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WEEKLY ECONOMIC AND MONETARY REPORT

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Perhaps the world should be paying more attention to what is happening in North Africa. However, for the markets, the key issues this week have been President Obama's State of the Union speech in the US, release of the report of the Financial Crisis Inquiry Commission (also in the US) and, of course, the World Economic Forum meeting in Davos.

I WORLD ECONOMIC FORUM

This is the 41st meeting of the WEF – which is an amazing achievement, given the almost universal cynicism that Davos provokes in that who don't attend (or who aren't invited). As always, a number of special reports have been prepared for the Forum to help advance the agenda. These include:

- A PwC survey of global executives, which found a sharp increase in confidence about the future. Forty-eight percent are now "very confident" of growth in the next year, compared with 31% in 2010 and only 21% immediately post-Lehman Bros. However, this percentage varies widely by country, with 80% of Germans "very confident" and only 15% of British executives.
- The Forum's own Global Risks Report, which listed 37 major problem areas. (It should be noted that, last year, the GRR completely missed the eurozone debt crisis.)
- An Oliver Wyman report entitled 'The Financial Crisis of 2015', which provides alternative scenarios for the next big banking crisis.

In addition, the IMF released an update of its World Economic Outlook ahead of the WEF. This was broadly optimistic. For the world as a whole, the Fund now expects growth of 4.4% this year, up from 4.2% last October. However, it also emphasises the fragility of this forecast – which, in any case, disguises a wide range of outcomes for individual countries and regions.

IMF: World Economic Outlook: 2011 GDP growth

Advanced economies	2.5%
US	3.0%
Eurozone	1.5%
UK	2.9%
Japan	1.6%
Emerging economies	6.5%
China	9.6%
Global growth	4.4%

This prompted Zhu Min (ex-deputy governor of the PBoC, and now an advisor to the IMF) to coin a phrase that has been widely repeated: a "three-speed recovery" – with emerging markets growing twice as fast as the US, and the US growing almost twice as fast as Europe.

What has also been widely reported has been the Fund's warning on US fiscal policy. It now expects the fiscal deficit to be 10.75% of GDP in 2011, while public debt (state and Federal) will be over 110% of GDP by 2016.

The US deficit is a big issue at Davos. George Soros warned this week that "too much of the stimulus went into consumption, which perpetuated the problem", and Ken Rogoff predicted a "a 5-year stretch where the overhang of debt in the advanced countries will hold back their growth".

At the macroeconomic level, the other concern in Davos is inflation. Standard Chartered's chief economist, Gerard Lyons, for instance, warned that "resource prices, rather than interest rates, now serve as the brake for the global economy" . This now seems to be the consensus view, though Raghuram Rajan also warned that too many countries still seem unaware of the inflationary threat.

The other big issue for the WEF is the fate of the eurozone – not least because most of the key players in the crisis are (or will be) in Davos.

Not surprisingly, the general tone is upbeat. French President Sarkozy, for instance, warned speculators not to bet against the euro: "Merkel and myself will never – do you hear me? never – let the euro fail… the euro is Europe." More practically, EU Monetary Affairs Commissioner Rehn predicted confidently that the EFSF bail-out fund would have its lending capacity increased substantially from today's effective €250 billion (the notional €440 billion has to be reduced by the need to pledge collateral). However, several well-known economists who are in Davos this week have been more sceptical. In particular:

- Carmen Reinhart (who recently co-authored a book on the history of financial crisis with Rogoff) called a eurozone debt rescheduling "inevitable";
- Larry Summers pointed out that "the laws of economics, like the laws of physics, do not respect political constraints";
- Fred Bergsten (although generally supportive of the euro) admitted that "I do expect significant restructuring in a few countries";
- Simon Johnson predicted a "serious crisis this year" that could lead to the emergence of a "Germanic" euro; and
- Soros warned that "you cannot wait until 2013" for a debt restructuring – and that "Ireland will force the issue".

As for the health of the banking sector, this is the first time for several years that the US Treasury Secretary has attended the WEF– giving Geithner the opportunity for informal talks with senior global bankers. At least two of them (Peter Sands of Standard Chartered and Gary Cohn, No 2 at Goldman Sachs) have already warned against too much regulation, while Deutsche's Josef Ackermann has clashed with the German government over its treatment of sovereign debt.

Other issues that are being discussed at Davos include:

- China: Nouriel Roubini (another well-known economist who is attending this year) made the telling point that China's growth rate is roughly the same as the US unemployment rate. According to the *WSJ*, China is 'ascendant' at Davos this year – even though its delegation is actually smaller than that of India. Much US pressure is being applied on Beijing to reduce its trade surplus; however, Sarkozy insisted in his keynote speech that China cannot be blamed for trying to boost its exports, since everyone else is doing the same.

- Increasing income inequality: This is an issue that is rapidly building in importance – and not only in Davos. Zhu Min, for instance, pointed out that, in 1968, the top 1% in the US owned 28% of the wealth; now, the equivalent figure is over 47%.
- Youth unemployment: The unrest in North Africa has thrown a spotlight on to youth unemployment. As the IMF's Masood Ahmed pointed out in Davos, this is now chronic – particularly in the Middle East.

One final point: this week, Roubini (always good for a telling phrase) came up with a new description of what he sees as a lack of global economic leadership – "the G-zero".

II THE EUROZONE CRISIS

It has been a generally quiet week – raising hopes that the crisis may be over, at least for now.

The good news was the overwhelming demand for the first €5 billion five-year bond issued under the EFSF's €440 billion guarantee. This carries a triple-A rating, and is backed by all eurozone member countries. Not surprisingly (since it offers a yield premium to *bunds*), it was eight times oversubscribed, with much of the demand coming from Asia. €3.3 billion of the money raised will go to Ireland.

As noted, there also seems to be a political consensus that – even if it is not to be formally expanded – a way must be found to ensure that the EFSF can raise (and lend) the full €440 billion. More controversially, there is still pressure (most recently, from Banque de France Governor Noyer) to let the EFSF buy government bonds, either directly or through the secondary market. In the last week, the ECB bought €146 million of government bonds from peripheral EU states – bringing its total holdings to €76.5 billion. That makes Trichet very nervous, and he, too, wants the EFSF to take up this role. Progress is likely to be made at the next ECOFIN meeting.

That said, there is one big problem that is looming over the eurozone.

The resignation of Irish PM Cowan and the decision by the Green party to quit the Fianna Fail-led coalition means an election may be held in Ireland as early as February 25. If, as expected, the centre-right Fine Gael party wins, the likely Finance Minister, Michael Noonan, has already said he will renegotiate the terms of the €85 billion bail-out – and the ECB has already said that there is nothing to negotiate.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, there is more and more concern about inflation – with crop prices up again this week, and sugar at a 30-year high. ECB President Trichet is now warning against 'second-round' effects, and is urging eurozone governments not to succumb to pressure for wage increases.

A THE US: As noted, Obama's State of the Union speech got a lot of attention this week – partly because Obama's own political standing has risen recently and partly because the Republicans are increasingly divided. Indeed, there were two Republican responses to the speech – one (the official one) by Rep Paul Ryan, which focussed on the continuing problem of the deficit, and one (unofficial) by Rep. Michelle Bachmann (on behalf of the right-wing 'Tea Party' faction) excoriating 'Obamacare' and the alleged socialism of the Obama Administration.

In fact, Obama's speech itself was fairly innocuous, concentrating largely on the need for structural economic change to see off the threat from China. More important was the CBO's semi-annual economic survey, released at the same time. This was a mixed bag. On the positive side, it expects inflation to remain very low, and it estimates that GDP growth this year should be a highly respectable 3.1%. On the other hand, unemployment will still be 9.2% at the end of this year, and the FY 2011/12 deficit will be close to US$1.5 trillion – or 9.8% of GDP (up from 8.9%). That compares with just 4.6% in Canada, and it suggests that it is only a matter of time before the markets start to take a less benign view.

The deficit also weighs on the Fed. The FOMC meeting on Tuesday and Wednesday (the first with four new members) produced an 11-0 vote in favour of leaving the funds rate unchanged and QE2 at US$600 billion. That was a bit of a surprise in that two of the new members (Plosser and Fisher) are deficit hawks, and can be expected to vote for higher rates. For the moment, however, they seem to be giving Bernanke the benefit of the doubt.

<u>As far as US economic releases are concerned</u>, the general picture this week is a bit disappointing. In particular, it was reported today that the preliminary estimate of the GDP growth rate in the fourth quarter was just 3.2%. That was up from 2.6% in the third quarter, but was a good bit lower than the 3.7% that had been expected. Fortunately, the markets have reacted quite positively since what seems to have held growth down is inventories; consumption and exports were both quite strong.

That said, it was also reported this week:

- that, according to the Case-Shiller index, house prices fell 0.5% in November – the fifth straight monthly drop;
- that durable goods orders fell 2.5% in December; and
- that initial jobless claims jumped an unexpected 51,000 in the latest week.

There was, however, some good news – even in the housing area. Indeed, new home sales rose a hefty 17.5% in December, while pending home sales were up 2%. In addition, the Conference Board's consumer index jumped this month from 53.3 to 60.6, and an NABE survey found that 42% of US businesses plan to increase hiring in the next six months (up from 29% a year ago).

That has given US equities a boost. Through early trading on Friday, for instance, the DJIA is up around 0.9% for the week, while the S&P 500 is up 1.0%. The Nasdaq – which has also benefited from a mini-boom in tech stocks – is up 2.4%. The downside, however, is a further steepening of the Treasury yield curve; the 2-30-year spread is now close to 400 basis points, a near-record.

B **<u>EUROPE</u>:** While most economists are nervous about the economic outlook, and although the consensus is that Europe is lagging behind more dynamic regions (and even behind the US), the news this week has been positive. At the eurozone level, for instance, it has been reported:

- that the composite PMI (a good proxy for manufacturing activity) rose from 55.5 to 56.3 this month, led by Germany and France;
- that industrial orders rose 2.1% in November, after a 1.4% increase in October;
- that the eurozone's Business Climate Index rose last month from 4.9 to 6.0; and
- that the retail sales index for January increased from 52.9 to a four-year high of 55.8 – again, led by Germany and France.

The strength of France and, in particular, Germany is unfortunately a problem – emphasising the widening North-South division within the eurozone. Indeed, it was also reported this week that, in Germany, the IFO business confidence index hit an all-time high in January, while, in Italy, the consumer confidence index fell from 109.1 to 105.9. Meanwhile, not surprisingly, German inflation is picking up: the CPI rose from 1.7% to 1.9% this month, which the Bundesbank feels is too high for comfort.

Outside the eurozone, the UK has had an unexpectedly bad week – prompted, in particular, by a 0.5% drop in GDP in the last quarter of 2010. That brought growth for the year to just 1.4%, far less than the 1.8% that had been expected. The only good news was that manufacturing activity was up; the overall growth figure was pulled down by a sharp drop in construction and by a fall in services activity.

Unfortunately, however, that wasn't the only bad news. In addition, it was reported:

- that the public sector borrowing requirement was GBP 16.8 billion in December – down from GBP 21.1 billion in November, but still a big number for the markets to swallow;
- that the GfK consumer confidence index slumped this month from -21 to -29, the lowest level in 22 months; and
- that retail sales growth slowed in January, with the volume index down from 56 to 37.

This has prompted a backlash against the Coalition government's austerity programme – not least from the CBI business federation, which is calling for lower taxes.

Unfortunately, that is almost certainly unrealistic. Indeed, BofE Governor King gave a speech this week in which he warned that inflation is the real danger, that the UK faces a decade of falling real wages and that there will have to be the toughest fiscal squeeze since the 1920s. At least two members of the MPC are already pushing hard for interest rate increases – and, given the UK's vulnerability to market forces, the Bank really has no choice in the matter.

C **JAPAN:** Ironically, S&P's unexpected decision this week to downgrade Japan's sovereign debt rating from AA to AA- (putting it on a par with China) may strengthen PM Kan's hand on economic reform and fiscal consolidation. It certainly makes it tougher for the Opposition LDP to vote against an increase in the consumption tax.

Kan also got two other pieces of (reasonably) good news this week:

- the pace of deflation appears to be easing, with consumer prices off just 0.4% year-on-year last month, the lowest level since 2009; and
- the unemployment rate fell unexpectedly in December, from 5.1% to 4.9% – the first drop since September.

No surprise, therefore, that the BoJ kept monetary policy unchanged when it met this week. Now, the question is whether Kan and Finance Minister Yosano have the political clout to tackle the consumption tax.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

At the beginning of the week, the consensus was that the euro should keep rising against the dollar on a widening interest rate spread. Speculators were also said to be long euros after a squeeze.

By and large, that has proven to be the case. At the close last Friday, the euro was trading at US$1.359/€. On Monday, it strengthened to US$1.365, and by yesterday the euro was trading at US$1.37 – helped by the FOMC's decision to leave US interest rates unchanged. That continued in early trading today, with the euro peaking above US$1.374. However, the market's reaction to the US GDP data has been to buy the dollar – and it has now recovered to US$1.362/€. That is still down 0.2% for the week, but momentum has changed.

Against the other major trading currencies, the dollar has been mixed:

- <u>against sterling</u>, it has strengthened by 0.8%, from US$1.598/GBP to US$1.585;
- <u>against the yen</u>, it has fallen by 0.5% (despite the S&P downgrade), from Y82.68US$ to Y82.27; and
- <u>against the Swiss franc</u>, it has weakened significantly by 1.5%, from SF0.957/US$ to SF0.942.

The dollar is also mixed against the two key commodity currencies. Against the Australian dollar, it has strengthened marginally, from A$0.991/US$ to A$1.007. Against the Canadian dollar, it has been virtually flat, at Can$0.994US$. However, it has fallen to a two-year low against the Swedish Krona, which has benefited from strong economic data.

V <u>OIL</u>

Last week, front-month WTI fell 2.43% to US$89.11 a barrel, while front-month Brent fell 1.08% to US$97.60 – leaving the spread between the two at an exceptionally wide US$8.49 a barrel.

This week, the price of WTI has fallen further – while March Brent has held its own. In early trading today, WTI is at US$85.86 a barrel (down 3.6% for the week), while Brent is at US$97.97 (up 0.4%). As a result, the spread in favour of WTI has widened to a hithertofore unthinkable US$12.11. This also means that, year-to-date, the price of front-month WTI has fallen over 6%, while that of Brent has risen 3.2%.

What is going on?

Clearly, the WTI market is not working. The reason seems to be the build-up of stocks at Cushing. They were up a further 2.3% last week, and are expected to rise further as supplies from Canada increase. In contrast, Brent is apparently supported by declining supplies from the North Sea and by strong demand from Asia.

That, however, doesn't seem enough to explain what is going on. There are clearly other factors at play – including the expectation that OPEC will increase production by around 330,000 b/d through February. In addition, there is a strong belief that speculators are playing a role; the number of futures contracts on Brent is apparently up 26% year-on-year, while those on WTI are up just 14%. Nevertheless, there is scepticism that the current price of Brent can hold in the face of a strong supply situation. Indeed, a majority of oil traders polled by Bloomberg expect the price to fall next week.

VI BANKING

It has been an important week as far as financial regulation is concerned.

A **THE FCIC:** The Financial Crisis Inquiry Commission – chaired by Phil Angelides – issued its 500-page final report this week. Unfortunately, the Commission did not live up to initial hopes that it would do for the banking industry what the Pecora Commission did for the Wall St. Crash in 1932.

One reason is that the Commission split along party lines. Indeed, the final report is signed only by the six Democrats; three Republicans issued their own report, and one other Republican put out his own personal statement. The different analyses of the crisis are, however, interesting:

- The main report concludes that the crisis was 'avoidable', but that both public and private leaders failed to grasp the build-up of risk in the system. It is very critical of Greenspan in particular, and emphasises the breakdown of governance structures at AIG and Fannie Mae. One interesting nugget of information (from Bernanke) is that, in his opinion, every major bank in the US except one (not named, but not Goldman Sachs) was at risk of failure. Indeed, the report reveals that Goldman got US$14 billion for its clients as a result of the bailout of AIG – and US$2.9 billion for itself. Without that, it would probably have failed.

- The minority Republican report takes a softer line on Wall St, emphasising the global nature of the crisis.
- The report by Peter Wallison (who is a right-wing economist at the AEI) focuses on the abuses in the housing market particularly at Fannie Mae and Freddie Mac.

B THE INDEPENDENT BANKING COMMISSION: In the UK, John Vickers, a former head of the Competition Commission, is leading an independent investigation of the banking industry, which is supposed to recommend structural reforms. The Commission is not due to report for two or three months, but the industry is worried that it might recommend major changes, including:

- separation of retail and investment banking;
- limits on proprietary trading;
- a capital surcharge for riskier banks; and/or
- size limits.

In an important speech this week, Vickers came down against breaking up the banks – but he did leave open the possibility of a US-style "Volcker rule", plus tough restrictions on what banks can do with guaranteed deposits.

C OLIVER WYMAN STUDY: A new report by OW came out with the fascinating conclusion that the US spends six times as much to regulate credit institutions as does Europe – US$1 million per US$1 billion of banking revenues, as against €150,000/€1 billion. (The ratio is similar for total risk–weighted assets.) This includes day-to-day supervision, consumer protection and the cost of conduct of business rules.

It is an intriguing finding, probably reflecting the fact that:

- the US has more banks in total than Europe (about 10,000 credit institutions, versus 6,500 in Europe) – many of which are very small;
- there is more Federal/state overlap in the US; and
- there is more consumer protection in the US.

VII NEXT WEEK

In the US, the main releases due are:

- non-farm payrolls for January (expected to be up 120,000);
- factory orders for December;
- the ISM index for January; and
- personal income/spending for December.

In Europe, key releases are:

- the eurozone PMI for January;
- eurozone unemployment for December; and
- eurozone retail sales for December.

The ECB's policy committee also meets.

In Japan, the most significant release is construction orders for December.

Regards,

GISE