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WEEKLY ECONOMIC AND MONETARY REPORT

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Obviously, there has been a great deal of attention focused on North Africa in the last two weeks – and on the danger that unrest could spread from the Maghreb to the Gulf. This is reflected in the cost of sovereign CDS cover and in the sustained high price of oil – though there are other factors reflected in this, and in any case the oil price is not as high as it might have been expected to be if pessimists about regional political stability were right. However, over the last two weeks, there has been a lot going on that has nothing to do with Arab unrest or the oil price, but that could be at least as important. Leaving aside today's news of a major earthquake in Japan (which could have a substantial impact elsewhere in East Asia), this would include:

- the eurozone crisis, which has flared up again, prompted by new ratings downgrades for Spain and Greece – as well as by the threat that a new centre-right government in Ireland might demand renegotiation of its bailout terms;
- the policy gap between the US and Europe, which has widened still further on both monetary and fiscal sides (though the BoE surprised the markets yesterday by keeping UK base rate at 0.5%);
- the growing concern that equity markets around the world have become 'toppy' (a concern that could well be exacerbated by the earthquake); and
- the domestic political situation in the US, which has become so partisan and highly-charged that it is less and less likely that any solution can be found to the huge fiscal problems that the country faces (at both Federal and state/local level) and on the equally fraught issue of 'settlements'.

On top of that, it is increasingly obvious that the big banks feel that they have defeated national and international efforts to rein them in – particularly with structural reforms of the industry. For most, it is clearly 'business as usual' – which means that high-risk business will continue essentially to be underwritten by the government guarantee of low-risk deposit-taking.

Just about the only good news of the last couple of weeks has come from China – where the government has set lower growth targets, has announced an unusual trade deficit (albeit for just one month) and has indicated a modest willingness to resume talks on renminbi appreciation.

I INTERNATIONAL ORGANISATIONS

Four developments are worth noting over the last couple of weeks:

- First, last week, Dominique Strauss-Khan announced that Nemat Shafik, 48, would succeed Murilo Portugal (who resigned as of March 4) as a deputy MD of the IMF. Known as 'Minouche', Shafik is almost universally popular – though she left the World Bank (where she was the youngest VP) under a cloud, following a bit of personal hanky-panky. She is Egyptian by birth, with UK and US citizenship, who has been most recently running DfID, the UK's aid agency. She is a very interesting appointment.
- Second, the BIS/G10 group held its Global Economy meeting in Basel last weekend. According to ECB President Trichet, there was a 'solid unity of purpose' on inflation – but even he was forced to concede that the timing on interest rate increases (particularly between Europe and the US) will be very different.
- Third, the political situation in the US, coupled with the impasse over the FY2011/12 budget, is making it less and less likely that the US will be able to deliver the US$3 billion or so that it has already pledged to the IMF and World Bank – or that it will participate in the next round of capital-raising for the ADB. The Obama Administration is fighting hard for the appropriations, but the mood on Capitol Hill is extremely negative. The price will be an inevitable diminution of US influence.
- Finally, it was reported today that the EBRD - set up in 1991 to help Central and Eastern Europe's transition to a post-Communist world – would like to extend its remit to cover North Africa, Egypt in particular. Given that Turkey is already a recipient of EBRD assistance, this makes sense – as does the skill set it offers. As the Bank's President,

Thomas Mirow, pointed out, there are 'stunning similarities' between North Africa now and eastern Europe 20 years ago.

III **NORTH AFRICA / MIDDLE EAST**

It is difficult to say anything constructive about what is going on in the Mahgreb (or the Gulf) as the situation is evolving day-to-day. However, it is worth pointing out that the issue of economic and political sanctions against the Gaddafi regime in Libya appears to be top of the agenda for today's EU Summit – a meeting that had previously been focused almost entirely on getting a consensus around Germany's controversial proposal for a eurozone 'Competitiveness Pact'.

As a result, it seems likely that the EU will announce a freeze of assets held in Europe by the Libyan Investment Authority and the CB (whose Governor, Farhat Omar Bengdara, surfaced in Istanbul on Tuesday claiming to be doing his job, after reports that he had fled to Switzerland). However, it may not be easy to enforce that freeze, given that the LIA (and Lafico, one of its subsidiaries) owns huge real estate interests as well as portfolio investments in banks, industrial groups etc. The position of ABC (59% owned by the LIA) and of other Arab banks with substantial Libyan ownership is also problematic. Within the EU, Libyan investment is most prominent in Italy (Unicredit, Finmeccanica, even Juventus FC) and Malta – though it has also been a big player in France and in the London real estate market.

There is also the issue of oil. Many European companies have apparently cut purchases of Libyan oil, not out of principle, but because they cannot get banks to finance the deals. However, the Chinese are still buying from the National Oil Company – as is Austria's OMV.

Finally, although it may seem small potatoes – it is worth noting the controversy that has arisen over the substantial donations that groups affiliated with Gaddafi (and his son, Saif) have made to UK universities – notably, the London School of Economics, where the director (Howard Davies, former head of the FSA) has already been forced to resign. This has raised a broader issue of the extent to which any university should associate itself with donors whose motive appears to be an attempt to buy

'respectability' (Harvard, in particular, has taken large sums from extremely dubious Russian 'oligarchs').

As for the broader regional impact of the Libyan crisis, stock markets have been hit hard. Since the beginning of last month, most Gulf markets are down 10-15% – though some of that also reflects the sense that, globally, markets are 'toppy'. (Perhaps the best example of this concern was the decision by Carl Icahn to return US$2billion to investors in his funds, because he didn't want responsibility for handling their money through what he expects to be a global market crisis.)

IV MICROFINANCE

One small (?sad) story that is worth flagging is what has happened to the one-time hero of the global microfinance movement, Mohammed Yunus.

On Tuesday, the Bangladeshi High Court upheld his removal from the board of Grameen Bank, which he founded 34 years ago - ostensibly because of his age (he is 70). The real reason is political. Three years ago, having won his Nobel prize, Yunus set up a political party to challenge the domestic political establishment, represented by the Prime Minister, Sheikh Hasina. This quickly became a personal struggle between the two – with Sheikh Hasina assisted by new academic studies questioning whether microfinance actually does as much as proponents claim to help the very poor and by examples of gregarious corruption in microfinance operations elsewhere. She has been trying to get rid of Yunus for the last three years – and may well succeed, although he plans to appeal to the Supreme Court. Sheikh Hasina's attack is undoubtedly unfair. True, microfinance was over-promoted by supporters, and Yunus himself has an arrogant streak. But Grameen has done good work, and has provided a model for hundreds of other micro-lenders. And whatever else he may be – Yunus is basically honest.

V EUROZONE CRISIS

As noted, the eurozone crisis has flared up again – despite an emerging consensus (reflected by the FT's influential columnist, Martin Wolf) that the 'peripheral' member

states are so marginal to the eurozone as a whole that their problems can be covered without jeopardizing the euro as a whole.

The main reason for the renewed concern is a series of ratings downgrades. In particular, at the beginning of this week, Moody's downgraded Greece's sovereign debt from Ba1 to B1 – ie. to 'highly speculative'. Its reasoning was endemic tax evasion and the likelihood of a forced restructuring. Although the Greek Finance Minister immediately called for EU regulation of the raters, it is significant that he followed up by firing the country's chief tax collector. Moody's has now cut Greece's rating nine notches in less than 18 months – and there may be more to come, given that Greece has to refinance €211 billion by 2015 and given the rapid growth of a civil disobedience campaign ('den plirono' - or 'won't pay') against payment of any kind of tax. Even the (pro-euro) FT warned that all the 'ingredients are there for a default'.

That was followed yesterday by a downgrade of Spanish debt (also by Moody's) to Aa2, largely because of a belief that the government has wildly underestimated the cost of recapitalizing Spanish banks. (It claims it will cost €15.2 billion to make them Basel-compliant; Fitch says €38 billion, and Moody's now suggests €40-50billion at least, with up to €120 billion if things go wrong.)

The result has been a bond market rout – at least for peripheral eurozone members. Yesterday, for instance, Spanish 10-year paper was yielding 5.555, the highest since January. Portugal was paying 7.8%, and Greek 10-year yields hit 12.9%. (Perhaps even more worrying, yields on 3-year Greek paper hit 17.7%.)

Were it not for the Libyan crisis, this would obviously be top of the agenda for today's EU Summit – and it will still be a major item, though final decisions are likely to be deferred until the next Summit (which is, conveniently, two days after the next round of regional elections in Germany). The main initiatives to be discussed are:

- Germany's proposal for a new 'Competitiveness Pact';
- attempts by Ireland and Greece to get easier terms on the bailouts that they have already negotiated through the EFSF;

- the conditions that will be attached to the new (permanent) European Stability Fund, which should take over from the EFSF in 2013; and
- proposals by the European parliament to control the CDS market (specifically, to ban 'naked' shorting, where speculators use CDSs to bet on the likelihood of a default without actually owning underlying securities) and to regulate the rating agencies.

The big issue is the Competitiveness Pact -- in particular, whether, as the Germans would like, it should include harmonization of corporate tax rates, reform of state pension systems, abolition of wage indexation and introduction of some sort of automatic 'debt brake' if debt levels get too high. Some of these issues clearly infringe on national sovereignty, and will be fought hard. However, it is worth emphasising that Merkel does not have a great deal of political leeway -- particularly given the series of state elections now underway, the resignation of her popular Defence Minister and the constant sniping from the implacably hostile President of the Bundesbank, Axel Weber (who, to her relief, will quit at the end of April to spend a year teaching at the University of Chicago).

Is there any good news for euro-enthusiasts? Well, to some surprise, the new Irish government did not immediately (or publicly) demand a renegotiation – though that is undoubtedly what it wants. At least in tone, it remains pro-euro. And the Greek government has announced that it will try to tap the expatriate Greek community (initially in the US) with a series of 'diaspora bonds'. However, it is hard to see that making a big difference given the size of Greece's funding requirements.

VI RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, there is a fairly general feeling that equity markets are close to (or at) a peak. That is not surprising given that the DJIA is up 85% since March 2009 and the S&P500 has almost doubled over the same period. Some correction seems due – not least, because consumer demand continues sluggish and the global economy seems increasingly susceptible to exogenous shocks (oil, commodities more generally), now the Japanese earthquake. However, it is worth emphasising that there are influential contrarians. In his annual letter to Berkshire-Hathaway

shareholders, for instance, the venerable Warren Buffett insisted that 'the best days lie ahead' and that 'our elephant gun has been reloaded'. Maybe.

A **THE US:** There are two ways to look at the US economy:

- 'top-down', focusing on the increasingly hostile political atmosphere in Congress, the stand-off over the Federal budget and the 'war' that is being fought by Republican governors on entitlements at the state level; or
- 'bottom-up', focusing on signs of economic recovery, which have undoubtedly picked up in the last couple of weeks.

'Top-down', the major development was a compromise agreement to keep the Federal government funded until March 18 (ie next week), subject to US$4 billion in spending cuts. An attempt to extend this to end-September was, however, defeated in the Senate – which means that the whole budget issue will be front-and-centre next week, with no-one looking good. The problem is enormous – but fairly simple. Interest on the US national debt is running at around US$200 billion a year; without any reform of entitlements, it will be US$928 billion in 10 years' time. That is unsustainable. Unfortunately, there is no consensus on how to handle it. Republicans won't increase taxes (particularly not on corporates) – and won't even agree to roll back tax breaks for oil and gas. They are willing to cut some entitlement programmes – but not Medicare and Medicaid, which are crucial for their elderly voter base. Democrats fight any cuts on entitlements – going well beyond Medicare/Medicaid. Neither party is willing to tackle defence spending.

An interesting *WSJ* poll, published this week, illustrates the problem. For 56% of respondents, job creation must be the top priority; for 40%, it is cutting the deficit.

When it comes to cutting the deficit, however, respondents didn't have a clue. The only areas that attracted majority support were:

- subsidies for nuclear (57%);
- Federal assistance to state governments (52%); and

- the Environmental Protection Agency (51%).

At the other end, only 23% supported cuts to Medicare, while only 22% supported cuts to education or Social Security.

In the meantime, the Governor of Wisconsin has (apparently) won his battle to abolish collective bargaining for state employees. This is a highly controversial issue, and Governor Walker has been vilified in the liberal press. However, there is no doubt that most states are living beyond their means – and one of the reasons is the cost of public sector wage/benefits deals negotiated in a very different economic climate. The problem is that 44.1 million Americans (almost 20%) are now eligible for food stamps – and many of them are low-paid public sector workers and their dependents.

As for the current economic environment, Fed Chairman Bernanke was modestly upbeat in his semi-annual Congressional testimony last week, insisting that 'downside risks to the recovery have receded, and that the risk of deflation has become negligible'.

Certainly, most of the recent economic indicators have been positive. In particular:

- non-farm payrolls rose 192,000 in February (with private sector employment up 222,000), while the unemployment rate fell to 8.9% – its lowest level in 20 months;
- the Chicago PMI hit a 13-year high in February, with the new orders component at its highest since December 1983;
- the (national) ISM purchasing managers index accelerated at its fastest rate in seven years last month, with the manufacturing index jumping from 60.8 to 61.4 (and the services index up from 59.4 to 59.7); and
- personal income rose 1% in January, with consumer spending up 0.2%.

Retail sales also appear to be picking up in the US – particularly the high end – and almost all the auto manufacturers reported that February was a strong month. That said, according to a Bloomberg poll, only one in seven Americans feels that a lasting

recovery has yet taken hold, and 63% still believe the country is 'on the wrong track'. In addition:

- first time jobless claims were higher than expected in the latest week, rising 26,000;
- construction spending fell for the second month in a row in January; and
- the trade deficit widened unexpectedly in January, by 15% to US$46.3 billion, as a 2.7% rise in exports was swamped by a 5.2% rise in imports.

It is a very mixed picture – not one that either the Administration or Congress can view with equanimity, particularly given that the Federal deficit hit a record US$222.5 billion in February.

So far, the bond markets have been fairly forgiving. Over the last two weeks, for instance, the 10-year Treasury yield has actually fallen from 3.43% to 3.40% (though it did hit 3.55% on Tuesday), while the 30-year yield has been virtually unchanged. That, however, is muddied by the possibility of capital flight from the Middle East. What might worry investors more is another warning from Pimco's Bill Gross – who has cut the fund's holding of US Treasuries to zero in the belief that the price will collapse when the Fed stops buying in June. Others believe foreign demand will emerge, but Gross's argument seems persuasive.

B EUROPE: As noted there is now a pretty open split between the Fed and the ECB (and the BofE) on monetary policy.

Last week, in particular, Trichet made it very clear that eurozone interest rates are on the way up – and almost certainly as early as April. As he put it, 'we are in a period of strong vigilance; an increase in interest rates at the next meeting is possible'. 'Vigilance' is a code word – and the markets have now factored in a quarter-point rise for April. Ditto (almost) for the UK; although the MPC left interest rates unchanged yesterday, with base rate at 0.5%, this is widely believed to have been a very close call. Even though one MPC 'hawk', Andrew Sentance is due to step down (to be

replaced, surprise, by an economist from Goldman Sachs), the consensus seems to be that base rate will go up next month.

As for the eurozone economy, what is increasingly clear is that disparities within the zone are widening. In the last two weeks, for instance, it has become very clear that the German economy is (in Weber's words) 'roaring ahead'. In particular, it has been reported:

- that German manufacturing orders were up 2.9% month-on-month in January; and
- that industrial production was up 1.8%.

The downside of this is, of course, inflation. Indeed, it was also reported last week that German inflation jumped from 2.0% to 2.2% last month, the highest since October 2008. That alone would be enough to force the ECB to act. In addition, the same sort of pressures are building elsewhere in the eurozone's 'Northern tier'. In France, for instance, industrial production was up 1% in January.

Unfortunately, the 'Southern tier' isn't doing so well. Even though the MI for the eurozone as a whole hit an 11-year high of 59.0 in February, industrial production fell 1.5% in Italy, Greek unemployment is now at a record 14.8% and 4.3 million Spanish workers are jobless. As a result, statistics for the eurozone as a whole are starting to become meaningless – though, by statute, the ECB has no choice but to set its policy on the basis of aggregates that are dominated by Germany and France.

There is also a growing political crisis within the eurozone.

We have already noted that Merkel was forced to accept the resignation of Defence Minister zu Guttenberg over the issue of academic plagiarism. He has been replaced by Thomas de Maiziθre (57), the former Interior Minister. He is a former State Secretary in East Germany (where his cousin was also PM) – but he has neither Guttenberg's political clout nor charisma. The same has been happening in France, where Sarkozy fired his Foreign Minister and Interior Minister. Michele Alliot-Marie went as the result of her imprudent relationship with the ousted Tunisian regime –

from which she and her husband received repeated 'favours'. She was replaced by a former PM Alain Juppı (known as 'the lightbulb', for the shape of his head rather than his brilliance). Sarko also took the opportunity to get rid of an old nemesis, Brice Hortefeux, who was replaced as Interior Minister by his chief of staff, Claude Guı ant.

With a change of government in Ireland and with Berlusconi still facing criminal charges in Italy, there is a real sense of political upheaval in the eurozone. It will be reinforced if, as expected, the CDU loses heavily in the B-W state elections on March 25.

As for the UK, David Cameron's Coalition government also took a hammering at a by-election last Thursday, in which the LibDem candidate actually came sixth. With local elections and a referendum on changing the first-past-the-post electoral system to be held in early April, the LibDems in particular must be wondering whether the joys of sharing in government are enough to outweigh the strong possibility that the party will be destroyed at its grass roots.

In the meantime, the National Institute has just concluded that the UK economy grew 0.2% in the December-February quarter, having contracted in the November-January period. Some sort of economic recovery seems to be underway, though it is clearly fragile. On the positive side, it was reported:

- that (according to the Nationwide index) house prices rose 0.3% last month;
- that the CIPS/Markit manufacturing PMI hit a record 61.5 last month;
- that the trade deficit fell from GBP9.7 billion to GBP7.1 billion in January, largely because of a 6.1% increase in exports; and
- that, reflecting this, manufacturing output rose 1%.

On the other hand, the services PMI (which covers 75% of the UK economy) fell from 54.5 to 52.6 last month, and retail sales were weak with like-for-like sales off 0.4% year-on-year. In addition, we are only just beginning to see the impact of the January increase in VAT – and the much vaunted package of public spending cuts and tax increases has barely begun to bite. Indeed, out of GBP113 billion in deficit reduction

measures already announced, only GBP9 billion have come in so far – though a further GBP41 billion will start with the new tax year next month. Under these circumstances, it is hard to be optimistic for the UK economy over the rest of the year.

C **JAPAN:** Today's massive earthquake appears to have been the biggest to have hit Japan in over 100 years, with potentially enormous economic repercussions elsewhere in the region, as well as in Japan itself. It is far too early to suggest a price tag; however, it is possible that the economic stimulus that would be provided by a reconstruction programme could do more to get the Japanese economy moving than years of negative real interest rates.

Perhaps fortunately for PM Kan, the earthquake is also bound to overshadow his increasingly desperate political situation – which would likely have seen his resignation before the summer.

Over the weekend, for instance, Foreign Minister Seiji Maehara resigned – ostensibly because of trivial campaign contributions made by a South Korean businessman over a number of years. In reality, Maehara was probably forced out because of his pro-American views and as part of an effort by other DPJ factions (including that led by former party boss Ozawa) to destabilize Kan. He has quickly been replaced by his deputy, Takeaki Matsumoto (51) - who is known to be far less pro-American (particularly on sensitive issues like Okinawa) and whose speciality is China. In the meantime, the Nikkei-225 has continued to fall, dropping 2.6% over the last two weeks. However, as a result of the earthquake, one would have to say that all bets are off as far as the Japanese markets are concerned.

D **CHINA:** The last two weeks have seen a modest – but significant – change in economic direction.

Last week, PM Wen Jiabao indicated that the government would set a lower target for economic growth over the next five years of 7% per annum – down from 7.5%. Given that China has consistently overshot previous growth targets, that may not amount to much, but it is a shift in emphasis – one that was reinforced at this week's

National People's Congress. There, the talk was of inflation and of boosting domestic demand – though there was (apparently) little or no willingness to concede that the answer to both these problems might be a substantial revaluation of the renminbi.

As for the Chinese economy itself, the big surprise of the last week was the announcement of a US$7.3 billion trade deficit in February – the first deficit since March 2010, and much bigger than expected. This may have been a statistical anomaly based on the Lunar New Year – and it seems to conflict with the message of US data (which showed a 12.5% increase in the bilateral surplus to US$23.3 billion in January). But it is being interpreted – cautiously – as good news. There are also one or two signs that the growth rate is, in any case, starting to level off. The official PMI, for instance, fell slightly in February, from 52.9 to 52.2, while the (unofficial) HSBC PMI eased to a seven-month low of 51.7.

Probably the most encouraging news of all out of China this week is that the top FX officials have apparently agreed to participate in an important seminar on currencies that has been organised for later this month in Nanjing by France, as part of its G20 Presidency. This high-level meeting will be presided over by French Finance Minister Lagarde, and will include among key participants Trichet and DS-K – as well as German Finance Minister Schauble and Russian Finance Minister Kudrin. It seems impossible that China will be able to avoid criticism over its policy on the renminbi.

Finally, the US has just appointed a new Ambassador to Beijing (to replace Jon Huntsman, who is still thinking about running for the Republican Presidential nomination). He is the current Commerce Secretary, Gary Locke (61) – a former Governor of Washington State, and (despite the name) a prominent Chinese-America.

VII **FOREIGN EXCHANGE MARKET DEVELOPMENTS**

Today's Japanese earthquake might have been expected to undermine the yen – in that it will (presumably) lead to further fiscal and monetary looseness and will stop the government from doing anything about the parlous state of public finances. In fact, however, the initial reaction of the market has been to buy the yen – and to buy

it quite hard, pushing it up from Y83.1/US$ at the close yesterday to Y81.89 (a rise of 1.4%), and from Y114.6/E to Y113.63 (0.85%).

Prior to that, the yen had actually weakened against both the dollar and the euro, falling from Y81.7/US$ on February 25 to Y83.1 yesterday and from Y112.4/€ to Y114.6.

All in all, over the last two weeks, the euro has probably proved more of a safe haven than the dollar – which is unusual. At the close on February 25, it was trading at US$1.376/€; by the close last Friday, it had hit US$1.399. Even though it has since eased to US$1.388, it is still up around 0.8%. As the *WSJ* put it, 'the euro, not the dollar, is the knee-jerk safe haven' – and it has undoubtedly got support from the tough line being taken by the ECB on interest rates (and conversely by the Fed's much softer line). Indeed, by the beginning of this week, the dollar was at a four month low against the euro, and the CME was reporting record bets against the dollar – which was most unusual particularly given the concerns about oil and the possibility of capital flight from the Middle East. To some extent, that changed on Wednesday, when it became clear that peripheral eurozone economies were once again in trouble – and after Spain's downgrade. But, for the most part, ECB hawkishness has managed to offset concerns about eurozone stability – at least so far.

VIII OIL

Obviously, it has been an important couple of weeks in the oil market - though, as we have emphasised before, the wonder is not that prices are so high, it is that they have not gone even higher. Given the way that oil markets have been driven by speculative trading, it would have been easy to envisage Brent in particular hitting new all-time highs of US$150 or more. Instead, looking at the last two weeks as a whole, prices for front-month marker crudes are up – but only by around 2.4% for WTI and 2% for Brent:

- WTI: On February 25, April WTI closed up 60 cents on the day, at US$97.88 a barrel. It then fell back to US$96.97 on Monday, before

jumping to US$102.23 on Wednesday – despite a report that US oil output was at an eight-year high in 2010, averaging 7.51 million b/d. By the beginning of this week, WTI was trading at US$105.44, and there were reports of hedge funds moving in. It was said that call options on WTI at US$150 by June had risen 40% in the previous week to 32 million barrels. That, however, seems to have been the peak. Despite the uncertainties associated with Japan, WTI is currently trading at US$101.30 – down US$1.40 for the day.

- Brent: The pattern for Brent has been similar – which is even more surprising given the global shortage of light, sweet crude caused by disruption to Liyan supplies. It closed on February 25 at US$112.14 a barrel, hit a high of US$16.35 on Wednesday, and then eased back to close at US$115.43 yesterday. Today, following the disruption in Japan, it has fallen further, to US$114.51.

What is going on? One factor is clearly that the market is taking seriously pledges by OPEC (and by Saudi Arabia in particular) to make good any shortfall. Crudes are not homogenous, and Arab Light is not a perfect substitute for the hole left by 1.2 million barrels of Libyan oil, but it helps – as does Nigeria's pledge to increase output of Bonny Light and Kuwait's increased production. Another factor is that some of the steam has been coming out of commodity markets more generally this week. Copper, for instance, hit a two-month low yesterday, and gold seems to have plateaued.

That said, the situation remains delicate – particularly following yesterday's bombing of Libya's big oil terminal at Es Sider, the first significant attack on a major oil installation. There was also a report yesterday that China's oil imports rose to 5.2 million b/d in February – up from 5.13 million in January. That is significant because China is a major purchaser of Libyan oil (taking about 11% of its exports, well below Italy, which takes 28%, and France, which takes 15%.

Under these circumstances, it is no surprise that analysts are still raising their short-term price forecasts. The US EIA, for instance, is now looking at an average price of US$105 a barrel for WTI this year, up from US$91 last month. Goldman Sachs has

also increased its forecast to an average price for Brent in 2011 of US$ 105 and US$99 for WTI – perhaps on the low side, given that it has also queried whether Saudi Arabia really has enough spare capacity to keep the market satisfied.

IX BANKING

On Wednesday, the IMF released a staff report complaining of slow government response on the restructuring of the global financial industry. It noted that the fiscal and monetary response to the crisis had been quick – but restructuring of the banks remains very slow. As a result, it said, 'confidence in financial systems is still highly dependent on explicit and implicit central bank and government support'.

That complaint is also at the core of a series of highly controversial interventions made over the last few weeks by the Governor of the BofE, Mervyn King (who, not coincidently, will become the UK's top financial regulator later this year, when the FSA is formally reabsorbed back into the Bank). Last Saturday, for instance, he published an interview in which he claimed that banks are still trying 'to make money out of gullible or unsuspecting customers', and argued that the only way to stop this is a fundamental restructuring of the banking industry to split commercial/retail activities from investment/trading business.

This is extremely contentious - not least in Britain. King appears to be trying to affect the recommendations of the Independent Commission on Banking, chaired by John Vickers, which is to decide whether new limits are to be put on the activities of UK banks.

King is probably right, in that there is plenty of evidence that, if banks are not forced to restructure, they will almost certainly game the system – and to co-opt their regulators.

That is well illustrated by the latest, much-publicised 'stress test' parameters that have been set by the new EBA for European banks. Last year's stress tests were widely considered a bit of a joke – and most (not all) observers seem to feel the

same about this year's attempt. The key elements that banks will have to model include:

- a 15% fall in equity values (compared with 20% in 2010) - but with no commodity price shock and no mention of commercial property;
- a 0.5% drop in eurozone GDP; and
- a 125 basis point rise in banks' average cost of funds.

There will also be an assumed 'haircut' on the value of banks' sovereign debt holdings – 19.8% for Portuguese bonds, 19.1% for Ireland, 17.1% for Greece (less than in 2010), 14.6% for Spain and 13.1% for Italy.

Maybe one is too cynical, but these look like tests that have been designed to ensure that no significant institution fails.

Regards

GISE