table involves:

- spending cuts of US $3 trillion over the next 10 years; and
- US $1.2 trillion in extra revenue through an overhaul of the US tax code.

This is supposed to share the pain between Democrats and Republicans – but it will not be popular on either side. On the spending side, both Medicare and Social Security are hit – which the Democrats hate. On the revenue side, even though there is formally no tax increase, the rewriting of the tax code essentially amounts to the same thing - and many conservative Republicans will therefore reject it.

If this deal falls through (as it still might), 'Plan B' is what is now referred to as the McConnell-Reid plan: Obama would propose a 3-stage US $2.5 trillion increase in the debt ceiling, which Congress will then reject. Obama would then veto this rejection and press ahead anyway – challenging Congress to overturn his veto. To do this would need a two-thirds majority in both Houses – which the Republicans cannot muster. In the meantime, negotiations would continue on a longer-term budget deal.

<u>A lot of this is posturing</u>. Earlier in the week, for instance, the (Republican-controlled) House of Representatives passed a 'cut, cap & balance' budget – safe in the knowledge that the Senate would reject it. That would have included a balanced budget amendment, which will never pass. It was just a way for 'tea party' Republicans to let off steam.

<u>Everyone is much more aware now of just how dangerous a US default would be</u>: White House budget director Jacob Lew, for instance, called it a "financial armageddon", and Egan-Jones (the smallest of the nationally-recognised rating agencies) has already cut the US sovereign rating from AAA to AA. As result, no one wants to push the US over the edge – not even the 'tea party' Republicans. Same sort of deal does, therefore seem more likely.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

The problems of debt in both the eurozone and US can be generalised. In the developed world as a whole, the debt:GDP ratio is now approaching the 90% threshold that two influential US economists (Carmen Reinhart and Ken Rogoff) have identified as the point at which it starts to impact adversely on the economy's ability to grow. As a result, there is a growing consensus that these "structural headwinds" mean that 2% GDP growth has to be the "new normal".

A THE US: While attention has been focussed on the debt ceiling/budget debate, the markets have also been affected by the Greek crisis. The combination of the two caused US equity markets (which had generally fallen around 2% last week) to drop a further 1% on Monday. However, better news since then has turned that around. Indeed, through early trading on Friday, the DJIA is up around 1.4% for the week, the S&P500 is up 1.7% and the Nasdaq Composite is up 1.5%. Moreover, the yield on the benchmark 10-year Treasury, which jumped to 3.01% yesterday, has fallen back to 2.98% - though that is still sharply higher than the 2.9% prevailing on Monday.

What seems to have been lost in the shuffle is the actual state of the US economy, and the danger (which seemed so acute a couple of weeks ago) that it might be sliding into recession. On this, the evidence is (as always) mixed. On the positive side, it was reported this week:

- that the NAHB housing market index improved in July from 13 to 15 (though that is still well below the 50 'neutral' level);
- that housing starts were up a very sharp 14.6% last month, with building permits also up;
- that the Philadelphia Fed's activity index rose this month from -7.7 to +3.2; and
- that the Conference Board's index of leading indicators rose 0.3% last month.

On the other hand, however:

- existing home sales fell 39% last month;
- initial jobless claims jumped 10,000 last week, to 418,000; and
- home prices were down 4% year-on-year in June – the sharpest drop since November 2009.

Moreover, maybe the markets ought to show a bit more interest in the monthly TIC data. Long-term capital inflows in May were just US $23.6 billion – well down from the previous month's US $30.6 billion, and considerably below what Washington needs to fund its twin deficits. China has been warning for some time that the US needs to get its house in order; this may be a sign that (as some reports have had it) it has finally started to cut back its purchases of US Treasuries.

B **EUROPE**: Although today's (apparent) terrorist attack in Oslo may change things the eurozone crisis has dominated thinking about Europe this week. As a result, there has been virtually no comment about the fact that the 'flash' estimate of the eurozone's PMI for July fell from 53.3 to just 50.8 – the weakest level since August 2009. Nor has there been much comment about the unexpectedly steep fall in Germany's IFO index, from 114.5 to 112.9. Together, these two releases do suggest that the eurozone economy is slowing down.

As for the UK, retail sales were up 0.7% month-on-month in June, which was a bit better than expected. Despite that, the latest MPC minutes (from the BofE) indicate that the threat of economic weakness makes a rise in UK interest rates less likely in coming months.

In the meantime, European equity markets – which had fallen anything up to 5% last week – have generally bounced back strongly this week. Through late trading on Friday, the CAC-40 is up 105 points (2.8%), the Xetra Dax is up 85 points (1.2%) and the FTSE 100 is up 35 points (0.6%). However, interest rates have started to nudge upwards; this week, the yield on the 10-year German *bund* has risen from 2.68% to 2.84%, while the UK gilt yield has gone up from 3.08% to 3.12%.

C CHINA

As noted, there have been stories in the press this week that China has been cutting its purchases of US debt. Early in the week, SAFE issued a statement, confirming that it was aware of the warnings of the rating agencies, and adding: "We hope the (US) government will correctly adopt responsible policies."

Of course, China is not exactly above criticism itself. Indeed, on Wednesday, the IMF issued its annual economic assessment of Beijing's policy. This concluded that the renminbi is still undervalued by anything up to 23% against a range of currencies. Despite this, the Fund also recommended a tightening of monetary policy. Even though the Fund confirmed its growth forecast of 9.6% for this year and 9.5% for 2012, China objected vigorously – and included a six-page list of objections in the report.

Whether or not the Chinese objections have merit, more doubts arose this week over the validity of Chinese data. According to a study by MEPS (an independent UK-based steel consultancy), China may be underestimating its annual steel production by as much as 40 million MT – which is equivalent to the entire production of Germany. It estimates that output in 2010 was 672 million MT, not 627 million.

The reason for this is interesting: official Chinese statistics apparently exclude production from high-polluting plants that should have been shut down. It appears that the central government may not have the political clout to impose unpopular plant closures on powerful regional governments.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the dollar firmed 1.0% against the euro, fell 0.4% against sterling and rose 1.3% against the yen. At the same time, spot gold rose almost US $55 per oz, to close at US 1,587.25.

This week, the pattern has been similarly diverse:

- US $/euro: At the close last Friday, the euro was trading at US $1.412/€. On Monday, it fell to US $1.403 on comments by Trichet reemphasising that the ECB will not accept defaulted bonds as collateral (a policy that now appears to have been abandoned). On Tuesday, it rallied on improved expectations of a deal at the Thursday eurozone Summit. Yesterday, it rallied still further, rising 1.1% against the dollar to US $1.438/€. This morning, it rose again, peaking at US $1.442 before inevitable second thoughts set in. It is currently trading at US $1.436 – still up 1.7% for the week.
- US $/sterling: Although the UK is not a member of the eurozone, it has still been affected by the sovereign debt crisis. The pound closed last week at US $1.612, fell back to US $1.607 on Monday, and then started to recover. It hit a high of US $1.633 this morning, but has since eased to US $1.631 – still up 1.5% for the week.
- Yen/US $: At the close last week, the dollar was trading at Y79.1. It fell to Y78.5 on Thursday, and then to Y78.35 today. The yen has clearly been a beneficiary of both the debt deadlock in the US and the eurozone debt crisis.
- SF/US $: The same has been true of the Swiss franc – generally perceived to be a proxy for gold. At the close last week, it was trading at SF0.816/US $. By Wednesday, confidence in a deal had pushed it down to SF0.82; however, second thoughts have given the franc another boost, and it is currently trading at around SF0.8164.

On the whole, the US dollar has also weakened against the key commodity currencies this week. Against the Canadian dollar, for instance, it has fallen 0.7%, and is currently trading at Can $0.9496/US $. Against the Australian dollar, it has fallen 2%, and is currently trading at A$0.921/US $.

Over the next week or so, what happens to the dollar depends almost entirely on the progress of the debt talks in the US and on whether the market does or does not have significant second thoughts about the Greek bailout package. As for gold, however, most analysts believe it still has some upside – not least because Chinese and Indian retail buyers are now in the market, as well as Asian central banks.

V **OIL**

Last week, the price of front-month WTI rose US $1.04 to close at US $97.24 a barrel, while the price of front-month Brent fell US $1.07 to US $117.36 – meaning the spread in favour of Brent was US $20.02, still exceptionally high.

This week, the front-month contract for WTI has shifted to September, while prices of both WTI and Brent have risen slightly. September WTI is currently trading at US $99.44 a barrel (up US $2.20 or 2.3%), while Brent is at US $118.45 (up US $1.10 or 1.0%) – meaning that the spread is down to US $19.10. Perhaps more significantly, the Brent market has returned to backwardation, with the spot price about US $2.50 higher than the one-year forward price. During the period when the IEA was pouring 60 million barrels of strategic oil stocks into the market, the Brent market had briefly been in contango. Nevertheless, it is still quite flat; earlier in the year, the backwardation had been around US $7.50.

The upward pressure on prices is primarily a result of the (not wholly unexpected) decision by the 28 IEA members not to continue with the stock drawdown in August. The general feeling seems to have been that its impact was minimal at best. In addition, the price of WTI was boosted by the latest EIA data, which showed an unexpectedly sharp 3.7 million barrel drawdown of US crude stocks in the latest week. They are now at a four-month low of just 351 million barrels.

VI BANKING

It has been an important week for the global banking industry.

A **EU STRESS TESTS**: The results of the EU's second round of stress tests were published late last Friday. They were broadly as expected. Nine out of the 91 banks that were tested "failed" (ie failed to maintain a core Tier 1 ratio of at least 5% under stress) – including Germany's Helaba, which dropped out of the process ahead of time in protest. (Its complaint was that it would have passed had it been permitted to count its 'silent' participations as Tier 1 equity.)

There were no real surprises in the list of failed institutions. The worst was Greece's ATE – an agricultural bank being taken over by the government, which managed a core Tier 1 ratio of just 0.8%, well short of the 5% threshold. Others in the worst-performing category were four Spanish *cajas*, Austria's Volksbanken (4.5%) and EFG Eurobank (4.9%). The surprise (if there was one) was that, in general, Spanish and Italian banks did surprisingly well: BBVA, for instance, had a post-stress core Tier 1 ratio of 9.2%, while Intesa had 8.9%. In total, the combined core Tier 1 capital shortfall at all nine failed banks was just €2.5 billion – which many observers felt to be implausibly low.

Although the tests were generally seen as an improvement on last year's exercise (and though it was accepted that the information given would let analysts run their own simulations), the general feeling remains that the tests didn't properly treat the possibility of a sovereign default. In particular, the write-downs of government debt were not based on market prices. Greek debt in the trading book, for instance, was only marked down by 15% - and it was easy to hide sovereign exposure in the banking book. In addition:

- there was no allowance for rising funding costs; and
- it was possible for banks to hide individual exposures that were less than 5% of capital.

Nevertheless, the tests were an improvement on last year – and they did throw up one or two unexpected findings. One in particular was the relatively weak showing of the big UK banks.

B **SYSTEMIC RISK CHARGE**: Both the FSB and the Basel Committee have been considering the problem of systemically-important banks this week. Two consultative papers were issued by the FSB on Monday:

- giving a list of the criteria that may be used to identify "globally significant international financial institutions" – or G-Sifis; and
- laying out the principles for unwinding and "resolving" troubled systemic banks.

These will go to the G20 for approval. The general idea is that there are around 28 G-Sifis, which will face a supplemental capital charge to reflect the damage they would do if they were to fail. It is effectively the price for being "too big to fail". Yesterday, the Basel Committee put out its own proposals for what that charge should be (on top of the minimum 5% Tier 1 ratio):

Basel Committee: Proposed G-Sifi charge

BofA	2.5%	Credit Suisse	2.0%	Credit Agricole	1.5%	BBVA	1.0%
Barclays	2.5%	Goldman Sachs	2.0%	Dexia	1.5%	BoNY	1.0%
BNP Paribas	2.5%	Morgan Stanley	2.0%	ING	1.5%	BPCE	1.0%
Citi	2.5%	UBS	2.0%	MUFG	1.5%	Commerz	1.0%
Deutsche	2.5%			Santander	1.5%	Mizuho	1.0%
HSBC	2.5%			Unicredit	1.5%	Nordea	1.0%
JP Morgan	2.5%					Rabo	1.0%
RBS	2.5%					State St	1.0%
						Wells Fargo	1.0%

C **<u>BANK OF AMERICA</u>**: It is worth watching BofA. Its stock has fallen 26% year-to-date, and its market cap is now below US $100 billion – compared with a book value in June of US $206 billion. It has also just reported a quarterly loss of US $8.8 billion, and some analysts are starting to question its ability to survive without another big slug of capital.

D **<u>BASEL 3/CRD 4</u>**: The European Commission has now introduced the new rules through which it intends to implement Basel 3. These are still a draft, and may well be modified.

The intention is that the main points will be covered in a Regulation – which means that no national deviation will be permitted. This Regulation will cover:

- an increase in the core Tier 1 equity requirement (known as CET 1) from 2% of risk-weighted assets to 4.5%;
- a very strict definition of "common equity Tier 1" that will exclude so-called co-cos; and
- a capital conservation buffer of 2.5% for systemically significant banks, which pushes their effective Tier 1 ratio up to 7% (if a bank falls below this, restrictions on dividends and bonuses will apply).

In addition, the Commission proposed a Directive that would permit individual member states to apply discretionary counter-cyclical capital requirements if, in the opinion of national regulators, lending is getting out of control.

It is also intended that there will be new leverage requirements from 2015, and a binding leverage ratio from 2018.

All in all, it has been calculated that these measures will cost European banks about €84 billion in new capital by 2015 and €460 billion by 2019. <u>They are bound to prove controversial</u> – particularly in the UK, while there are plans to "ring fence" local banks' retail operations. It is also worth noting that, while the Europeans are pressing ahead with Basel 3, the US still has to implement Basel 2.

VI NEXT WEEK

Key releases in the US next week include:

- the advance measure of second quarter GDP growth;
- consumer confidence for July;
- durable goods orders for June; and
- the Fed's "Beige Book".

Elsewhere, markets will look for:

- UK GDP data;
- the GfK confidence index in Germany;
- eurozone consumer confidence; and
- Japanese household spending.

Regards,
GISE