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WEEKLY ECONOMIC AND MONETARY REPORT

15 April 2011

It has been a week of competing international meetings – the BRICS in China, the G7 and G20 in the margins of the Spring Meetings (of the IMF and World Bank) in Washington. No significant progress seems likely to be (or to have been) made at any – and, indeed, there appears to be a backlash developing, especially against the G20. It has been widely noted, in particular, that no progress has been made since the 2009 G20 Summit in Pittsburgh on either of the two key issues that were identified at that time – the US deficit and the Chinese surplus.

In any case, the most dangerous problems are (for once) regional or national, rather than global. They are:

- the growing probability that the Greek debt crisis will blow up again; and
- the increasingly vituperative debate in the US over fiscal policy – which has now shifted from the FY2010-11 budget to the FY2011-12 budget and the need to raise the Federal debt limit.

Plus, as we have noted before, there are important political developments this weekend – including Parliamentary elections in Finland (that could derail any attempt at a further bailout of Greece or Portugal) and Presidential elections in Nigeria (which could exacerbate North-South and Muslim-Christian hostility).

I WASHINGTON MEETINGS

As usual, the IMF published several reports ahead of the Spring Meetings:

- The *World Economic Outlook*: The Fund's short-term GDP forecasts are generally a bit lower than last October, but the degree of certainty which the IMF attaches to them has increased:

IMF: GDP Forecasts

	2011	2012
US	2.8%	2.9%
UK	1.7%	2.3%
Eurozone	1.6%	1.8%
Japan	1.4%	2.1%
China	9.6%	9.5%
MENA	4.1%	4.2%
Emerging markets	6.5%	6.5%
World	4.4%	4.5%

According to the WEO, there are encouraging signs that food prices are moderating. However, big risks remain. In particular, rich countries need to produce more credible plans for fiscal consolidation. In addition, the Fund warns of a possible oil price spike to US $150 a barrel or more, and of an escalation in the sovereign debt crisis to 'core' economies (notably the US).

- *Fiscal Monitor*: This took particular aim at the US – which was criticised by the IMF as the only major country (other than Japan) that will increase its underlying fiscal deficit in 2011. By 2016, the Fund says, the US and Japan will be the only countries with a rising public debt: "It is important that the US undertakes fiscal adjustment sooner rather than later."

Other than that, concrete achievements at the Spring Meetings seem to have been few. However, IFC did announce a new US $2 billion 'skills initiative' aimed at boosting the employability of young people in the Arab world, where youth unemployment is now averaging over 25%.

As noted, G7 and G20 Finance Ministers and central bankers are also meeting in Washington today.

To some extent, the G20 meeting has been upstaged by the BRICS Summit (see below), and by a general feeling that the G20 itself has become bogged down. (As the *FT* put it, "why persevere with the circus?".) The most that can be expected is agreement on technical methods to measure global imbalances, so that a more substantial discussion can be held in Cannes, France next November.

II **BRICS SUMMIT**

This meeting, held on the Southern Chinese island of Hainan, was the first BRICS meeting to include South Africa. Although the Chinese were very careful to ensure that the undervaluation of the renminbi was not on the agenda (indeed, Vice-minister Li Yong insisted that concerns about the exchange rate were "another political tool… to contain Chinese economic development"), there were several significant areas of agreement:

- It was agreed that there should be less dependence on the US dollar, and that what the world needs is a "broad-based international reserve currency" – perhaps based on the SDR. (There appears to have been some discussion on whether the renminbi should be added to the SDR basket.)
- There should be tougher regulation of commodity derivatives, so as to reduce the volatility of food and energy prices. (It is now a common complaint that speculators are driving all commodity markets.)
- "More attention" should be given to controlling the damage done by "massive" cross-border capital flows.

To reinforce its attack on the dollar, the group announced that it would set up a series of mutual credit lines in national currencies. China's contribution is to be RMB 10 billion; Russia pledged US $500 million in rouble equivalent.

III **EUROZONE CRISIS**

It has been a bad week for the eurozone – and there is a sense that the 'endgame' for the Europe's sovereign debt crisis is getting closer.

It began with a blow from outside the eurozone itself.

Over the weekend, Icelandic voters refused – for the second time – to endorse their government's pledge to repay the €4 billion that the British and Dutch had spent to bail out depositors in failed Icelandic banks. The first vote was 93/7; this time it was 60/40 – largely because the terms on offer this time were less onerous. The UK and The Netherlands will now take Iceland to the EFTA Court in Luxembourg and thence to the European Court; in the meantime, Iceland's application to join the EU is blocked. Nevertheless, the Icelandic economy has started to grow again, the banking system has unfrozen, and there is a strong feeling that Iceland did the right thing in forcing its creditors to take a hit.

The next issue was the <u>Portuguese €80 billion bailout package</u> – currently being negotiated jointly with the IMF, with a target date of May 16 (in time to meet June 15 redemptions).

The main problem here is that there is no government to negotiate with. Moreover, as the IMF made clear, Portugal is the only developed country that is expected to suffer a recession next year. It is projecting a 1.5% fall in GDP this year, and a 0.5% drop in 2012. Nevertheless, talks are continuing.

<u>A more immediate issue is Greece</u>. On Wednesday, German Finance Minster Schauble warned that Greece may need to take "further steps" to deal with its debt problem. What those 'further steps' might be became clearer on Thursday, when *Die Zeit* carried a story saying Greece needed to get rid of 40-50% of its debt to ensure viability. The result was a sharp increase in Greece's funding costs. Yesterday, Greece's two-year paper was yielding 17.8%, while 10-year paper hit a record 13.3%. (In comparison, Portugal's 10-year Notes were yielding 8.9%, also a record.) In addition, Greek CDS cover hit 1,139 basis points – implying a 65% chance of a default within five years.

FM Papaconstantinou is to present preliminary plans to Parliament today, on how Greece is to cut its deficit by at least €23 billion over the next three years. More detail will apparently be given after Easter; in the meantime, the markets seem likely to move further against the government. Technically, Greece is fully-funded through the rest of this year – though it has to sell €25-30 billion of long-term debt in 2012. However, the current consensus is that the crisis is likely to come to a head before then. Unfortunately, if it does, there are wider implications. If, for instance, Greece does impose a 'haircut' on holders of its sovereign bonds, it will become a lot harder for the Basel Committee to maintain the fiction that such bonds should be zero-weighted for bank capital purposes.

And don't forget Ireland... Although the new Fine Gael government has been careful not to threaten default, it is also utterly unwilling to increase its 12.5% corporate tax rate – which France and Germany are demanding as the price for giving it the interest rate reduction on the bail-out funds that it is demanding. The result is a stand-off – reflected in a decision by Moody's to cut its sovereign debt rating by another two notches, from Baa1 to Baa3, the lowest investment grade.

So far, the only good news concerns Spain. On Wednesday, the IMF's *Global Financial Stability Report* concluded that Spain is a "completely different case" from the other PIGS, and that it has "decoupled" from the rest of the eurozone's periphery. That was reinforced by a pledge from China to continue to buy Spanish debt – though it was partially undermined yesterday when the head of IFO (the German think-tank) warned that the eurozone crisis could still spread to Spain.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

There are two related sub-texts this week. One is the continued concern about inflation – reflected in the increasing propensity of central banks (in emerging markets, as well as in the developed world) to push up interest rates. In recent weeks, for instance, South Korea, Brazil and Chile have all raised rates – and China is expected to do so again soon. The other is the continuing disruption to global supply chains caused by the

Japanese earthquake/tsunami; both Toyota and Ford announced that they were shutting automobile assembly plants this week as a result of the disruption.

A **<u>THE US</u>**: It is hard to know what to make of the <u>budget battle</u>.

As noted, last Friday, the Administration and Congress hammered out a US $38.5 billion package of spending cuts that kept the government operating and permitted final approval of the FY2010/11 budget deal. That was progress – of a sort. However, it is fairly trivial given the size of the deficit, and given the fact that US $112 billion in Bush-era tax cuts (primarily to 'the rich') are due to expire at the end of the year. The fight now shifts:

- to the FY2011-12 budget (the first Congressional vote on which is due today); and
- the US $14.3 trillion Federal debt ceiling, which must be increased before it is due to be breached around May 16.

There is a great deal of political posturing involved in all this – and almost always, a deal is cobbled together in the end (as it was last week). The problem is that, this time, there are three parties involved – the Democrats and the White House (who are promoting a 12-year plan to bring the deficit down to 2.5% of GDP, that is made up 3:1 of spending cuts and tax increases), moderate Republicans (led by the House Speaker, John Boehner, who would probably go along with Obama) and the more radical 'tea party' (currently led by Rep. Paul Ryan, who is demanding huge changes to US healthcare spending). The "tea-partiers" are threatening to push the US into default – and Treasury Secretary Geithner, for one, seems to be taking the threat seriously. He has been doing the rounds this week, warning Wall St. that – if the 'tea party' got its way – the US could easily face the same problems as Greece.

It won't happen – but markets do expect negotiations on the FY 2011/12 budget and the debt ceiling to go to the wire.

In the meantime, the 'big guns' on the Fed Board continue to be more 'doveish'. Vice-chairman Yellen, for instance, emphasised this week that the inflationary impact of commodity prices is expected to be 'transitory' (and got some support from Goldman Sachs, which urged investors to book profits now, since the commodity sector is due for a fall). NY Fed President Dudley also predicted 'excess slack' in the US labour market through the end of 2012, and two other Governors – Elizabeth Duke and Daniel Tarullo – emphasised that there is no sign of inflation spreading.

There is some evidence for their position. In particular, it was reported this week:

- that retail sales rose a lower than expected 0.4% in March, the weakest rise since June; and
- that first time jobless claims rose 27,000 in the latest week, much more than expected.

On the other hand, the Fed's own 'Beige Book' survey saw business conditions improving in all 12 districts, although real estate and construction are still lagging. In addition, the Empire State (NY) business index jumped in April from 17.5 to 21.7, industrial production rose 0.8% last month, and the preliminary reading for this month's Michigan confidence index jumped from 67.5 to 69.6.

Perhaps of more concern to the Fed *ought* to be US inflation data. This week, it was reported that producer prices rose 0.7% in March and that consumer prices rose 0.5%. What probably gives the Fed some room to ease further is that 'core' CPI rose just 0.1%. However, it is also worth noting that monthly TIC data (overseas purchases of Treasury securities) saw net flows fall in February from US $51.1 billion to US $26.9 billion – a warning shot, given Washington's need to cover its deficit in the markets.

Despite that, it is significant that the yield on the 10-year Treasury benchmark has fallen this week from 3.58% to 3.46% - suggesting that US paper is still a safe haven for foreign investors.

B **EUROPE**: While the Fed's 'big guns' have been doveish, the ECB's equivalents have been more hawkish – with Mario Draghi, Yves Mersch, Axel Weber and (new boy) Luc Coene all talking tough this week on the threat of inflation. That was also picked up in the ECB's *Monthly Bulletin* – and, indeed, it was subsequently reported that eurozone inflation in March had been revised up from 2.6% to 2.7%. (For the EU-27, it is now over 3%.)

That's probably OK for Germany. Although it was reported this week that the ZEW investor confidence index had (surprisingly) fallen in April from 14.1 to 7.7, it was also reported that exports rebounded in February and that industrial production was strong last month. There is also a case for higher in Italy – at least on the grounds of inflation, which hit 2.8% in March, the highest rate since October 2008. France can also live with higher rates; indeed, the OECD increased its GDP growth forecast this week from 1.6% to 2.0% - suggesting a strong recovery.

What about the UK?

Inflation remains a problem in Britain – even though the CPI fell unexpectedly from 4.4% to 4.0% last month. MPC 'hawk' Andrew Sentance has warned that the weakness of sterling means that inflation will almost certainly go over 5%. That means higher interest rates – probably sooner, rather than later. The problem is that the tax rises and spending cuts that came in with the new fiscal year are bound to hit activity. Retail sales, in particular, were already falling – according to the BDO High St. tracker they were down 1.2% year-on-year in the five weeks to April 3, and according to the BRC *Monthly Report* they were off 1.9% in March. True, unemployment fell slightly in the November-February quarter, but there is every reason to believe the next few months will be tough.

Under these circumstances, it is no surprise that most European equity markets are down this week – though bond markets are also benefitting from 'safe haven' status. The 10-year UK gilt, for instance, has seen rates fall from 3.82% to 3.66%, while the equivalent *bund* yield has fallen from 3.48% to 3.43%.

C **JAPAN**: PM Kan is having a tough time. His DPJ did poorly in regional elections over the weekend, with the opposition LDP picking up support. This was followed by another serious earthquake aftershock in Tokyo, rating 7.1, and by the upgrading of the Fukushima disaster to a category 7 event – on the same level as Chernobyl.

That has focused attention on the plant's operator, TEPCO – which seems unlikely to survive as a private sector entity. The problem is that TEPCO supplies 29% of Japan's electricity. At the present time, 13 of its 17 nuclear reactors are off-line, as are half of its 20 oil-fired plants and both its coal-fired generators. As a result, the government is expected to limit power use this summer to three-quarters of last year – which will have a huge impact on Japanese industry.

No surprise, therefore, that last Friday's 'econowatchers' survey showed a record fall last month – from 48.4 to 27.7, its lowest level since early 2009. No surprise, either, that the Reuters *Tankan* survey for April fell from +15 to -13 – having been in positive territory for the previous year. Equally, no surprise that the Nikkei-225 fell another 1.8% this week, to close at just 9,592.

C **CHINA**: One of the reasons for the Nikkei's fall is a pick-up in China's inflation rate, to 5.4% in March – which seems certain to prompt another interest rate increase.

The problem is that, so far, higher interest rates have had little or no impact. Housing sales, for instance, were up 26% year-on-year by value in the first quarter, and it has just been reported that first quarter GDP growth was at a 9.7% rate – even higher than the 9.4% that had been expected. On top of that, China's foreign exchange reserves rose US $197 billion, and are now a record US $3.045 trillion. From the point of view of the global economy, just about the only 'good' news is that China had a trade deficit of US $1.02 billion in the first quarter – its first quarterly deficit since 2004. That said, exports surged in March – and the expectation is that the second quarter will show a substantial surplus.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

Today's strong US industrial production number has given the dollar a modest boost, and it now appears likely to end the week more or less unchanged against most other major currencies – albeit sharply down against the Japanese yen. However, it is worth emphasising that, on a trade-weighted basis, the dollar is still close to a 15-month low – primarily because of the belief that the Fed is taking a softer line on monetary policy than other central banks:

- US $/euro: At the close last week, the euro was trading at US $1.443 – having strengthened from US $1.415 the previous Monday. It hit a high of US $1.45 on Wednesday, ahead of Obama's pledge to tackle the US deficit – but has since fallen back to US $1.441, essentially unchanged for the week. The main factor holding down the euro would appear to be the Irish downgrade and the growing fear of a Greek default.
- US $/sterling: The pound closed last week at US $1.638 – up from US $1.603 the previous Monday. It fell as low as US $1.626 on Tuesday, but has since recovered to US $1.633 – down just 0.3%, primarily (it would appear) because of the unexpected fall in UK inflation, which has given some ammunition to MPC 'doves'.
- Yen/US $: The dollar closed last week at Y86.0/US $ - up from Y84.35 over the week. The yen has generally had a strong week, despite talk of a resurgent 'carry trade'. It firmed to Y83.6/US $ on Tuesday, and has since strengthened further. It is currently trading at Y83.1 – up 3.4% for the week.

One (not altogether convincing) reason for the yen's strength is said to be the knock-on effect of higher inflation in China.

The dollar has also been broadly unchanged against the commodity currencies. It is flat for the week against the Australian dollar, and up 0.8% against the Canadian dollar. It has also strengthened 1.3% against the New Zealand dollar. It has, however, fallen against the Swiss franc by 1.9%, from SF0.911/US $ to SF0.894 – which probably reflects the continuing rise in the gold price. Gold has risen this week from US $1,469-50/oz to US $1,475-20 – or by 0.4%.

VI OIL

It has been another big week in oil markets – though prices of both marker crudes are down week-on-week:

- WTI: At the close last Friday, WTI for May delivery was trading at US $112.79 a barrel – up US $4.85 week on week. It was also trading at a discount of US $13.86 to front-month Brent – reflecting both the fact that the Brent market is more susceptible to developments in North Africa and the oversupply situation in the domestic US market. This week, that oversupply situation has worsened. US crude inventories rose 1.63 million barrels in the latest week, to 359.3 million, and stocks at Cushing are now at a record 42 million barrels. No surprise, therefore, that prices have eased. May WTI hit a low of US $106.25 on Tuesday, and is currently trading at US $107.77 – down 4.5% for the week. This is WTI's first weekly fall in a month.
- Brent: As noted, the Brent market is more vulnerable to developments in the Middle East and North Africa – even though it is not a perfect substitute for Libyan crude. At the close last Friday, Brent for May delivery was trading at US $126.65 a barrel, having risen US $7.95 over the week. It, too, fell sharply on Monday and Tuesday, closing at US $120.92. The May contract expired on Thursday at US $122.36, with the June contract taking over at US $122.00.

June Brent is currently trading at US $121.73 – down 3.95% for the week. This means that Brent's front-month premium over WTI is virtually unchanged, at US $13.96.

What is interesting, however, is the price curves for the two marker crudes.

Brent is now in backwardation, with May 2012 around US $4.50 more expensive than prompt crude. WTI is broadly flat. This suggests:

- that markets are still unconvinced that the situation in the Middle East and North Africa is under control; and
- that the situation at Cushing is still a drag on the US market.

There are, however, a number of other factors in the market.

One is a sell recommendation issued by Goldman Sachs at the beginning of the week – largely because it claims to see "nascent signs of oil demand destruction" in the US as a result of higher prices (gasoline is currently selling for an average of US $3.79/US gallon). Another is a new oil demand forecast from OPEC which foresees average demand growth this year of 1.39 million b/d – down from 1.44 million last month.

On the other hand, <u>there are still concerns about Nigeria</u>. Last weekend's Parliamentary elections passed off quite smoothly, but this weekend's Presidential elections could be more divisive – particularly if the incumbent (and favourite) Goodluck Jonathan does not win a majority. Jonathan is from the oil-producing Niger delta region, and there could be serious unrest if he is beaten by the Northern (Muslim) candidate, the former President Muhammadu Buhari.

In addition, there have been claims this week (*inter alia*, by the IEA) that Saudi Arabia 'throttled back' its oil production in mid-March by 300-500,000 b/d – apparently because it didn't have enough buyers. If true, that will tend to underpin prices gong forward.

Coupled with strong growth in China, the consensus is still for higher prices – with Brent hitting US $130 over the next couple of weeks.

VII BANKING

A THE VICKERS COMMISSION: The main story of the week is probably release of its Interim Report by the UK's Independent Banking Commission.

The reason for this is that – just as London is the principal global centre for wholesale financial services – the UK was (and arguably still is) 'best in breed' as far as financial regulation is concerned. Hence the worldwide interest in whether the IBC would base its recommendations for the future of UK banking on:

- more capital and more (micro and macro-) prudential regulation; or
- structural changes to make the entire banking system safer.

In the end, the Commission bottled out. Its main recommendations are:

- that the retail operations of UK banks should be 'ring-fenced' from their wholesale and market operations;
- that retail banks should maintain a 'core Tier 1' capital base of at least 10% of risk-weighted assets; and
- that debt incurred by the banks must be 'loss absorbing' – ie that bondholders must not expect to escape in the event of bank resolution.

In addition, it recommends that Lloyds Banking Group (the biggest UK retail bank) be forced to sell more of its branches to increase competition on the UK High St.

The problem with the report (which, after all, is only an interim document) is that it doesn't define 'ring-fencing', it doesn't explain how firewalls between the retail and investment banks will operate, and it doesn't deal with the problems of EU banks operating in the UK as branches. Nevertheless, it has already provoked a lively debate about bank regulation – not just in the UK.

B EUROPEAN BANK STRESS TESTS: Last Friday, the (new) European Banking Authority released details of the latest stress tests that the top 90 European banks will have to pass. (Of these banks, 24 are Spanish, 13 are German, and six are Greek.) the key parameters are:

- a 0.75 percentage point rise in interest rates on sovereign bonds;
- a 1.25 point increase in short-term borrowing costs;
- a 0.5% fall in eurozone GDP; and
- a 15% fall in European stock markets.

Banks will also be required to maintain a 'core Tier 1' capital ratio of 5%. However – and this is the point that cynics have already jumped on – banks will not have to acknowledge any losses on sovereign bonds that are held in the banking book (which is where about 60-70% of bonds from the so-called PIGS are supposed to be).

C US SENATE ATTACK ON GOLDMAN: Sen. Carl Levin, chairman of the Permanent Sub-committee on Investigations, published the results of a two-year inquiry into the financial crisis this week – and kicked up a storm by alleging that Goldman Sachs (and Deutsche Bank) had violated US securities law by selling CDOs without informing buyers that it had short positions against those same securities. Levin and his Republican opposite number, Tom Coburn, have urged the Department of Justice and the SEC to follow up.

VIII NEXT WEEK

As noted, there are important elections in both Nigeria and Finland this weekend. In the latter case, what concerns Europe is that the so-called "True Finn" party has a 50/50 chance of ending up in a coalition government – and that its main election pledge is to block any further bailouts to Greece, Portugal or Ireland.

As far as US economic releases are concerned, the ones to watch next week are:

- leading economic indicators for March;
- the Philadelphia Fed index for April; and
- existing home sales for March.

Elsewhere, the key releases are:

- eurozone consumer confidence for April; and
- Japanese consumer confidence for March.

Friday is a holiday in the US and Europe. We will, therefore, submit our report on Thursday.

Regards,
GISE