WEEKLY ECONOMIC AND MONETARY REPORT

20 May 2011

The big story of the week has clearly been the scandal surrounding Dominique Strauss-Kahn, which has dominated headlines around the world, even among those who previously didn't have a clue what the IMF was or did. However, there have been other things going on. In particular, it is worth emphasising the growing concern about a stock market bubble. Last week's IPO of Glencore - the secretive commodities trader that was originally founded by the notorious Marc Rich, and which is now controlled by the equally elusive Ivan Glasenberg - stunned the markets. It valued the company at over US$10 billion, and even though the stock has not performed as well as some had hoped in the aftermarket, it is still an astonishing price to have paid. But it (almost) seems to make sense when measured against this week's IPO of LinkedIn - a social networking site for adults that acts as a sort of jobseekers' network. Last year, LinkedIn made a profit of US$15.4million on total revenues of US$243million; its IPO gave it a market cap of US$9billion - making it the biggest US IPO since Google (Glencore floated in the UK).

A lot of people are starting to see patterns: the market seems to be repeating the early stages of the last Internet bubble - and the outcome is unlikely to be any different.

I THE DSK AFFAIR

Although a lot of the interest in this is prurient (and one must admit that the detail - and the speculation around it - is gripping in a gossipy way), it matters.

First, there is no doubt that (despite his history as a serial womaniser who is utterly incapable of separating his personal and professional lives), DSK radically changed the IMF, in particular by making it much more proactive with regard to the issues of the day and by refocusing it on the problems of the eurozone. The latter is, of course, controversial - and unpopular with some of the Fund's traditional clients in Latin America, Africa and Asia. But, under DSK, the Fund is considered a more important global player which gets itself involved at an earlier stage in crisis management and resolution. In the case of the eurozone, it is (rightly or wrongly) perceived to be more sensitive to the political implications of the crisis than individual governments or the ECB. Bizarrely (given its reputation during the Latin debt crisis), the Fund is widely felt to be Greece's 'friend' - quietly pushing for some sort of 'soft' rescheduling against the much tougher line from the ECB (and France). Second, DSK's arrest (and, on the basis of what is currently known, probable conviction for an offense that carries a prison sentence) changes the political outlook in France. Although he was not an official Presidential candidate, he was five percentage points ahead of Sarkozy in the polls, and was expected to resign from the Fund within the next couple of months to return to France to run as the Socialist party candidate. That is now out of the question - which leaves the party without a champion who could threaten Sarko. The most likely alternative seems to be that the party will nominate François Hollande - the (deeply uncharismatic) 'partner' of its last Presidential candidate, Segolene Royal, who failed spectacularly in her own bid. An alternative is the current party leader, Martine Aubry - the daughter of former European Commission President, Jacques Delors. None of them seems likely to threaten Sarko - which has convinced many of the cynical French electorate that DSK was set up by the French security services. That seems inconceivable - except that the DSG has been responsible for some outrageous stunts (including sinking the 'Rainbow Warrior', the ship operated by Greenpeace). Whatever, the Socialist party is now in deep trouble - and there is a serious chance that it could run third in the Presidential election, meaning that the final vote will be between Sarko and the new (squeaky-clean) leader of the National Front, Marine le Pen (daughter of the much more controversial Jean-Marie).

The immediate problem is to find a successor for DSK at the Fund - which is currently being run by the First Deputy MD, John Lipsky, who is supposed to retire in August (he is 64), probably to be replaced by a former US Treasury official, David Lipton. Lipsky is perfectly competent - but he lacks DSK's political clout, particularly with the Europeans. (Lipsky's own role is apparently being filed by the Fund's new Deputy MD, Nemat 'Minouche' Shafik - the Egyptian-born ex-World Bank VP, who was recently hired away from the UK's DfID. Her astonishing rise is itself worth much more analysis than it has so far received.) To no surprise, the Europeans are suddenly keen to hang on to their preemptive right to nominate the Fund's MD - even though, when DSK got the job, there was a sort of informal agreement that the next MD would come from the emerging world. As German Chancellor Merkel put it, this is (in the EU's eyes) no time to shift the IMF's attention away from Europe. Hence the strong support that she and the rest of the Europeans are giving to Christine Lagarde, the French Finance Minister.

Lagarde is a credible candidate. She spent 20 years as a lawyer in the US (where she headed the global policy committee of Baker & Mackenzie), so the Americans like her. She speaks perfect English (so the British are backing her). And, as a woman, she would represent some kind of diversity for the Fund (so the press likes her). She is also extremely competent and has done a good job as FM and as spokesman for the G7/8 and G20. Ironically, however, she is likely to be less 'forgiving' of Greece than was DSK. However, the process of appointing her may take a month or more, and things could change. The Europeans control about 35% of votes on the IMF Board, and would command a majority if the US supported their candidate (the US now has 17%), but Lagarde would probably lose out if the rest of the world could coalesce around another candidate. At the present time, the most plausible alternatives are said to be:

- Kermal Dervis, ex-World Bank, ex-UNDP, now at Brookings and said to be personally close to Greek PM Papandreou (his candidacy is, however, in some jeopardy as a result of an old sex scandal at the World Bank that is now being resuscitated in the US press);
- Arminio Fraga, the ex-President of the Brazilian CB;
- Agustin Carstens, the Governor of the Mexican CB;
- Trevor Manuel, the former FM in South Africa (who steered the economy through the very dangerous early days of majority rule); and
- Tharman Shanmugaratnam, currently the FM in Singapore.

Other less plausible names include Montek Singh Ahluwahlia from India (too old), Sa Kong Il from South Korea (also too old), Marek Belka (Poland), Thomas Mirow (Germany) and the ubiquitous Stan Fischer (currently Governor of the Bank of Israel). One possibility is that - to avoid a delay - the Europeans could propose that Lagarde step in the fill the remainder of DSK's term, without any commitment beyond that.

II EBRD

One of the reasons that Thomas Mirow's name is being mentioned at all as a candidate to succeed DSK is that he is launching an important initiative at the EBRD, of which he is the current President. The Bank is holding its annual meeting in Astana, Kazakhstan this weekend, and Mirow is seeking Board approval to extend its lending to North Africa - specifically to Egypt, Morocco and Tunisia. Given the importance that the US (in particular) attaches to supporting the so-called 'Arab Spring', the Board is likely to go along.

III G8 SUMMIT

It is easy to forget that preparations are now fully underway for next month's G8 Summit in Deauville, France. This week, the G8 released an Accountability Report, in preparation for the Summit, which acknowledges that it has missed the aid targets that were set at the Gleneagles Summit - though it insists that it has done rather better than the (pessimistic) recent report of the OECD's Development Assistance Committee. The OECD claims the commitment is being missed by about US$19billion a year; the G8 says the gap is just US$1billion.

IV EUROZONE CRISIS

The problems of DSK should not distract attention away from the eurozone crisis - which has taken a couple of turns this week.

The good news was that the ECOFIN meeting on Monday approved (as expected) the €78 billion bailout package for Portugal - a package that appears to have support from both the outgoing Socialist government in Lisbon and the PSD, which is likely to emerge as the largest party after the June 5 election. However, it is important to appreciate that the package is pretty tough - tougher than the Portuguese electorate has been led to believe. Support for it could easily disappear.

Other than that, the focus has been on Greece. Over the weekend, the European Commission issued its report on the Greek economy - which did not make comfortable reading. According to the Commission, the budget deficit this year will be 9.5% of GDP (compared with a target of 7.4%), falling to 9.3% in 2012 (not 6.5%). The main reason is that tax revenues are well behind schedule. One way to close the gap might be to accelerate the privatization process - which is being pushed hard by the IMF. There has even been a proposal that the EU should take over the privatization programme from the Greek government - though that is widely considered politically unacceptable. The problem is that the whole issue of privatization is extremely controversial in Greece, with the cabinet itself split on whether entities like the power company could be sold. Without a political consensus behind privatization, it is unrealistic to expect buyers to emerge.

That means more austerity. The government seems resigned to an extra €6billion of cuts this year - though whether they will ever happen must be open to doubt. ECB Council member Lorenzo Bini Smaghi rubbed it in this week - demanding that the Greek government convince its public 'to pay taxes' and 'to retire at 65' - like normal people. It missed no one's attention that Bini Smaghi comes from Italy, where taxpaying sometimes appears voluntary.

The ECB seems to be emerging as the advocate of a very tough line on Greece. In particular, it is adamantly opposed to any rescheduling, reprofiling or restructuring of Greek debt - all of which appear to be commonsense to an increasing number of German politicians. Its argument (made repeatedly by Trichet) is:

- that a 'soft' restruc6ruing (ie one that merely stretches maturities) will inevitably be followed by a 'hard' one (which involves a real 'haircut');
- that it will be devastating for Greek banks and pension funds; and
- that it would hit the ECB itself, since the Bank holds at least €45 billion of Greek bonds it has bought in the market.

The French appear to be sympathetic to the ECB's position. However eurozone President Juncker said yesterday that he 'wouldn't exclude' a reprofiling of Greek debt. That was enough to push the Greek 10-year yield up to 16.5% and the two-year yield up to an astonishing 25.3%. Five-year CDS coverage currently costs 1,330bp.

In the end, Greece will have to have a rescheduling - and bondholders will have to take a haircut. What the ECB is really trying to do is to put off the evil day until after the new ESM is established in 2013. The statutes of the new mechanism are to be agreed over the next week or so - and that is likely to prove difficult. The Germans are still insisting that private bondholders must be 'bailed in' (ie must share in any haircut). The French (whose banks are more exposed to Greece than German banks) are opposed. Negotiations on this are likely to be very difficult.

V RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: Contrary to earlier hopes, the Administration has so far been unable to use Obama's increased political clout to settle the row over debt and the deficit. While VP Biden is still leading talks with Congressional figures, positions seem to be hardening - especially over Medicare. With debt, the deficit and the budget all tied together, it looks increasingly likely that no deal will be wrapped up until the US government finally runs out of money on August 2. (It is already in breach of its debt limit, but the Treasury can use cash management tools to keep paying bills for another couple of months.) That undoubtedly complicates policy for the Fed as well - and may be one reason for the FOMC leaving policy on hold at its last meeting. According to the minutes released this week, the Fed is pressing ahead with plans to end its QE program, but is not yet in a position to push interest rates up. Essentially, policy is on hold until the fiscal situation becomes clearer.

In the meantime, the markets and the real economy appear to be going in different directions. While investors are generally optimistic about the direction of both stocks and bonds, US economic indicators have taken a turn for the worse. There are counter-indicators. For instance, it was reported this week that first time jobless claims dropped 29,000 in the latest week, which was better than expected. However, most releases have been negative. In particular:

- the Empire State (NY) activity index fell in May;
- the Philadelphia Fed index also fell from 18.5 to a seven month low of 3.9, thanks to a steep drop in factory output;
- new home construction dropped 10.6% in April, or 23.9% year-on-year;
- manufacturing output fell for the first time in 10 months in April, dragged down by an 8.9% fall in vehicle production;
- leading indicators dropped 0.3% last month, the first fall since June 2010; and
- previously owned home sales fell 0.8% to a weak annual rate of just 5.05million.

There is a growing sense that the US is heading for a train wreck unless the Administration and Congress can do some sort of deal on the deficit that will turn sentiment around.

B **EUROPE**: At the eurozone level, the only significant release this week has been inflation. Headline inflation rose last month from 2.7% to a 30-month high of 2.8%, while core inflation jumped from 1.5% to 1.8%. Inflation is also an issue in the UK, where the headline rate jumped to 4.5% in April. Despite that, the BofE's MPC voted 6:3 in favour of no change in interest rates at its May 5 meeting - and the minutes of the meeting were more doveish than expected. As far as Germany is concerned, the major question is whether the torrid pace of first quarter growth can be sustained; according to the

Bundesbank, the answer is No. It expects a sharp slowdown.

Elsewhere, the main issue is politics. We have already noted the impact of DSK's problems on French domestic politics. In Italy, Berlusconi's PoF party took a beating in local elections, particularly in Milan, where its candidate for mayor lost badly to the Centre-left. However, the PM's ability to hold on in the face of overwhelming odds remains a thing of wonder.

C **JAPAN**: To some surprise, the BoJ left monetary policy unchanged when its Council met this week. The reason that there was some surprise is that the economic number have been pretty desperate, and there was some hope that the Bank might try to inject some further stimulus - though its room for maneuver is exceptionally limited. What got markets excercised were two releases in particular:

- It was reported on Wednesday that first quarter GDP fell 0.9% - or at an annual rate of 3.7%. Obviously, the reason for that was the earthquake/tsunami. However, it is worth remembering that the earthquake did not strike until March 11 - which means that the impact on domestic spending must have been devastating.
- That was confirmed by the 0.6% drop in household consumption in the quarter.

The government insists that it sees signs that the economy is bouncing back. However, having fallen 2.13% last week, the Nikkei225 has just closed down again this week.

VI FOREIGN EXCHANGE MARKETS DEVELOPMENTS

Concern about the US economy has broadly been offset this week by concern about the eurozone debt crisis and by the unexpectedly sharp first quarter downturn in Japan. The result has been that there has been no decisive currency move:

- US$/euro: The euro closed last Friday at US$1.420/€ buoyed by comments from Merkel suggesting that - just maybe - the eurozone could stagger on to 2013 before the next big crisis. It hit a high of US$1.425 yesterday, on weak US economic data, but has failed to capitalise. It is currently trading around US$1.424.
- US $/sterling: The pound closed last week at US$1.621. It fell slightly on publication of the MPC minutes, which showed a strong majority against raising UK interest rates any time soon, but has rallied a bit since then and is currently trading around US$1.624.
- Yen/US$: The dollar closed last week at Y80.8/US$. It firmed to Y81.8 yesterday after weak economic data from Japan, and is currently trading around Y81.7.

The dollar has also been pretty stable against the Swiss franc, easing marginally from SF0.888/US$ to SF0.878, and against commodity currencies. Week-on-week, it has strengthened against the Canadian dollar from Can$0.968/US$ to Can$0.973 and against the Australian dollar from A$0.943/US$ to A$0.938. None of these moves is particularly significant. What might be significant is a comment yesterday from the President of the Chicago Fed, suggesting that the Fed is not yet worried about inflation. That contrasted sharply with contemporaneous comments from ECB Council member Gertrude Tumpel-Guggerell, who insisted that the ECB must move expeditiously to unwind its 'non-standard' monetary operations - ie to end bond purchases. Going forward, that ought to favour the euro over the dollar.

VII OIL

There is growing concern among consuming countries about the direction that OPEC is going to take at its next Ministerial meeting, scheduled for June 8. The reason is the strong likelihood that the meeting will be chaired by Iranian President Ahmadinejad - who appointed himself Acting Oil Minister this week, apparently as part of a complex political strategy to outflank Supreme Leader Ali Khameini. Iran is a strong advocate of higher oil prices, and - it is widely assumed - will be opposed to any suggestions (eg. by Saudi Arabia) that production should be increased to drive prices lower. That is certainly one factor helping keep prices firm.

Other elements of price support over the last week have included:

- the continuing stalemate in Libya;
- the flooding in the Mississippi basin, which has added further distortions to the US market; and
- an IEA report alleging that OPEC output is still 1.3% below pre-crisis levels.

US inventories have also been a factor. Although gasoline stocks were up (albeit less than expected), crude stocks were flat in the latest week and distillate stocks were down 1.2 million barrels. Perhaps more significant, US refinery operating rates increased week-on-week from 81.7% to 83.2% - which suggests further price pressure. Indeed, Goldman Sachs (which had been predicting a correction) now claims that prices are set to rise through year-end, and Platt's reported that the market is now 'structurally bullish'. JPMorgan and Barclays have also recently shifted their opinion in favour of higher prices.

That said, gasoline futures have actually fallen quite sharply this week in the US, and the average pump price of gasoline has fallen for the first time since January (albeit only by 3c/US gallon) Suggestions that the Mississippi flooding may be past its worst have also helped, and the price of front-month WTI has eased this week from US$99.65/barrel (which is what the June contract closed at last Friday) to US$98.82 - which is where the July contract is trading today. As for Brent, the July contract has also eased – falling from US$113.85/barrel to US$111.43.

VIII NEXT WEEK

In the US, the main releases next week are:

- new home sales for April (which could be down sharply based on previously owned homes data);
- durable goods orders for April (always volatile);
- the second estimate of first quarter GDP growth (likely to be around 1.8%);
- the final Michigan confidence index for May; and
- personal income and consumption for April.

Regards,
GISE