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WEEKLY ECONOMIC AND MONETARY REPORT

5 February 2010

This has been one of the scariest weeks since the height of the financial crisis a year or so ago. In particular, fears about Greece have mushroomed into much broader fears about a sovereign debt crisis. US markets have suddenly started to wonder whether the eurozone can actually hold together (it almost certainly can, and will). Plus, there are new and more general doubts about economic recovery – not least in the US. There have even been doubts about the sustainability of the Chinese economic miracle. The result has been a broad-based sell-off in equity markets, and a flight into the (relative) safe-haven of the US dollar. There are also increasingly public concerns about bond markets, given the huge budget deficits that major economies have accumulated as they have tried to spend their way out of recession. Whether that spending has worked is now being debated; but what is inescapable is that it has left a legacy that will weigh on public finances and on growth for years to come.

I WORLD ECONOMIC FORUM

What were the main themes to come out of Davos this year?

That is a harder question than usual to answer. Apparently, 80% or more of the discussion revolved around banking reform, but much of it was dismissed as "displacement activity". Indeed, the general feeling among journalists at the WEF was that high-profile bankers simply "didn't get it" – they really couldn't understand the level of popular support for the so-called "Volcker rule", or for bashing the banks more generally. True, Deutsche Bank's Josef Ackermann proposed a global bank wind-down fund (to be financed, "to a large degree", by the industry itself). But even that seemed to be self-serving in that it appeared to be intended only to get the regulators off the banks' backs.

No surprise, therefore, that there was apparently no meeting of minds in a closed-door session that top bankers had with financial regulators in Davos. The strong

feeling remains that the bankers are moving too slowly – and only with great reluctance.

Other points that came out at the WEF:

- There appears to be a widening split in approaches to financial regulation between the US and Europe. This is potentially very dangerous since it could end up unravelling much of the work done by the Basel Committee and by other international agencies.
- This year's meeting continued a trend that has been evident for some time – the rise of China as a global player. Beijing's denial of basic human rights is now being seen increasingly as less important than its 'decisive' and 'meritocratic' governance structure, and the success of its brand of "state capitalism". The converse of this is that Europe seems increasingly marginalized – an impression that has subsequently been confirmed with Obama's decision not to accept an invitation to attend the Madrid Summit of EU leaders in May.
- Sarkozy's opening speech raised the possibility of Europe supporting its economic model by recourse to protectionism. Fortunately, this wasn't followed up – but there is no doubt where French sympathies lie.

One disappointment (at least for the organizers) was the low level of US participation. The only invitee who was authorized to speak for the Obama Administration was Larry Summers, which meant that there was (for instance) no strong defence of the Administration's proposals on bank reform (about which Summers is known to be sceptical).

II BANKING

A THE VOLCKER RULE: The best defence of the Administration's plans came from Paul Volcker himself. Writing this week in the *New York Times*, he offered a condensed version of his earlier testimony to Congress. His basic message was clear. In his view, "adding further layers of risk to the inherent risks of essential commercial banking functions doesn't make sense".

This means, he said, that ownership or sponsorship by commercial banks of hedge funds and private equity funds should be prohibited. It also means that proprietary trading should be tightly restricted.

In his view, that will have little impact on positive aspects of financial innovation. There are lots of independent funds, very few of which are 'too big to fail'. That said, Volcker acknowledged that "what we do need is protection against the outliers" – which means that there must be "authority by a relevant supervisory agency to limit (the) capital and leverage" employed by 'shadow' banking institutions. In addition, there must be a new 'resolution authority', authorized to intervene if any systemically-important institution is on the brink of failure. That appears to include support for the (impractical) British idea of a 'living will' for banks.

The key point in Volcker's proposals is that, in the event of failure, "stockholders and management will not be protected".

He also proposed that the Fed should be "charged with reviewing and appraising market developments" – something that is crucially important in fast-changing markets.

Volcker's proposals have wide popular appeal. However, the US bank lobby is now pouring huge amounts of resources into opposing them – and it is significant that Sen. Shelby (ranking Republican on the Senate Banking Committee) attacked Volcker strongly when he testified. In addition, the Europeans are generally cool on structural change to the banking industry. Bizarrely, it appears that the Obama Administration is far more radical on banking reform that most American lobby groups – and far more so than European governments.

B **BANK OF AMERICA:** Another bizarre development this week was the civil fraud complaint that has been filed by the NY State Attorney-General, Andrew Cuomo, against Bank of America, its former Chairman/CEO Ken Lewis, and two other senior executives. The suit (filed under NY's Martin Act) alleges that BofA

"intentionally failed to disclose" more than US$16 billion in losses which were hidden in Merrill Lynch's books – which, if disclosed, would probably have derailed BofA's takeover of Merrill. The 90-page indictment accuses Lewis of an "arrogant scheme…to deceive shareholders".

Of course, by buying Merrill, BofA was also doing the US Treasury's bidding, which complicates the case substantially.

III THE "CLUB MED" CRISIS

What started as a little local problem in one of the smallest of the eurozone member-states has spread like a brush-fire. It now threatens to engulf Portugal – and two leading US economists (Nouriel Roubini and Paul Krugman) have both warned this week that Spain could be next. Fears that the crisis could lead to the collapse of the euro and to the break-up of the eurozone mean that the furore over Greece is the main reason that global stock markets plunged on Wednesday and Thursday – led by Southern European markets.

This is almost certainly over-the-top. However, while Europeans generally believe that the political commitment to hold the eurozone together is sufficient to overcome the crisis, Americans tend to see the eurozone as overwhelmingly an economic construction – and they, therefore, assume that 'basket-cases' (like Greece and Portugal) will eventually have no choice but to exit, so that they can regain the ability to devalue their way out of their economic problems.

Certainly, looking at Greece's economic and financial situation, things seem pretty bleak – and, with farmers and public sector workers both planning a series of strikes, there just isn't the domestic political will to absorb the pain that is implied by the government's commitment to drive the budget deficit down from 13% of GDP (or more) to 3%. Reflecting this, Greek CDS protection rose 24 yesterday to 415 (which means US$415,000 a year to protect US$10 million for five years) – pulling Portugal and Spain behind it. (Portuguese CDS protection rose 32 to a record 226, while Spain was up 17 to 164.)

The numbers are daunting. Aside from the well-known debt ratios, Greece also ran a US$37 billion current account deficit in the 12 months to November, and its cumulative deficit between 2001 and 2008 was around €170 billion. It was also revealed this week that Greece has another €40 billion in "hidden" debt that it had not previously reported to the EU. As a result, the Commission is now opening a legal case against Greece for "failing to provide accurate statistics".

Given that Greece has to refinance around €54 billion this year, it is no wonder that the markets are nervous. It got an €8 billion issue of 5-year bonds away last week – but investors were subsequently hit hard when the government announced another 10-year issue this month. As a result, 10-year yields have hovered between 6.5% and 7.5%, depending on the noises coming out of Frankfurt.

PM Papandreou's strategy has been to blame the crisis, not on government profligacy, but on "speculators" who want to break the euro. That is probably good politics. However, the EU has made it clear that any help it will give (and it will help Greece) is conditional on cuts in "average nominal wages" across the Greek public sector, a rise in the retirement age, increased fuel levies and new luxury taxes. Under Articles 121/122 of the Lisbon Treaty, it also intends to establish a very close monitoring arrangement (which has been described as making Greece a "European Protectorate").

All of that said, however, no one wants to be left holding Greek paper if (as it might) the ECB decides not to accept lower-rated paper as collateral – which means that it may be very difficult for the Greek government to go on attracting buyers for its bonds. That doesn't mean that those who predict a break-up of the eurozone (or, at least, that Greece will quit) are right; the political will to hold the single currency together is still very strong. But there is no sign that the crisis will go away. Indeed, it is likely to continue to spread – to Portugal, and, perhaps, to Spain.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

G7 finance ministers and central bankers are meeting today in Canada – at a remote location just outside the Arctic Circle, on Baffin Island. This bizarre location is

supposed to ensure a friendly, "informal" tone for the discussions. It is probably also intended to draw attention to Canada's strategic role as an Artic power – which could become increasingly important if global warming means more of the region becomes accessible. In fact, it really just emphasises how irrelevant the G7 has become, since the focus of global attention has shifted to the G20. No communiqué is (apparently) to be published – though reports today talk of ministers being badly split on how/whether/when to reverse their policy of monetary easing.

One rumour: There have been reports this week that Dominique Strauss-Kahn may step down from the IMF at the end of this year, so that he can run against Sarkozy for the French Presidency in 2012.

A THE US: Today's much-anticipated employment data for January (the first important economic release for the month) is a mixed bag:

- On the positive side, the unemployment rate fell unexpectedly from 10% to 9.7% (it had been expected to be unchanged).
- On the negative side, total non-farm payrolls (which had been expected to rise 15,000) fell 20,000, and December's fall was revised from 145,000 to 150,000.

The market's initial reaction was fairly positive – even though one reason for the drop in the jobless rate was an increase in long-term unemployment, with more people no longer actively seeking work. An encouraging aspect of the data is that manufacturing employment rose 11,000, the biggest jump since April 2006. Plus, the average work-week increased slightly. However, this optimism may not last. What ought to worry the markets is a fall in state and local government employment; that could be the beginning of major layoffs by tax-strapped communities.

Other than that, this has been a fairly thin week for US economic statistics. The good news has included:

- a 0.4% rise in personal income in December, which was a bit higher than expected;
- a 0.2% rise in personal spending, which was a little lower;

- a rise in the manufacturing ISM (purchasing managers) index for January, from 54.9 to 58.4% (the services index also rose, only marginally);
- a 1.0% rise in pending home sales in December; and
- a 1.0% rise in factory orders in December.

The bad news has included:
- another fall in both car and truck sales last month;
- an unexpected rise of 8,000 in initial jobless claims in the latest week; and
- a 1.2% fall in construction spending in December.

On balance, therefore, the good news probably outweighs the bad – but only just. And not enough to offset wider global concerns. As a result, for the first four trading sessions of the week, the DJIA was off 183 points (1.8%), the S&P500 was down 36 points (3.3%) and the Nasdaq was down 46 points (2.1%). In early trade today, markets were up – which appeared to be a technical response to a sharp jump in the volatility index yesterday. However, that did not last, and the general trend remains bearish.

B EUROPE: Trichet has spent most of this week trying to convince the markets that the eurozone should not be punished for Greece's problems – and, indeed, has tried to suggest (not very successfully) that it is "business as usual". One statistic that he has repeatedly brought out is that the average fiscal deficit in the eurozone this year is 'only' about 6% of GDP – less than half that of Greece or the UK, and much lower than that of the US. As a result, he also indicated that the ECB will bring its current round of monetary easing to a halt soon after the Bank's next MPC meeting on March 4.

Greece's problems are likely to dominate next week's European Summit – which will be chaired by EU President Van Rompuy (who has remained largely invisible since his appointment). Van Rompuy will apparently use Greece's crisis as a reason to push for much tighter cohesion on economic policy – bringing him into inevitable conflict with thte UK (and probably Germany).

As far as eurozone economic releases are concerned, it was reported this week:

- that the eurozone PPI rose 0.1% in January, though it was still down 2.9% year-on-year; and
- that the composite Markit activity index fell from 54.2 to 53.7.

Equities have also fallen across the eurozone. The Xetra Dax, for instance, was down 76 points (1.4%) through Thursday, while the CAC-40 was down 128 points (3.4%). Both are down again today. In general, eurozone economies are continuing their recovery – but it is pretty feeble.

The biggest concern, however, is Spain. Unemployment hit 18.8% in the fourth quarter, and is now over 4 million. Plus, the Zapatero government has had to commit to bringing the budget deficit down from 11.4% of GDP last year to 3% by 2013. As a result, last Friday, it unveiled a €50 billion package of spending cuts. That may keep the ratings agencies happy, but it is unlikely to appease the electorate.

As for the UK, it, too, is torn between the need to ensure that the economy is out of the woods and the fear that the markets will turn against gilts (and sterling).

On Monday, the Treasury issued a policy paper listing the options for major spending cuts – which, given the size of the UK fiscal deficit, are inevitable. On Thursday, the BofE followed this up by announcing that it is "pausing" its policy of Quantitative Easing, having pumped GBP 200 billion into the economy since March by buying Treasury bonds. Now, the issue is whether QE worked; initial verdicts are negative, in that (although GDP growth has turned positive, just) the evidence is that banks hoarded cash rather than lent it out.

In the meantime, the end of QE has raised fears (admittedly, not yet borne out) that UK interest rates will have to rise sharply.

As for the British economy, it was reported this week:

- that broad money (M4) fell 1.1% in December – further evidence that QE did not work as well as expected; and

- that personal insolvencies hit a record in the fourth quarter of last year.

On the other hand, however, both the Nationwide and the Halifax reported that house prices rose in January, although it was also reported that mortgage approvals fell in December (the first drop in 13 months).

C **JAPAN:** Not much good news out of Japan either – where Toyota's problems (it has already had to recall 8.1 million cars, at a total cost of around US$2 billion) have hit suppliers across the country. For the week as a whole, the Nikkei-225 is down 141 points (1.4%), with US$30 billion having been wiped off the value of Toyota alone.

Plus, it was reported that the consumer price index was down 1.2% in December, and that monthly wages were off 6.1% year-on-year – the 19th fall in a row.

The only good news was that the DPJ Secretary-general Ozawa escaped indictment as the result of a political funding scandal. However, several of his aides have been arrested.

D **CHINA:** For the first time in months, there is real concern about the sustainability of Chinese growth. There have been reports that loan defaults are soaring, and stock markets have now fallen for three straight weeks. Plus, the OECD – which published its first report on China for five years this week – has joined those (including Obama) who are urging a revaluation of the renminbi, which Beijing still refuses to consider.

That said, HSBC's manufacturing index for China jumped is January to a new record – at the same time as the official PMI fell from a 20-month high.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Several factors have been working in the dollar's favour this week – notably the crisis of confidence in the eurozone. Even after the Commission endorsed Greece's plan to cut its deficit, the market sold off the euro. In addition:

- sterling was hit by it own debt crisis (and the fear of a ratings downgrade), as well as by fears that neither the ruling Labour party nor the opposition Conservatives will win an overall majority in the general election that is likely to be held in early May; and
- the Swiss franc has been held affected by rumours that the SNB has intervened at least twice this week to push the franc down against the euro.

The yen has been an exception. However, the Australian dollar also fell when the Reserve Bank unexpectedly held interest rates unchanged (after three starlight increases). Other commodity currencies, including the Norwegian krone, followed suit. Against the major currencies, the dollar was up approximately 1.1% for the week on a trade-weighted basis:

- US$/euro: At the close last week, the euro was already trading at a six-month low of US$1.388, having fallen 1.2% over the week. Since then, it has fallen further – dropping to US$1.365 after the US employment data was released. Week-on-week, that is a further rise of 1.7% for the dollar.
- US$/sterling: Last week, the pound fell 1.2% against the dollar, closing at US$1.600. This week, it has fallen a further 2.3%, trading today at US$1.563.
- SF/US$: The Swiss franc closed last week at SF1.006/US$. It is known that the SNB is extremely concerned with the SF/euro rate, and it is believed that it intervened both on Monday and today to hold the franc down. Whatever, it firmed against the dollar to SF1.058 on Monday, but has since eased to SF1.075/US$.

The outlier is the yen. At the close last Friday, it was trading at Y90.46/US$. By Wednesday, it had weakened to Y91.1/US$, but today it is trading around Y89.15 – up 1.4% for the week against the dollar.

V OIL

Last week, Brent for March delivery lost 1.9%, to close at US$71.46 a barrel, while front-month WTI dropped 2.2% to close at US$72.89. The general feeling was that prices were close to key support levels.

As noted, one of the main factors pushing prices down has been general weakness in commodity prices. That has continued this week, with the R/J CRB index down 1.6% this week alone. In addition, it was reported by the EIA that, in the latest week, US crude stocks rose 2.3 million barrels, largely because of a 559,000 b/d increase in imports, which are now running at around 8.43 million b/d.

On the other hand, it was reported on Monday that the CFTC was still long oil. Coupled with strong economic data on both Monday and Tuesday, that pushed WTI up to US$77.23 a barrel and Brent to US$76.06. Since then, however, crude has fallen sharply – and it dropped again today on the employment data. In mid-day trading, March Brent is at US$71.46 - flat week-on-week, but down 6% from its Tuesday close. Meanwhile, March WTI is trading at US$72.95 – up 0.1% for the week, but down 5.5% from Tuesday. It is widely assumed that Saudi Arabia (in particular) and OPEC in general will defend an oil price of US$70, but that is about the only help oil is getting at the present time.

VI NEXT WEEK

As noted, G7 ministers are meeting today in Canada, and there will be an EU Summit in Brussels next week. The second round of Presidential elections in the Ukraine will also take place this weekend; the slight favourite is the pro-Russian candidate, Viktor Yanukovych. However, if he wins, his (relatively) pro-Western opponent, Yulia Tymoshenko, will inevitably cry foul.

As far as US economic releases are concerned, the most significant next week are:

- the trade deficit for December (expected to be around US$35 billion);
- retail sales for January (expected to be up 0.4%); and
- the Michigan sentiment index for February (expected to be up slightly).

Elsewhere, the key releases are probably:

- the economy-watchers survey for January in Japan;
- the BofE's Quarterly Inflation Report;
- the ECB's Monthly Bulletin; and
- eurozone GDP for the fourth quarter of 2009.

Regards,
GISE AG