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WEEKLY ECONOMIC AND MONETARY REPORT

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After a slow start, the markets have woken up to events in North Africa. Even before President Mubarak's resignation (which is being portrayed in some parts of the press as a military coup and elsewhere as a triumph of democracy), markets were susceptible to speculation that the Suez Canal and Sumed pipeline might be vulnerable to any unrest in Egypt. That has helped sustain oil prices at close to US$100 a barrel; perhaps more important, it has also underpinned the US dollar, which is benefiting from its 'safe haven' status.

I INTERNATIONAL ORGANISATIONS

A **G-20:** Preparations are now well underway for the meeting of G20 Finance Ministers due to take place in Paris on February 18-19. According to press reports, the agenda includes:

- the eurozone debt crisis;
- global FX policy (ie the perennial problem of renminbi undervaluation);
- financial regulation (in particular, the new, tough 'stress tests' that the UK has imposed on British banks); and
- the possibility of creating guidelines on the permissible imposition of capital controls by emerging economies.

The meeting will also consider a report on the IMF, which was commissioned by French FM Lagarde from a panel chaired by Michel Camdessus. This proposes new measures for ensuring that G20 nations have a bigger voice in Fund affairs.

B **IMF:** This week, the Fund's Internal Evaluation Office (its allegedly independent in-house 'watchdog') released an important report into why the IMF was so slow to pick up on the post-2007 financial crisis. This is a fascinating document, with lessons for other bureaucratic organisations that are prone to what the IEO calls 'groupthink'.

The basic problem seems to have been that the Fund's senior management felt that dissent from the institution's party line would be negative for their careers. Too often, that 'party line' came from governments of major G7 countries – notably the US and (more surprisingly) the UK. The report suggests that "the IMF often seemed to champion the US financial sector", that it displayed "naive admiration" for US and UK 'light touch' financial regulation, and that staff members were too easily impressed by the confidence of UK Treasury officials. This meant, among other things, that a remarkably prescient 2005 report by lower level staff into the vulnerabilities of the global financial system did not get the attention it deserved.

Perhaps surprisingly, the Fund's Executive Board appears to have been more open to dissent. It was at the staff level that that "speaking truth to power" appears to have been discouraged.

C **OECD:** This week, the OECD issued a new report suggesting that, for governments who need to raise revenues without doing too much damage to growth, the best alternative is higher property taxes. Since almost all advanced economies are in this boat, expect more upward pressure on property taxes.

II EUROZONE CRISIS

As noted, the crisis will be one of the main agenda items for next week's G20 Finance Ministers meetings (as well as for the eurozone meeting which takes place on Monday).

What this means is that France will try to build international support for the 'grand bargain' that it agreed in principle last weekend with Germany – but which has since run into a number of problems. In outline, it appears that Germany has agreed that the only way forward for the eurozone is a common fiscal policy – ie making the eurozone into the dreaded 'transfer union' that the Bundesbank and conservative German politicians have long opposed. To make this a bit more acceptable at home, Merkel is however insisting that all eurozone members:

- abolish wage indexation;

- establish a common basis for assessing corporate tax (which is a bit short of demanding full tax harmonization);
- align their pension systems (eg retirement ages); and
- implement new, tough rules on reducing fiscal deficits (one proposal is that if a country's debt exceeds 60% of GDP, it will pledge to cut the excess by 5% each year).

These are tough measures, and they have upset just about everyone – including the Dutch, who don't want changes to their pensions system. Less surprisingly, Greece and Italy have both protested formally that the debt reduction targets are way too tough.

Will the package go through? It is very hard to say. However, something along these lines does seem to be the price that Germany is demanding for institutionalising and expanding the EFSF – and for essentially underwriting the debt incurred by the rest of the eurozone. Even so, Merkel will have a hard time selling any kind of deal back home. At the end of next week, there will be a series of state elections, which will reveal the extent to which German voters are prepared to support peripheral eurozone members.

But it isn't just Germany's reluctance to pay. Ireland faces a general election on February 25, and both the centre-right Fine Gael party (which is likely to win) and the left-nationalist Sinn Fein have said they will renegotiate the €85 billion bail-out, particularly the blanket guarantee to bank bondholders. Equally, it is hard to see Greece going along; it was reported yesterday that unemployment hit a record 13.9% in November (it is undoubtedly higher now), with youth unemployment at 35%.

That illustrates the key point in a report that was released on Wednesday by Bruegel, an influential think-tank in Brussels: Greece is insolvent. There is no room for further austerity, and no point in the EFSF (or anyone else) lending any more to Athens until there has been a debt restructuring/reduction.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

While US and European equities have remained remarkably bullish, despite the geopolitical and economic uncertainties, emerging markets have started to get nervous. According to the *Financial Times*, US$7 billion was pulled out of emerging market equity funds last week – the biggest withdrawal in three years. (According to JP Morgan, the pace of withdrawals accelerated this week, with its emerging market index down 4.1%.) The reason the FT gave was twofold: worries over the Middle East (likely to increase after Mubarak's departure), and the impact of food inflation.

A THE US: While there is widespread agreement that Greece is insolvent (along with Ireland, Portugal, Spain and possibly Italy), the US continues to get an astonishingly easy ride. Indeed, as noted, the dollar and the bond market have benefited from the perception that the US is a safe haven from what is going on in the eurozone and North Africa.

And yet… Earlier today, it was reported that the US trade deficit widened 5.9% in December to US$40.6 billion – bringing the total deficit for 2010 to US$498 billion, up 43% year-on-year. That is lower than the US$699 billion in 2008, but it is still almost 4% of GDP – and it is not sustainable. At some stage, investors will notice.

But, apparently, not yet. One reason may be that much of the US trade deficit is related to oil; ex-petroleum, the deficit in December was just US$15.3 billion, the lowest level since March. Another reason is that the bilateral deficit with China was down – dropping from US25.6 billion to US$20.7 billion.

Other than that, this has been a thin week for economic releases – though what little news there has been was fairly positive. In particular:

- first-time jobless claims fell 36,000 in the latest week, to 383,000; and
- the (preliminary) reading of the Michigan confidence index for February rose from 74.2 to 75.1.

More important, perhaps, is the kerfuffle in the municipal bond market. Most analysts believe that the fears that were raised a few weeks ago (by star analyst, Meredith

Whitney) were overblown. However, the market has taken a number of blows this week – including rating cuts for both New Jersey and Arizona. Illinois has also had a lot of trouble trying to sell US$4 billion in bonds to meet its annual pension bill. Despite (or, perhaps, because of) that, the yield on the 10-year Treasury benchmark – the ultimate safe haven investment – has gone up only 5 basis points, to 5.70%.

The concerns in the muni market are just one of the problems that the Fed is going to have to tackle. Although Bernanke defended his approach to Quantitative Easing again this week, it is clear that he is facing growing opposition within the Board. Two important 'hawks' are Jeff Lacker and Dick Fisher; a third, Kevin Warsh (who was Greenspan's protı gı) resigned this week – leaving two seats unfilled.

B **EUROPE:** Something odd has been going on at the ECB over the succession to Trichet (whose non-renewable terms end in April 2012).

Until very recently, the hot favourite was the Bundesbank President, Axel Weber – a feisty conservative, who was known to have opposed the ECB's decision to start buying up the debt of troubled eurozone members. A couple of weeks ago, however, stories started to appear in the press suggesting (a) that he didn't want the job; (b) that Merkel didn't want to him to get it; and (c) that he was somehow unfit. Now, the story has become even more murky, following his decision to step down from the Bundesbank as of April 30. Maybe he is sick. Maybe he is insufficiently 'pro-European'. Or maybe he wants to replace Josef Ackermann (also stepping down) at Deutsche Bank. Whatever, he appears to be out of the running to replace Trichet – which leaves (it is said) five other candidates:

- Mario Draghi, Governor of the Banca d'Italia;
- Klaus Regling, the (German) boss of the EFSF;
- Erkki Liikanen (Finland);
- Nout Wellink (The Netherlands); and
- Yves Mersch (Luxembourg).

Draghi is the most competent – but, as an Italian, he is suspect. Regling (who has no central banking experience) denies that he wants the job – but he may have it forced on him.

One other political story: Two key members of Sarkozy's government – PM Francois Fillon and Foreign Minister Michele Alliot-Marie – are fighting for their political lives as a result of the revelation that they took freebie vacations from Egyptian President Mubarak and Tunisian PM Ben Ali respectively. Sarko would love to see the back of Fillon (who had become virtually unsackable), but it would be very damaging to France's plans for its G20 Presidency to lose two senior figures at this stage.

As for Germany, as noted, Merkel is about to face a series of state elections which may be devastating for her coalition partner, the FDP. They are also a risk for the CDU, particularly given her willingness to institutionalise fiscal transfers to weaker eurozone members at the same time as she has been forced to abandon efforts to work out a joint CDU/SPD approach to welfare reform. Plus, the German economy is suddenly looking a bit wobbly. Although it was reported this week that the 2010 current account surplus rose to €129.9 billion (5.2% of GDP), it was also reported:

- that industrial orders fell 3.4% in December, with capital goods orders down 6.6%;
- that construction output fell 24.1% in December because of bad weather; and
- that industrial production in general was down 1.5%, with manufacturing down 0.1%.

On the positive side, German auto-makers reported strong sales last month, which may suggest that December was just a blip.

Outside the eurozone, no real surprise that the BofE's Monetary Policy Committee held the UK's base rate unchanged at 0.5% when it met this week, or that it also left the QE programme at GBP 200 billion. However, with inflation at 3.7% and at least two MPC members now actively promoting higher rates, an interest rate rise in the next couple of months still seems likely.

That said, it is not a certainty – and one reason is because the MPC does not like to be seen to be reacting to external pressure. In the last couple of weeks, there appears to have been a campaign in the press (not least in the *NY Times*) to portray

BofE Governor King and some of his senior staff as out of touch – and even incompetent. The suspicion is that these stories started with former MPC member David Blanchflower – an aggressive Keynesian, now back at Dartmouth College, who wants the Bank to take a much more aggressive line on QE, despite the sharp rise in UK inflation.

The problem is that prices are an issue in Britain – whatever Blanchflower might say. It was reported earlier today that input prices rose at an annual rate of 13.4% last month, while output prices rose at a rate of 4.8%. In addition, it was reported on Wednesday that food price inflation is currently running at 4.6%.

Other than that, UK economic releases this week have been spotty. On the positive side, it was reported:

- that (despite the rise in VAT) same-store sales were up a stronger-than-expected 2.3% year-on-year in January; and
- that the fall in house prices may be slowing, with the RICS index improving from -39 to -31 last month.

On the other hand, new car registrations were down 11.5% year-on-year in January (because of the end of the 'scrappage' scheme), and the trade deficit hit a record GBP 9.2 billion in December. Given that exports have been one of the few economic bright spots in recent months, that was bad news.

C **CHINA:** Yet again, the US Treasury Department has 'wimped out'... Last Friday, it released its latest report on whether China is or is not to be officially designated as a "currency manipulator" (a status that would open its exporters up to legal challenge in the US). Once again, it concluded that – although "more rapid progress is needed" on renminbi appreciation – China is not a currency manipulator. Indeed, given domestic inflation in China and looking at its currency on a trade-weighted basis, the renminbi is actually up 5-6% since last Spring (ie it is revaluing at an annual rate of around 10-11%).

In the meantime, the PBoC has also raised domestic interest rates again – this time from 5.81% to 6.06% – to curb inflation. Although the inflation rate fell from 5.1% to

4.6% in December, it is expected to go above 6% in January. The rise in rates was, therefore, no surprise.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Today's announcement that Mubarak is stepping down in favour of the military's High Command seems bound to increase anxiety in the Middle East – and, therefore, to underpin the dollar's role as the 'safe haven' of choice. Plus, the dollar had been well-bid all week on the continuing problems of the eurozone – notably the higher yields that Portugal has been forced to pay to fund itself in the markets. Even the Swiss franc has come under some pressure this week against the dollar – though, in this case, the reason appears to be an unexpected fall in Swiss inflation.

Whatever, the dollar is up across the board:

- US$/euro: At the close last Friday, the euro was trading at US$1.359 – down from US$1.363 the previous day. By Wednesday, it had bounced back to US$1.371 – but, since then, unrest in the Middle East has caused the dollar to strengthen. The euro is currently trading at US$1.354 – down 0.4% for the week, and down 1.2% from its mid-week high.
- US$/sterling: At the close last week, the pound was trading at US$1.609. Since then, it has traded in a very narrow range, and is currently US$1.600 – down 0.6% for the week.
- Yen/US$: The dollar closed last week at Y82.28/US$. It fell as low as Y81.9, before hitting a high of Y83.56 earlier today. It is currently trading at Y83.43 – up 1.4% for the week.
- SF/US$: The dollar closed last Friday at SF0.956/US$. It recovered to SF0.967 at the close yesterday – and it is currently trading at SF0.974, up 1.9% for the week.

This is the third straight weekly gain for the dollar against the euro. It was also helped by the unexpected increase in US consumer sentiment (reported earlier today) and by Weber's decision to step down from the Bundesbank. That could prove the most important factor, given that it suggests that the days when the Bundesbank could dictate ECB policy are now over.

V OIL

Perhaps surprisingly, oil futures fell on the announcement that Mubarak had resigned. March WTI, for instance, fell 54 cents to US$86.19 a barrel – though Brent bounced back, and is currently up 16 cents at US$101.03.

What is clear is that the oil market is not too bothered by an eventuality that most traders had already factored in. However, any sign that either the Suez Canal or the Sumed pipeline might be closed would change perceptions sharply.

For the moment, however, it looks as though front-month WTI will fall again this week, while Brent will be up:

- WTI for March delivery closed last Friday at US$89.03 a barrel, down 0.6% for the week. The price continued to fall through Thursday, closing yesterday at US$86.73. If today's price holds, it means WTI will have lost US$2.84, or 3.3%, this week.
- March Brent has held up much better. It closed last Friday at US$99.83 a barrel (up 0.5% for the week), and hit a high of US$101.82 on Wednesday. Assuming today's price holds, it will have risen 1.2% for the week.

It is fairly easy to understand the strength of the oil price, given the perceived insecurity about Middle East supplies. After all, on Monday, the Venezuelan Oil Minster was quoted as saying that prices could double if Suez were closed. In addition, EU Commissioner Oettinger (who ought to have known better) added to market unease by suggesting on Thursday that Saudi Arabia's reserves were "overstated by as much as 40%" – though the impact of that was diluted by an IEA report suggesting that OPEC had actually increased its output in January by 280,000 b/d to 29.85 million.

What is harder to understand is the Brent/WTI spread, which increased this week from US$10.80 to more than US$15, and which is now US$14.84. It is clear that the market for WTI has essentially become dysfunctional. True, US crude stocks rose again this week by 1.9 million barrels, but it is the situation in Cushing, OK that

seems to be driving WTI down. Increased supplies from Canada and, now, from North Dakota, coupled with storage constraints, mean Cushing is awash with oil that has to be moved on.

As a result, markets are currently focusing almost entirely on Brent – which is far more directly influenced by what is happening in North Africa and Egypt.

VI BANKING/INVESTMENT

A EXCHANGES: There have been several big moves in the stock exchange space this week – and more are expected as exchanges consolidate and as they all try to capture the global derivatives business.

The biggest agreed move is the London Stock Exchange's GBP 4.3 billion takeover of the Toronto Exchange, which is the world's largest venue for mining and natural resources shares. This is likely to go through, though technically it is subject to regulatory approval in Canada. Much bigger – and also much more controversial – is the proposed merger of the Deutsche Boerse and the NYSE/Euronext, which involves about US$24 billion (all in stock). This would link the two biggest derivatives exchanges, and it will be strongly opposed by other trading venues (notably Chi-X and BATS). Whatever, it has now prompted the Hong Kong Exchange to announce publicly that it is looking for a partner.

It remains to be seen whether any of these mergers creates value. There are many sceptics who believe that the concept of a consolidated trading platform in a physical location is archaic, and that the future must lie with much cheaper technology-based venues.

B THE US: The White House has just published a report on the future of Fannie Mae and Freddie Mac. This does not make a clear recommendation, but it does lay out the options – including full privatization and a continuation of the status quo. The problem is that housing finance is extremely politicized in the US, and no Congressman really dares to suggest dismantling Fannie or Freddie.

In addition, the Fed has just published proposed new rules on what is or is not a 'systematically-important institution' (ie which institutions will fall under direct Fed supervision, with additional capital requirements). The key criteria are expected to be:

- that more than 85% of the institution's activities are financial in nature;
- that it has more than US$50 billion in assets; or
- that it has "significant" relations with other financial institutions that have assets over US$50 billion.

Comments are due by March 30.

C THE UK: The British government surprised its banks this week by increasing the special bank levy (which it imposed on banks last year, to offset the super-profits they were earning as a result of official support) by GBP 800 million to GBP 2.5 billion. This was not entirely a surprise, and the extra GBP 800 million had been expected to come in next year in any case. But it has got the banks (and their lobbyists) complaining about a 'tax ambush'. What it really is is punishment for their refusal to cap bonuses and their reluctance to boost lending.

On both points, however, modest progress was made this week:

- On bonuses, UK banks agreed that they should be lower in total this year than they were in 2010.
- On lending, the Big 4 banks did agree to GBP 190 billion of new commitments – GBP 76 billion of which is due to go to SMEs.

VI NEXT WEEK

In the US, next week is likely to be important. Key releases include:

- retail sales for January;
- housing stats for January;
- industrial production for January;
- consumer price inflation for January; and
- the Philadelphia and NY Fed surveys.

Elsewhere, as noted, UK consumer price data is due. In addition, markets will focus on:

- eurozone industrial production for December;
- the ZEW index in Germany;
- fourth quarter GDP data in France and Germany; and
- the BoJ's Monetary Policy Committee meeting.

As noted, a eurozone Finance Ministers meeting will also be held, along with a G-20 meeting in Paris at the end of the week.

Regards,

GISE