WEEKLY ECONOMIC AND MONETARY REPORT

27 May 2011

No surprise that the G8 Summit in Deauville seems to have been little more than a photo opportunity; on the economic side at least, the key international forum is now clearly the G20 – which meets in Cannes in November. That said, the focus on North Africa is encouraging, even if firm commitments are few. Otherwise, this week has been dominated by continued speculation about DSK's successor at the IMF and about the eurozone's sovereign debt crisis. On the latter, it is worth noting that next week sees completion of the 'troika''s assessment of Greece's efforts to meet its fiscal targets.

I G8 SUMMIT

As noted, economics does not seem to have played a big part in the Deauville Summit (which concludes this evening). The draft communiqué insists that "global recovery is gathering strength and becoming more self-sustained" – but that is about all. The main issues for discussion seem to have been:

- The so-called "Arab Spring": There is a general pledge to boost assistance to North Africa – to Tunisia and Egypt (who were both represented in Deauville) in particular – though specific commitments are scarce. The French are urging a US $40 billion commitment to the region as a whole, and the MDBs are supposed to contribute US $20 billion – but this is not broken down in any meaningful way. This is apparently to be known as the "Deauville partnership". More usefully, the US has pledged US $1 billion in debt relief and an extra US $1 billion in guarantees for Egypt, but that is about all. However, the EBRD will expand its operations into the region (if it can overcome the hurdle that it can only operate legally in countries with a multi-party democratic system). And the Summit does seem to have shown support for Qatar's proposal for a Middle East Development Bank.

- Cybersecurity: French President Sarkozy had organised a high-level meeting on internet regulation ahead of the Summit, and key digital entrepreneurs (including Facebook's Mark Zuckerberg and Google's Eric Schmidt) were invited to Deauville. France's aim was apparently to promote a global regulatory regime as a way of protecting France's "cultural heritage"; however, the US appears to have headed this off.
- Japan: PM Kan (who finds himself under increasing pressure at home) had hoped to use the Summit to advance his plea for an EU-Japan FTA – on his terms. However, it appears that the Europeans were unwilling to withdraw their demand for greater market access in Japan and for an opening up of the service sector. That said, there has been the usual (by now, ritualistic) endorsement of the Doha round.

And, of course, French FM Lagarde's candidacy for DSK's job at the IMF came up (see below).

As noted, the Summit avoided most economic issues. However, that did not stop other bodies from releasing reports ahead of the Summit, designed to influence the debate.

The most important was the OECD, which published its semi-annual *World Economic Outlook* on Wednesday. Generally, its new forecasts are slightly more pessimistic than those released in November, particularly with regard to inflation:

OECD: World Economic Outlook

		2011	2012
GDP	US	2.6%	3.1%
	Eurozone	2.0%	2.0%
	(Germany	3.4%	2.5%)
	Japan	-0.9%	2.2%
	OECD-34	2.3%	2.8%
	China	9.0%	9.2%
Inflation	OECD-34	2.3%	1.7%
Unemployment	OECD-34	7.9%	7.4%
Fiscal balance	OECD-34	-6.7%	-5.6%

Despite this, the OECD called on the Fed and BofE to raise interest rates – and on those CBs who are already raising rates to do so more rapidly.

The other report released ahead of the Summit came from the Nielson polling organisation, which surveyed 28,000 individuals globally to find out what are their major worries. Top of the list is the fear of food price inflation (13%), ahead of the general economic situation (11%), job security and health care (8% each).

II IMF LEADERSHIP

To no surprise, the French FM, Christine Lagarde, formally declared her candidacy for the managing directorship on Wednesday – and (having made her pitch at Deauville) has embarked on a trip to China, Brazil and India to build up support.

Since the Europeans have 32% of the votes at the Fund, she is the clear favourite. She is also competent, popular – and a woman. However, she is a lawyer by background, not an economist – and that may count against her. Plus (as practically every serious commentator has pointed out), the Europeans had *almost* promised that the next Managing Director after DSK would be from an emerging economy. So, she cannot be considered a shoo-in.

If she doesn't get the job (and there is also the problem of a court case, in which she is accused of helping Bernard Tapie, a disgraced French businessman), who will?

The clear favourite among the alternatives to Lagarde is Agustin Carstens (52), governor of the Bank of Mexico. He has a PhD from Chicago, and spent three years as a deputy MD of the Fund. He is widely felt to have done a very good job; he is, however, very fat and his health may be suspect. Other possibilities include:

- Trevor Manuel (55), the Planning Minister in South Africa, who had an excellent reputation as FM after majority rule. He has, however, upset a lot of people at home by accusing his own government of racism against mixed-race South Africans. (His own background is Cape Coloured/Jewish.)
- Grigori Marchenko, Governor of the CB of Kazakhstan, who is backed by Russia.

There has also been some support for Mulyani Indrawati, former Indonesian Planning Minister (now at the World Bank), and Zeti Akhtar Aziz, Governor of Bank Negara Malaysia. Both have the advantage of being women; Zeti also has a PhD from Wharton. One of the early favourites, Turkey's Kermal Dervis, dropped out on Tuesday – apparently for fear that details of his adventures at the World Bank would be publicised. The OECD's Angel Gurria has also been promoting himself – though his membership has leaned heavily on him to support Lagarde.

Whatever, nominations have to be in by June 10, and the hope is that the appointment can be made by June 30.

III EUROZONE CRISIS

It has been another difficult week – particularly for Greece, which will receive the results of the IMF/ECB review of its austerity programme next week. If that is (as some fear) negative, it could well provoke a crisis.

In the meantime, Paul Krugman (the Nobel prize-winning economist) warned this week that there is now a 50% chance that Greece will have to quit the eurozone, and the ECB's former chief economist, Otmar Issing, insisted that the only way Greece had managed to join the eurozone in the first place was by "cheating" and "deception". Just to rub it in, Fitch downgraded Greece's debt yet again, from BB+ to B+, and the Greek Commissioner in Brussels, Maria Damanaki (famous in Athens as a former Communist agitator), warned that the only alternative to further austerity is a return to the drachma.

That won't happen – but there is also enormous domestic opposition to further austerity. Indeed, former Finance Minister, Antonis Samaras (who heads the ND Opposition), insisted this week that austerity is a "failed formula" because it stops the Greek economy from growing (and hence keeps tax revenues down). He also attacked privatisation – which is seen by many as Athens's best bet to reduce the deficit. The government is committed to selling off at least €50 billion of state assets – and (according to the *FT*) there are those who believe that receipts from privatisation could eventually reach €200-300 billion. That sounds like sheer fantasy – as does the idea (floated by the Dutch) that the EU might set up an independent committee to handle Greece's privatisation programme. In the meantime, however, the IMF has indicated that, unless there is progress on privatisation, it may not release the next tranche of its share of Greece's €110 billion bailout package, due on June 29.

That would be a disaster. The Fund has also said publicly that it will not make more money available unless Greece can demonstrate that it can finance itself for at least the next twelve months – which prompted Issing to claim that Greece is not just illiquid, "it is insolvent".

So, what can be done? Even if the privatisation programme takes off on a bigger scale than the government currently envisages, the options look bleak. They are:

- to continue rolling over Greek debt (and piling up new debt) for as long as it takes – with no end in sight;
- to swap existing bank debt for some kind of higher-grade EU security (the 'Brady bond' approach); and/or
- to go for some kind of rescheduling/reprofiling/restructuring, involving longer maturities and/or a lower interest rate.

The problem is that, even though more and more European politicians are advocating the last option, it is being fiercely resisted by both the Greek government and the ECB.

The government is scared that its banks and pension funds could not survive a 'haircut'. The ECB worries about two things:

- the impact on its own balance sheet (it has bought €75 billion of government bonds, about 2/3 of which are Greek, plus around €150 billion of other financial assets); and
- the danger of contagion.

Contagion is a real risk; indeed, Moody's warned this week that a Greek restructuring would mean a downgrade for other eurozone economies – and both Spanish and Italian bond markets have been hit hard (though that also reflects the poor performance of the incumbent governments in regional elections).

Whatever, the ECB is doing whatever it can to stop a Greek restructuring – warning that even a 'voluntary' lengthening of maturities would force it to stop accepting Greek paper as collateral (which would tip Greek banks into crisis). In the meantime, both the cost of CDS protection and the spread of Greek debt over German *bunds* have continued to increase this week to record levels – dragging the cost of Portuguese, Irish and Spanish paper up as well.

<u>There is really no good news</u> – though it was announced on Wednesday that the Chinese may have agreed to participate in the next round of fund-raising for the EFSF (which intends to sell €10 billion in 5 and 10-year notes next month, to help finance its bailout of Portugal). Indeed, there are one or two "wild cards"; for instance, Rep Cathy Rodgers has just introduced into the US House of Representatives a bill that would stop the US participating in any IMF bailout if the country involved is not complying with the EU's own debt/deficit limits. (The irony of an American politician laying down the law on EU fiscal policy appears to be lost on her.)

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **US**: It has been a mixed week for economic data. On the positive side, it was reported:

- that new home sales jumped a stronger-than-expected 7.3% in April – though that was still down 23.1% year-on-year;
- that personal income rose 0.4% last month; and
- that the Michigan confidence index jumped from 69.8 to 74.3 this month, sharply better than expected.

On the other hand:

- durable goods orders fell 3.6% in April; and
- new jobless claims rose 10,000 in the latest week.

Plus, there were several releases that were a bit disappointing. In particular, the first quarter GDP growth rate was confirmed at 1.8% (a little lower than the revision that had been expected), with the increase in consumer spending cut from 2.7% to 2.2%. There is evidence that is not a one-off; indeed, it was reported earlier today that consumer spending rose just 0.4% last month – less than the 0.6% that had been expected.

All in all, the picture is one of hesitant recovery – with signs that consumer demand is faltering. That is reflected in generally weak quarterly earnings by US retailers – which has hit the major equity indices. Through early Friday, for instance, the DJIA is down around 0.8% for the week, the S&P500 is off marginally and the Nasdaq is down 0.4%. Conversely, the yield on the benchmark 10-year Treasury has eased from 3.15% to 3.07% - reflecting the decreased likelihood of any imminent tightening by the Fed.

B **EUROPE**: In contrast, Trichet continues to hint that an interest rate rise by the ECB is just around the corner – and his likely successor, Mario Draghi, has been

polishing his hawkish credentials by insisting that inflation and public debt are the big issues and that "overheating is a clear and present danger".

That's fine - except that the economic data is looking a bit less encouraging. In particular, it was reported this week that eurozone factory orders fell 1.8% in March – with German orders off 3.4% and French orders down 0.7%. This was the sharpest drop in six months, and it was unexpected. In addition, executive and consumer confidence has been hit. According to the Commission's monthly index, confidence in the eurozone as a whole fell from 106.1 to 105.5 in May – with both manufacturing and services down. And the eurozone's PMI fell in May from 57.8 to a seven-month low of 55.4 – with the slowdown particularly noticeable in Germany.

Not everything is disappointing. Germany's IFO index, for instance, came in better than expected in May – holding steady at 114.2 after three straight falls. And the astonishing 1.5% increase in first quarter GDP was confirmed. But – all in all – there are significant signs of slowdown in the eurozone.

That is less true in the UK – where the economic data this week has been mixed. On the positive side, it was reported:

- that (according to the Nationwide building society) house prices rose 0.3% in May, though they were still down 1.2% year-on-year; and
- that the GfK/NOP consumer confidence index jumped in May from -31 to a five-month high of -21.

On the other hand, household spending was reported to have dropped 0.6% in the first quarter, while net investment slumped by 7.1%. Moreover, the CBI's retail sales index fell from 21 to 18, and the value of construction contracts awarded to major firms slumped.

This seems to have left the BofE's MPC in a dilemma. The Bank's chief economist, Spencer Dale, insisted this week on the need to raise interest rates, but another member argued that "putting up Bank interest rates would be exactly the wrong thing to do at this stage". That may be true in terms of the macroeconomic conjuncture; however, there are other considerations. The PSBR, for instance, hit GBP 10 billion in April – up from GBP 7.2 billion a year ago, and far worse than the GBP 6.5 billion that had been expected. Funding on this scale may soon start to scare the market (though, to be fair, the yield on the 10-year gilt has actually fallen this week from 3.35% to 3.31%).

It is worth emphasising the series of political setbacks that incumbent governments (of whatever ideology) are experiencing within the eurozone. In Italy, for instance, the second round of regional voting this weekend will almost certainly confirm the anti-Berlusconi trend. Equally, the continuing series of regional elections in Germany (it was Bremen last week) is very damaging for both the CDU and FDP.

C **JAPAN**: The bad news for PM Naoto Kan is that his DPJ nemesis, Ichiro Ozawa, has apparently decided to launch a campaign to force Kan out. Ozawa is highly controversial, and is unlikely to get the premiership himself. But Kan is weak politically – and his position will not have been improved by his failure to convince his European G8 colleagues to initiate talks on an EU-Japan FTA. He also faces a no-confidence vote from the Opposition LDP, over his allegedly tardy response to the earthquake and subsequent crisis.

It is certainly true that the Japanese economy has been hit hard by the crisis. This week, for instance, it was reported:

- that exports were down 12.5% year-on-year in April, while imports (boosted by fuel) were up 8.9% - producing a hitherto unthinkable trade deficit of Y464 billion for the month;
- that retail sales were down 4.8% year-on-year in April; and

- that automobile production was off 75%.

The only 'good' news is that consumer prices were up 0.6% year-on-year – the first increase since 2008. The downside of that, however, is that it largely reflected the higher cost of imported oil. Meanwhile, the Nikkei-225 (which fell 0.43% last week) is down again this week – falling 0.9%, to close at 9,522.

D **CHINA**: There is no doubt that a re-rating of China is underway. Equity markets have now fallen for seven straight sessions, and are down around 12% year-to-date.

Part of the reason for this is political: Beijing clearly faces a new round of unrest, and parts of Mongolia are now under martial law. In part, it also reflects weaker economic data: HSBC's PMI, for instance, fell in May from 51.8 to 51.1. But, in large measure, the key is concern about what is felt to be a credit bubble. This was epitomised by an article in *China Daily*, quoting work by an American economist, Victor Shih. Shih's argument is that bank credit is now an unsustainable 130% of GDP, and that upward of US $1.6 trillion has been lent to over 8,000 Local Government-Financing Vehicles (LGFVs) – which are little more than scams used to facilitate corruption and keep workers in low-productivity employment. In his view, the bubble must burst soon – though the fact that all the debt is domestic may mean the PBoC can step in. Whatever, lots of foreign analysts are getting nervous.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the dollar strengthened slightly across the board – by 0.4% against the euro (which was down about 6% month-on-month), by 0.1% against sterling, and by 1.1% against the yen. The only major currency to hold its own was the Swiss franc, which also hit a series of records against the euro.

This week, the situation has changed as the markets have come to worry about what will happen to the dollar post-QE2. The euro also got a modest boost from Klaus Ringling's

confident assertion that China would participate in the next round of EFSF funding. In addition, the Swiss franc sold off at the beginning of the week on rumours of SNB intervention – though it quickly turned around again when it became clear that such intervention was unlikely.

As a result, the dollar has generally been weaker:

- US $/euro: The euro closed last Friday at US $1.415. It hit a two-month low of US $1.402 on Monday, but has firmed steadily since then, and is currently trading at US $1.427/€. That means the dollar is down 0.8% for the week.
- US $/sterling: The pound closed last week at US $1.619. It then fell to US $1.612 on Monday, but has bought back steadily – despite mixed UK economic data (and lower gilt rates). It is currently trading at US $1.648 – up 1.8% for the week.
- Yen/US $: At the close last week, the dollar was trading at Y81.65. It hit a high of Y82.2 on Wednesday, but has since eased back to Y80.79 – down 1.1% for the week.
- SF/US $: The dollar closed last week at SF 0.878. It hit SF0.879 on Tuesday, but has since fallen to SF0.852 – down another 2.9% on the week.

The US dollar is also down 0.7% against the Australian dollar. It is, however, broadly flat against the Canadian dollar. The New Zealand dollar has strengthened on (more) rumours of Chinese buying. In the meantime, gold continues to rise. It closed last week at US $1,494/oz; it is currently trading at US $1,527 – up 2.2% for the week, broadly compensating for the weakness of the dollar.

V OIL

Through last Friday, marker crudes were off around 10% for the month – and both WTI and Brent were down for the week, closing at US $99.49 a barrel (off 16 cents) and US $112.39 (off US $1.44) respectively.

This week, prices of both crudes have increased:

- WTI for July delivery is currently trading at US $100.56, up 1.1%, having been as high as US $101.32 on Wednesday; while
- Brent is currently trading at US $115.04, up 2.4% for the week.

As a result, the spread in favour of Brent has increased from US $12.90 to US $14.48 – reflecting a sharp 616,000 barrel increase in US crude stocks in the latest week and relatively downbeat US economic data.

That said, most traders are still bullish on oil prices – and it is significant that both Goldman Sachs and Morgan Stanley have revised their oil price forecasts up. (That was a particular surprise from Goldman, which had cut its forecast only two weeks ago.) Goldman is now forecasting a price for Brent of US $120 by year-end and US $130 a year from now. Morgan Stanley is projecting that Brent will average US $130 next year.

Factors that are likely to impact the market in the short term include:

- the start of the US summer driving season after the Memorial Day holiday; and
- an alleged shortage of diesel in China.

In addition, there is the forthcoming OPEC Ministerial Meeting, which begins in Vienna on June 8. Iranian President Ahmadinejad will (apparently) *not* attend – though it is unclear who will chair the meeting. So far, Iran has been surprisingly conciliatory – hinting (a) that there is a supply gap, and (b) that OPEC will try to fill it. As a result, there is currently some expectation that quotas might be revised up.

In the meantime, it is worth watching the case that the US Justice Department is bringing against Arcadia Petroleum and two of its traders, who are accused of

manipulating the oil market in 2008 by creating the illusion of a shortage in Cushing, Oklahoma. It is hard to see how this charge can be made to stick, though it is politically popular.

VI NEXT WEEK

US markets will be closed on Monday for the Memorial Day holiday. Thereafter, the key economic releases include:

- the Case-Shiller house price index for March;
- the ISM indices for May; and
- non-farm payrolls for May (expected to be up around 220,000).

Elsewhere, markets will focus on the official PMI data in China, and PMI data for most European countries. In Japan, industrial production for April will confirm the devastating impact of the earthquake/tsunami.

Regards,
GISE