WEEKLY ECONOMIC AND MONETARY REPORT

15 July 2011

For once, it is not just the (apparently endless) crisis of the eurozone that is occupying the attention of market commentators. Although there are signs that Europe's problems are reaching some kind of end-game, the focus of concern has actually shifted to the US – and to the apparent stalemate over the Federal debt ceiling. Wednesday's decision by Moody's to put the US on negative credit watch was not exactly a surprise, but it was a very clear sign that something which had long seemed inconceivable is now quite possible.

I THE US DEBT CRISIS

It was reported yesterday that Obama had walked out of a meeting on the debt limit with the House Majority leader, Eric Cantor – a very abrasive Congressman from Baltimore, who is close to (though not a member of) the 'tea party' faction within the Republican party. As he left the room, Obama was reported as saying: "This may bring my Presidency down, but I will not yield."

How has it come to this? The basic problem is that US finances are in such rotten shape that the Federal government currently has to borrow 40% of the money it spends. That is fine as far as the markets are concerned; the yield on the 10-year Treasury benchmark is currently just 2.96% (actually, down from 3.02% week-on-week) and there is no sign whatsoever that the government is having any difficulty selling its paper. But it may no longer be legally able to borrow because it is running right up against the Congressionally-mandated debt limit, currently US $14.3 trillion.

This is a problem that comes up every few years – and, every time, a deal is done at the last moment. In this case, 'the last moment' is sometime between next week and August 2 – when the Treasury Department estimates that the money runs out. The crunch then comes on August 3, when the Federal government is due to mail out 70

million cheques (to welfare recipients, Federal retirees, disabled veterans etc). the market appears confident that normal rules will apply, and that some kind of deal will be cut. However, many observers are much less confident. In particular:

- as noted, Moody's put the US on negative credit watch this week – following a similar move by China's Dagong rating agency; and
- the Intrade on-line betting market (which is pretty good at forecasting financial market developments) now puts a 60% probability on no deal by August 2.

The reason for the concern is that Congressional Republicans may be in no position to compromise. Since they hold a majority in the House, they have a stronger position than the Administration – but not so strong that they can completely ignore the Democrats. The initial deal – which came very close to being signed – was a jumbo package, a so-called 'Grand Bargain', which would have permitted a rise in the debt ceiling in return for a US $4 trillion cut in the deficit over 10 years. This would have been made up of about 75% in spending cuts and 25% in tax increases of one sort of another. At the last minute, however, the Senate Republican leader, John Boehner (who is a moderate), pulled the plug – under intense pressure from 'tea party' Republicans who continue to insist that any package must include no tax increases of any sort. Obama then offered a smaller US $2 trillion package, with even fewer tax increases – but that, too, was rejected.

What the 'tea party' Republicans want is a massive programme of cuts in government spending (except defence), and – more controversially – the privatisation of Medicare. Given the popularity of Medicare (especially among elderly Republican voters) this is an odd position to take – and the most recent poll shows that 67% of the US electorate believes that higher taxes are necessary and inevitable. Nevertheless, <u>this has become an issue of principle</u> – and many 'tea party' Republicans seem willing to risk losing their Congressional seats to push through what they genuinely believe the country needs: a smaller government.

Is there any room for compromise? Another moderate Republican, Sen. McConnell, has offered a proposal that the *FT* has described as "constitutional chicanery". He suggests that the President should propose a three stage increase in the debt limit, totalling US $2.5 trillion. Congress would then refuse to agree this, and would return the bill to the White House. At that point, Obama would go ahead anyway – and could only be stopped by a 2/3 majority in both the Senate and House. This is a legal sleight-of-hand, and the *FT* dismissed it as "astonishing, deplorable and unacceptable" – but it would buy the Administration some time, and it is starting to pick up bipartisan support. At the moment, that is about the best the Administration can hope for.

II THE EUROZONE CRISIS

While concerns about the US debt ceiling are growing, the eurozone crisis continues to fester – though there are signs that the endgame may be approaching.

The major development over the last week has been the market's decision to target Italy. This may come to nothing – particularly because Berlusconi and Finance Minister Tremonti have put aside their deep mutual antipathy to ram through a €45 billion austerity package that is designed to eliminate the budget deficit by 2014. (The final vote on this, in the Chamber, is due tonight; it is expected that the package will pass.) However, the focus on Italy was a major shock – pushing the 10-year bond spread between Italy and Germany to almost 300 basis points. According to the BIS, French bank exposure to Italy is €98 billion; German bank exposure is €51 billion. If market pressure continues, the consequences could be disastrous.

Unfortunately, that is not the only evidence that the crisis is not contained to Greece. On Tuesday, for instance, Moody's downgraded Irish debt again – this time, from Baa1 to Ba1. And, on Monday, it was reported that an independent audit of Spain's Castilla-La Mancha region showed its deficit to be twice what was officially reported – reinforcing the fears of those who have long believed that Spain's finances are worse than they appear. Perhaps more significant, today's *FT* carries an article pointing out that the

spread between French and German bonds is now at its widest since 1997, having increased over the last couple of weeks from 30-40 bp to 77 bp. There is real fear in the market that France could be the next to lose its AAA rating – not something Sarkozy could easily accept with a Presidential election so close.

In the meantime, there continues to be nothing but bad news about Greece – which was also downgraded again this week, this time by Fitch to CCC (which implies "a real possibility" of default). The price of CDS cover for Greece has also soared; it now equates to an 86% chance of default within the next five years. The two year yield on Greek paper is an astronomic 32%, and the 10-year spread over *bunds* is an equally astonishing 1,400 bp.

Why? Well, one reason is that the Greek government's commitment to austerity clearly isn't working. This week, it was reported that the budget deficit actually rose by 28% in the first half year, as revenues *fell* 8.3% and spending *increased* 8.8%. In addition, no one seems to have confidence that things will improve. On Tuesday, PM Papandreou publicly blamed other eurozone leaders for "indecisiveness and errors" which, he said, had caused the crisis, and he insisted that the eurozone as a group had done "too little too late to convince the markets" that it stood behind Greece. The IMF also added its contribution. Although (as expected) it authorised payment on the next tranche of the first €110 billion bailout package, its staff report made it clear that it was only going along with this because of the wider implications of a "chaotic" default. It emphasised, in particular, the need for the ECB to continue to make liquidity available to Greek banks.

Is there a way out?

There are a number of suggestions floating around. The IIF, for instance, has now moved beyond its original support of the so-called "French plan" (which was widely dismissed as a confidence trick against Greece). It is now emphasising the need for the eurozone to commit to a buyback of Greek debt (now around €350 billion) if the private

sector is going to share the pain. That approach has also been endorsed by the *WSJ*, which points out that it would not necessarily count as a default.

The other, more radical, alternative is to ditch the legal proscriptions of the Maastricht Treaty altogether, and to convert Greek debt (and that of other peripheral states) into so-called "Eurobonds", which would be backed by the full faith and credit of the eurozone as a whole. That would be a huge step, which would require creation of a new eurozone fiscal authority; but it is being strongly supported by Tremonti in particular.

III IMF

Two important (albeit expected) appointments were announced this week:

- David Lipton, currently a senior White House advisor on economic affairs, will replace John Lipsky as first Deputy MD on September 1 (though he will start at the Fund on July 26). He is a former Treasury Undersecretary, who actually began his career (fresh out of Harvard) at the Fund in 1981. He is a strong Democrat, who spent much of the GW Bush Administration at Moore Capital (a hedge fund) and Citigroup, where he was head of global country risk management. He was also closely associated with the efforts of the controversial economist, Jeff Sachs, to reform the economies of Eastern Europe. It is worth noting that the new MD, Christine Lagarde, was extremely critical of hedge fund managers when she was finance minister in France.
- Zhu Min, 58, currently an adviser to the MD, has been appointed to a new post as the Fund's fourth deputy MD. He is a former deputy Governor of the PBoC, who also spent six years working at the World Bank. He has an MPA from Princeton and a PhD from Johns Hopkins.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

Early this week, a new poll was released on the public's reaction to the austerity programmes now being pushed through in both the US and Europe. Perhaps surprisingly, the only country in which support for austerity had fallen sharply over the last year (from 69% to 55%) was the UK; in the US, Germany, France, Italy and Spain, there remains a strong majority that is supportive of austerity.

However, almost everywhere there is a big majority in favour of cutting back development aid – 75% in the US, 69% in the UK etc.

A THE US: The big issue in Washington is clearly the talks over the debt limit and the budget. But that is not the only problem; last week's very poor jobs data has reawakened fears of a 'double dip' – fears that Fed Chairman Bernanke did nothing to assuage, when he told the House Financial Services Committee on Wednesday that "deflationary risks might re-emerge" and that the Fed was ready to help "if needed". That hint of a third round of Quantitative Easing pushed the gold price up, and hit the dollar – but it left Treasuries largely unaffected.

Is Bernanke's concern (which was also reflected in the latest FOMC minutes), justified? Probably, yes. For instance, it was reported this week:

- that the FFIB's small business confidence index fell in June from 90.9 to 90.8 – meaning that the sector is still in "recession territory"; and
- that the Empire State (NY) business index was also stuck in recession last month, though it improved a bit from -7.8 to -3.8.

On the other hand, retail sales for June surprised on the upside, growing 0.1% (compared with an expected fall of 0.2%). And – despite the June employment data – first time jobless claims fell sharply in the latest week. Moreover, it has just been

reported that industrial production rose 0.2% last month – less than expected, but still positive.

Whatever, there are clearly few price pressures yet – despite two rounds of QE. For instance, it was reported this week that producer prices fell 0.4% in June – the first fall in a year. However, that was entirely due to a fall in energy prices; 'core' PPI actually rose 0.3%. In addition, the CPI also fell last month, dropping 0.2% - though, again, core consumer prices were up 0.3%.

One concern *ought* to be the trade deficit – which jumped 15.1% in May to a two-and-a-half year high of US $50.2 billion. As noted, there is no sign yet that the government is having any trouble funding this, but it must be worrying that imports continue to rise while exports are flat (at best). It may explain the weakness of US equity markets, with the DJIA down around 200 points (or 1.7%) so far this week.

B **EUROPE**: The buzzword in the EU these days is austerity:

- In France, the National Assembly approved a constitutional change this week, intended to limit budget deficits and bring the budget back into balance in three years. This "Golden Rule" now has to get a 60% majority in a Special Congress – if Sarkozy decides to call one.
- In Italy, as noted, Berlusconi and Tremonti have (temporarily) put aside their differences and have cooperated to push through a €45 billion austerity package.
- In Spain, there is talk of more budget cuts – prompted by the problems of Castilla-La Mancha.

Even in Germany, the focus is on austerity – with the IMF's latest Article 4 report supporting more fiscal consolidation. Given that the Fund is predicting that the German economy will grow 3.2% this year, that should not be too painful.

As for the UK, the picture is very mixed indeed. While the British media has been (obsessively) focussed on the implosion of Rupert Murdoch's media empire, it was reported:

- that total retail sales were up 1.5% year-on-year in nominal terms last month – but were down sharply in volume terms;
- that the trade deficit ballooned from GBP 7.6 billion to GBP 8.5 billion in May – largely because of a 5.8% jump in imports; and
- that total unemployment fell 26,000 in the March-May quarter – but only because of a sharp increase in the number of full-time students.

There is also mixed news on housing. The RICS index of UK house prices jumped to +27 in June, which was good. However, the Rightmove index fell 1.6% this month – the first drop in prices it has recorded this year.

Whatever, the BofE has limited room to respond. Although consumer price inflation eased from 4.5% to 4.2% last month (with the RPI also falling, from 5.2% to 5.0%), it is still more than twice the BofE's target. The best the MPC can do is hold interest rates steady for a few more months.

C **JAPAN**: On Tuesday, the BoJ issued a prediction that output in the third quarter will finally hit pre-March 11 levels. Despite that, it kept interest rates effectively at zero – mindful, no doubt, of the continuing upward pressure on the yen. One result was downward pressure on equities – with the Nikkei-225 (which was up 2.73% last week) off 164 points (or 1.6%) this week.

D **CHINA**: The good news is that growth remains strong, with GDP in the second quarter up at an annual rate of 9.5%. That was a bit slower than the first quarter, but stronger than expected. The downside of this, however, is that this growth is still largely investment-driven; domestic consumption remains relatively weak – despite the fact that industrial production was up 15.1%, its strongest performance in over a year.

The immediate worry remains inflation. Food prices were up 14.4% in the year-to-June, with pork (the Chinese staple) particularly affected.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

It has been a busy week in currency markets, with the euro coming under heavy pressure early on. It closed last Friday at US $1.426/€ (down from US $1.448 week-on-week). It then fell to US $1.399 on Tuesday – as well as hitting a record low against the Swiss franc. That suggested (according to the *WSJ*) that "the endgame is getting nearer" – particularly given that the euro had fallen 4% against the dollar in a week. There was even talk that the US $1.30 level could be tested.

In fact, it didn't happen – at least, not yet.

On Wednesday, the euro recovered to US $1.416/€ in part because of Bernanke's comments on the possibility of more monetary easing. It was also boosted by talk that the ECB has been buying Italian and Spanish debt, and that the Chinese had also been buying eurozone assets. Warnings about the US credit rating also hit the dollar. Nevertheless, the euro has eased again today – largely because of the better than expected industrial production data in the US. It is currently trading at US $1.4103 – down 1.1% for the week.

Elsewhere, the dollar has had a mixed week:

- Against sterling, it has weakened slightly – from US $1.605/GBP to US $1.6108 – a fall of 0.4%.
- Against the yen, it has strengthened by 1.3% - from Y80.7/US $ to Y81.74. That is despite the yen hitting its strongest point since March 11, breaking Y79

on Wednesday. That provoked MoF to send a warning of possible intervention – and the markets moved accordingly.

- Against the Swiss franc, the dollar has continued to slide. It closed last Friday at SF0.838/US $, and is currently trading at SF0.817, a drop of 2.5%. Once again, the SF is a good proxy for gold – the price of which has risen US $54 this week, or 3.5%, to a near-record US $1,586.40/oz.

The dollar is also mixed against the main commodity currencies. Week-on-week, it has risen 0.7% against the Australian dollar (to A$0.939/US $), while it has eased 0.6% against the Canadian dollar (to Can $0.959/US $).

In the short run, the main factor is clearly the progress (or otherwise) on resolving the eurozone crisis. However, if it becomes clear that the August 2 deadline for raising the US debt ceiling will not be met, that could be devastating.

VI OIL

Last week, Brent for August delivery rose US $6.56 to US $118.33 a barrel, while August WTI rose US $1.26 to US $96.20 – pushing the front-month spread in favour of Brent to US $22.13.

This week, prices have fallen – though the spread in favour of Brent has continued exceptionally high (touching a record US $22.63 yesterday). In early trading today, August WTI is at US $95.43 a barrel (down 0.8% for the week), while September Brent (the new front-month marker) is at US $115.55 (down 2.3%). That means the spread has narrowed to US $20.12 – still very wide.

One factor that has affected the price, particularly of WTI, is the bearish tone of Bernanke's Congressional testimony. That seems to have more than offset the impact of the latest EIA stock data, which showed inventories of US crude down 3.124 million barrels in the latest week.

In addition, the IEA's *Monthly Oil Market Report* suggested that OPEC is currently producing around 30 million b/d – with Saudi Arabia's output around 9.7 million b/d last month. That is still below what the IEA believes the real "call" on OPEC is – around 31.3 million b/d - but it suggests that OPEC discipline is fraying.

Despite this, 13 out of 30 analysts contracted by Bloomberg for its weekly survey predict that prices will go up next week. Eleven believe they will go down.

VII TRADE

One story that emerged this week is worth flagging – not least, because it may presage a rash of similar actions by other countries.

It was reported today that Argentina has introduced a licensing regime that attempts to impose an equivalent export obligation on anyone who obtains a license to import any of more than 4,000 items. This is administered on a company-by-company basis, and it ends up forcing importers of (say) automobiles or consumer electronics to find exports (say) of meat or grain of comparable value. Most economists would say this is simply protection – and therefore to be deplored. However, it may well have a wider appeal – particularly in countries with a chronic trade deficit. (Oddly, Argentina has a surplus: In May, the trade surplus was US $1.68 billion, or US $4.77 billion for the first five months of the year.)

VIII BANKING

The big issue this week is the release of the 'stress tests' that the European Banking Authority has been overseeing at 91 European banks. It is expected that the much-delayed results will be released at 5pm London time today – ie after European markets are closed.

This makes any serious analysis impossible. However, a few points are worth making.

First, even though these stress tests are tougher than those that were conducted last year, they may still be dismissed as a bit "soft". The key assumptions that the banks have been required to factor in are:

- a 0.5% drop in eurozone GDP;
- a 15% drop in European equity markets; and
- a "haircut" in the value of sovereign debt which is not held in the banking book.

To pass, banks have to maintain a "core Tier 1" capital ratio of not less than 5%.

One critical issue, where the EBA seems to have been tough is the definition of capital. It appears to have excluded some popular forms of quasi-equity – notably the "silent participations" that some of the German *landesbanks* have (which amount to a form of subordinated debt). That has already led Helaba – one of the 13 German banks in the test – to pull out. It claims that it is unreasonable for the EBA not to accept €2 billion of this debt as capital, and that it would easily have met the 5% target if the EBA had been more reasonable.

Helaba's decision suggests some other *landesbanks* may fail. There is also concern about some of the Spanish *cajas* – as well as at least two Greek banks. This has led to much criticism of the EBA – in particular, from BaFin and the Banca d'Espana.

The real problem, however, may come later, when bank analysts get a look at the results. Unless there has been a last minute change of heart, the intention is that each bank will reveal enough information that independent analysts can run their own stress tests; that could be devastating.

Two other – conflicting – developments this week:

- On Tuesday, the IIF issued a report by a special committee (chaired by Peter Sands, the chairman of Standard Chartered) criticising the trend towards tougher and tougher regulation – and the “tick-box” mentality of supervisors.
- Earlier today, the IMF released a report (prepared for next week’s G-20 deputies’ meeting) which argues that EU banks are still under-capitalised and that they need better resolution plans.

IX NEXT WEEK

It is a fairly thin week for economic data in the US. The most significant releases are likely to be:

- the Philadelphia Fed index for July;
- leading indicators for June; and
- home sales and housing starts for June.

So-called TIC data (long term capital flows) for May will also be released. Until now, markets have not given these figures the attention they deserve.

Elsewhere, key releases include:

- the ZEW survey in Germany for July;
- leading indicators for July in China;
- eurozone consumer confidence for July; and
- the IFO business climate index for July in Germany.

Regards,
GISE