Αρχείο

WEEKLY ECONOMIC AND MONETARY REPORT

18 February 2011

In geopolitical terms, the big issue is clearly what is happening in North Africa, and indeed across the Arab world. It is certainly having an impact on energy markets – and, perhaps, in foreign exchange markets as well. However, as far as the economic debate is concerned, the key issue continues to be inflation – and whether (or to what extent) central banks should try to offset it by pushing up interest rates. The bulk of academic/intellectual opinion is that the latest rise in inflation (energy, food etc) is "exogenous" – and, therefore, that the monetary authorities should do nothing. However, the markets may not accept that, and they may well punish those who appear indifferent to the threat of ever-higher prices. It is a tricky balance for policy-makers, but there is no doubt that pressure for higher interest rates is growing on both sides of the Atlantic.

I G20

The first meeting of G20 finance ministers (and leaders of the main international financial institutions), under the French chairmanship, is taking place in Paris today and tomorrow.

According to press reports, the rise in food prices (and the damage it is doing to the poorest countries) is top of the agenda. (According to a World Bank report released this week, food prices have risen 29% in the last year, and are now at 'dangerous levels'; as a result, 44 million people world-wide have been pushed into extreme poverty since last June.) It is said that France wants to put tough restrictions on commodity speculators – who, it claims, are responsible for the run-up in prices. Those restrictions are being promoted in the name of global food security, but they are in fact part of a broader attack on financial speculation – and they have already run into opposition from major farm exporters, notably Brazil and Argentina.

Other agenda items are unlikely to make much progress either. They include:

- efforts to boost alternatives to the US dollar as a reserve currency (perhaps including the SDR); and
- proposed new guidelines for when emergency capital controls might be permissible.

However, it is possible that there will be some progress on producing an agreed set of indicators that would give an early warning of global imbalances. The US has been pushing for this, and wanted clear, numerical thresholds. Germany has apparently agreed in principle – but without the numbers.

There will also be a discussion of where the eurozone's economic/financial crisis stands, and what various parties are doing in the area of financial (re-)regulation. No major breakthrough is likely.

II THE EUROZONE CRISIS

Most of the news this week has been positive – though perceptions could well change next week after the Irish elections (which are virtually certain to produce a Fine Gael-led government pledged to renegotiate the terms of the ECB/IMF €85 billion bailout).

In particular, the *WSJ* reported on Monday that the ECOFIN ministerial meeting held over the weekend had agreed that the EFSF (which will become the permanent European Stability Facility after 2013) must be able to lend troubled eurozone members at least €500 billion – up from no more than €220 billion at present. However, there are still differences over the degree of 'conditionality' that should be attached to EFSF help. Germany, for instance, wants all beneficiaries to sign up to its proposed competitiveness pact. Others have more specific concerns. France, in particular, still wants Ireland to raise its very low corporate tax rate; the IMF wants Greece to help its own finances by

selling €50 billion in state assets. As French Finance Minister Lagarde pointed out, unfortunately “nothing is agreed until everything is agreed”.

In addition, this week:

- Greece got a passing grade from the IMF in its latest review of economic progress – meaning that the Fund will disburse the next tranche of its rescue package in March. Greece is apparently on track to cut its deficit to 7.4% of GDP by year-end.
- EU Commissioner Rehn hinted that there might be some “flexibility” as far as the interest rate on Ireland’s €85 billion bailout is concerned – albeit, not until next year.
- The market for the sovereign bonds of weaker eurozone economies seems to have improved – particularly for Spanish paper. Reflecting this, it appears that the ECB bought no bonds last week (though it may have been forced to buy some Portuguese paper this week).

There is one new danger that needs to be flagged, however: the financial position of the Spanish *cajas* (the troubled housing lenders) is apparently even worse than had been thought. They have now acknowledged that they cannot meet the deadline that was previously set for boosting their capital.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

One of the reasons that pressure is increasing on policy-makers to push interest rates up is that the overall global growth picture is improving – which means that there is now more space to worry about ‘second order’ problems like inflation. Indicative of this, the OECD published its composite leading indicators this week – up from 102.5 to 102.8 in December. According to the accompanying analysis:

- Germany, Japan and the US are experiencing "relatively robust expansion"; and
- Canada, France and the UK are seeing "continued moderate expansion".

However, on the other hand:

- there is a "downturn emerging" in Italy; and
- "new data points to a downturn" in China.

A **The US**: Evidence of the OECD's "relatively robust" expansion has been a bit thin on the ground this week. Perhaps the strongest release was the Philadelphia Fed's business sentiment index, which jumped from 19.3 to a seven-year high of 35.9 this month. That confirmed the message of a more modest rise in the Empire State (NY) index, from 11.9 to 15.4. In addition, US housing starts rose 12.8% in January (though new permits fell sharply). For the rest, it was reported:

- that industrial production rose just 0.1% in January – far less than the 0.6% which had been expected;
- that retail sales rose just 0.3% in January, which was only half what was expected (ex-autos, sales were also up 0.3%);
- that leading indicators rose only 0.1% last month; and
- that first-time jobless claims jumped by a sharper than expected 27,000 in the latest week.

Nevertheless, in the latest FOMC minutes, the Fed has upgraded its GDP forecasts. It now expects US growth of 3.4-3.9% this year (up from 3-3.6% six months ago). The worry is, however, inflation. This week, it was also reported:

- that US import prices rose 1.5% in January alone (and were up 5.3% year-on-year);

- that producer prices rose 0.8% last month (with the core PPI up 0.5%, the biggest monthly jump since October 2008); and
- that consumer prices rose 0.4%, or 1.6% year-on-year.

Nothing very scary there – but the trend is clearly in the wrong direction, and it will increase the resolve of FOMC 'hawks' (like Dick Fischer and Charles Plosser) to push for an increase in the Fed funds rate. That said, it is worth noting that interest rates have fallen this week in the US Treasury market. The yield on the 10-year Treasury benchmark, for instance, has fallen from 3.65% to 3.60%, while the 30-year yield has dropped from 4.71% to 4.67%. That, however, may just reflect the US role as the "safe haven" of choice for Middle East investors. Whatever, it will be a relief to the Treasury, since TIC data this week showed that long-term capital inflows into the US fell in December from
US $85.1 billion to US $65.9 billion.

This week also saw the Administration's first stab at a budget for FY 2012.

No one takes this too seriously, but it is at least an indicator of what the White House wants. The key proposal is that discretionary spending is to be frozen for five years – which means that the deficit should reduce from 10.9% of GDP to 3.2% by 2015. That said, this year's deficit will still be a mind-boggling US $1.65 trillion – and that is before Congress gets to work.

Finally, Fitch Ratings published a report this week on the pension liabilities of US states and cities – warning that the problem is severe enough to force a downgrade. Together with the increasingly acute funding problems of Chicago (and of states like Kentucky), investors are starting to wonder whether Meredith Whitney – whose warnings of imminent municipal bankruptcies were widely dismissed – might have been right after all.

B **EUROPE**: There seems to be a growing consensus that the next President of the ECB (when Trichet steps down later this year) will be Mario Draghi – Governor of the Banca d'Italia and (yet another) alumnus of Goldman Sachs. Draghi (who was endorsed by *The Economist* today) is extremely well-regarded – but it is worth emphasising that his appointment will be controversial, particularly in Germany (where any Italian is assumed to be 'soft' on inflation).

The reason Draghi seems likely to get the nod is because, following Axel Weber's mysterious resignation, Merkel has decided to nominate her youthful economic adviser, Jens Weidmann, to be Bundesbank President. The alternative would have (apparently) been to move Jürgen Stark from the ECB; as it is, the consensus is that, if Stark stays at the ECB, there can be no German at the top.

That said, Weidmann is interesting. Although he is a former student of Weber, most of his academic background was in France. He also worked at the Banque de France (as well as at the IMF); it is, therefore, safe to say that he will be more sympathetic to French ideas of a so-called 'transfer union' than was Weber – whose resignation appears to have reflected his unyielding opposition to unlimited bail-outs for peripheral eurozone economies.

The spat over Weber is not the only personality problem facing Merkel at the moment. Her (extremely popular) Defence Minister, the 39-year old aristocrat, Karl-Theodor zu Guttenberg, is embroiled in a nasty row over alleged plagiarism in his PhD thesis. (All German politicians apparently need a doctorate to show they are serious – though German doctorates are two-a-penny.) It is possible that he could be forced to resign, which would be a big blow given that the CDU/CSU faces seven state elections in the next couple of months (the first of which, in Hamburg, is this weekend).

Coincidentally, zu Guttenberg's travails closely mirror those of the French Foreign Minister, Michele Alliot-Marie – who is facing growing pressure to resign over evidence

that her family had undisclosed business (as well as social) links with deposed Tunisian President Ben Ali.

Economically, the Commission published its latest consumer confidence index for the EU-27 this week. It was considered disappointing, unchanged from January at -12.4, with concerns about both unemployment and inflation growing.

The Commission also published GDP growth data for the eurozone. In the fourth quarter of 2010, GDP growth was 0.3% for the eurozone as a whole – a little bit lower than expected, and down from the third quarter. However, that disguises a wide spread of outcomes. At one end of the scale, for instance, Estonian GDP was up 2.3%, followed by Bulgaria and Lithuania at 1.7%. At the other end, Greek GDP fell 1.4% and Portuguese GDP fell 0.3%. In the middle were Germany (+0.4%, France (+0.3%), Spain (+0.2%) and Italy (+0.1%).

As far as individual eurozone member states are concerned, it was reported this week:

- that German producer prices rose 1.6% last month, twice what was expected – thereby increasing fears of inflation; and
- that, according to Insee, French business confidence fell this month from 108 to 106.

As for Italy, the nation remains transfixed by the prospect that PM Berlusconi will have to stand trial in a criminal court on April 6 for having sex with an underage prostitute. The parallel with Al Capone (who was eventually jailed on income tax charges) is inescapable.

As for the UK, it has been pointed out by several academics that an interesting experiment in practical economics is now underway. Both the US and UK face very similar economic problems – and, initially at least, both reacted in the same way with

massive programmes of Quantitative Easing. Now, however, the authorities seem to be heading in different directions:

- in the US (despite the 'wish list' of cuts in Obama's budget submission), fiscal policy remains loose and monetary policy is still very accommodative; while
- in the UK, the Coalition government has imposed a savage fiscal squeeze, while the BofE is hinting very strongly that there will be at least two interest rate hikes this year.

The fear among Keynesians is that the UK will tip into a second recession; the fear among others is that, if the authorities do not act, the market will force a sterling crisis.

In the meantime, there is certainly no sign of a 'double dip' in the UK. Indeed, it was reported today that retail sales jumped 1.9% month-on-month in January, despite the rise in VAT. However, it was also reported this week:

- that the BDO business confidence index fell from 94.8 to 92 in December;
- that unemployment in the 16-24 year old range is now 20.5%; and
- that mortgage lending fell 13% last month.

More important – at least as far as BofE Governor King is concerned – consumer price inflation hit 4% last month (with the RPI, which includes housing costs, up 5.1%). That is twice the BofE's target. Given that prices of everyday goods and services are now rising twice as fast as wages, labour unrest seems inevitable. As a result, one MPC member, Andrew Sentance, is now openly challenging King, and is calling for a substantial increase in interest rates "sooner rather than later".

C JAPAN: PM Kan is another leader facing a political challenge – though, given that his personal popularity has now fallen below 10%, that may not be surprising. Yesterday, it was reported that a breakaway group of 16 Diet members would set up a

separate faction within the ruling DPJ under the leadership of Koichirio Watanabe. It is assumed that he is a proxy for the former party kingmaker, Ichiro Ozawa.

Can the PM survive? It will be hard given that GDP fell 0.3% in the fourth quarter (following the end of automobile sales incentives). However, Japanese GDP grew 3.9% for the year as a whole, and – as noted – growth prospects for this year look fairly good. Moreover, equities are strong. The Nikkei-225, for instance, was up 2.2% this week, after a 0.6% gain last week.

D CHINA: When Japan released its disappointing fourth quarter GDP data, China became officially the second largest economy in the world – though GDP per capita is still only US $4,300 (according to the IMF). Allegedly, it is now set to overtake the US before 2050.

Maybe; but its first priority is to handle the bubbles which appear to be developing. Even though judicious 'massaging' of the data (in particular, reducing the weighting for food) meant that the inflation rate dropped from 5.1% to 4.9% last month, the PBoC has continued to tighten bank reserve requirements to rein in lending and to hold down house prices – which are now rising strongly in all urban centres.

The good news is that there is some sign that reliance on exports is abating. Last month, the trade surplus came in at US $6.5 billion – down from US $13.1 billion in December. However, the bilateral surplus with the US was a hefty US $13.5 billion – up 24% year-on-year. Even though total imports are rising far faster than exports, the surplus will continue to be a major source of friction.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the main story was the US dollar – up 1.8% against the SF, 1.5% against the yen, 0.7% against sterling and 0.4% against the euro. It was also up strongly against commodity currencies. This week, the dollar has lost momentum – despite its 'safe

haven' role. The main reason seems to be the perceived unwillingness of Bernanke to countenance an interest rate hike. In contrast, the BofE's MPC made it clear this week that it expected UK interest rates to rise (even though the Bank was at the same time downgrading growth forecasts), and today, Lorenzo Bini Smaghi, a key ECB Council member, confirmed that the ECB's priority is now to confront inflation. The upshot is that the dollar has given back most of its gains:

- US $/euro: At the close last Friday, the euro was trading at US $1.352/€. It fell further to a three-week low of US $1.35 on Monday, but has since recovered fairly steadily. It is currently trading at US $1.363 – up 0.8% for the week.
- US $/sterling: At the end of last week, the pound was trading at US $1.600/GBP. It has risen fairly steadily through the week as concerns about UK inflation have increased, and it is currently trading at US $1.6213 – up 1.3%.
- Yen/US $: Last Friday, the dollar closed at Y83.52/US $. It hit a high of Y83.8 on Tuesday, but has since eased back to Y83.39 – down a minuscule 0.2% for the week.
- US $/SF: The dollar was trading at SF 0.975 last Friday. The Swiss franc's role as a proxy for gold has continued to help it, and it is currently trading at SF 0.952 – up 2.4% for the week.

The US dollar has also fallen back slightly against the Canadian dollar and other commodity currencies.

Clearly, the potential for unrest in the Middle East is a major concern. However, the biggest issue appears to be whether or not the authorities in question are willing to let interest rates rise in order to counter the perceived threat of inflation.

V OIL

Last week, WTI for March delivery fell US $3.45 a barrel, to close on Friday at US $85.58. Over the same period, March Brent was broadly unchanged, closing at US $99.83 – which implies a spread over WTI of US $14.25 a barrel.

This week, both marker crudes have risen:

- WTI: The March contract (which expires on February 22) fell to US $84.32 on Tuesday, but has since recovered. It is currently trading at US $87.69 – up 2.5% for the week.
- Brent: The February contract expired at the end of last week. The April contract, which closed last Friday at US $100.94, hit an intraday high of US $104.30 on Monday – its highest level since September 2008. Although it has fallen back since then, it is still trading at US $103.17 – up 2.2% for the week.

This also means that – although most traders expected the gap to narrow – the premium in favour of WTI remains at a historically very wide US $15.48.

What is driving the oil price up? And what is keeping the Brent premium so wide?

On the former question, there is no doubt that political uncertainty is playing a growing part. Today, the markets are focussing on Libya in particular, but there are also concerns about the Suez canal (particularly if Iranian warships try to transit). In addition, however:

- it was reported this week that China's crude imports averaged 5.1 million b/d last month, up 27% year-on-year; and
- the entire commodity sector is strong, with the R/J CRB index rising this week from 337 to 343 and with gold (in particular) rising from US $1,363/oz to US $1,388.50.

Whatever, the average price of traded oil is now at or close to a two and a half-year high.

As for the spread, while traders still expect it to narrow, it is clear that the price of Brent is more sensitive to unrest in the Middle East. At the same time, WTI is sensitive to the level of stocks in the US. In the latest week, US domestic crude inventories were up another 860,000 barrels. Although stocks at Cushing, OK are down from their record level in January, they are still very comfortable – and are clearly dragging on the market.

VI BANKING

A CO-COs: The most interesting development of the week was Credit Suisse's highly successful attempt to boost its capital with so-called "co-cos" (contingent convertible bonds). These bonds have a provision that they will automatically convert to equity if a particular condition is met – in this case, if Credit Suisse's Tier 1 equity ratio falls below 7%. There had been considerable scepticism whether any investors would be interested, but that seems to have been disproved.

The first SF 6 billion tranche of co-cos was sold on a private placement basis to Qatar Holdings and the Olayan Group – who agreed to swap their existing Tier 1 debt into co-cos in 2013 for a return of 9-9.5%. That was considerably lower than expected.

The second tranche was US $2 billion in 3-year notes, which was offered yesterday. Apparently, total bids amounted to US $22 billion, and the yield was just 7.88%. Given this reception, other banks are bound to follow.

B UK FINANCIAL POLICY COMMITTEE: The British government published an important consultative paper on financial regulation yesterday, which included details of the membership of the new Financial Policy Committee – the body within the BofE that

is supposed to control systemic risk. What is particularly interesting is the make up of the four independent members of the FPC. They are:

- Michael Cohrs, a leading US-born investment banker who was previously with Deutsche Bank and Goldman Sachs;
- Donald Kohn, Bernanke's former deputy at the Fed;
- Alastair Clark, the former head of stability at the BofE (who was eased out two years ago by the Governor); and
- Richard Lambert, the former editor of the *FT*.

VII NEXT WEEK

Elections in Ireland will almost certainly lead to a change of government. State elections in Hamburg will hit Merkel's CDU.

Economically, the main releases in the US (where Monday is a holiday) include:
- the Case-Shiller home price index for December;
- consumer confidence for February;
- home sales for January; and
- the second estimate of fourth quarter GDP.

In Europe, key releases include:
- the composite eurozone PMI for February;
- the IFO business climate index for Germany;
- the German GfK consumer index for March; and
- UK consumer confidence for February.

In Japan, look for the January trade surplus and consumer prices.

Regards,
GISE