Αρχείο

WEEKLY ECONOMIC AND MONETARY REPORT

12 February 2010

Once again, the markets have been almost entirely focused on the crisis in the eurozone – specifically, whether the problems of Greece can be contained, or whether they will spill over to Portugal and (in particular) to Spain.

Until yesterday's EU Summit, the consensus was clear: Germany would do whatever was necessary to keep Greece from defaulting – even at the risk of contagion. That is still the most likely outcome. But the Summit was a surprise (and, for the Greeks, a disappointment) in that it produced only a general political declaration of support. No one "wrote a cheque". As a result, and as discussed below, the new consensus is that the problem is far from over.

The implication of that is further pressure on the euro – and (temporarily at least) relief for both the dollar and sterling.

I G7 MEETING

As expected, the G7 Summit in Northern Canada was a very low-key affair – reflecting the sense that the more important talking shop for international issues is now the G20. The only significant decision was the (widely predicted) agreement by G7 governments to cancel Haiti's foreign exchange debt. (However, that does not affect its bilateral debt to non G7 countries, notably Venezuela.)

There was apparently also discussion about the UK's plan to impose a global tax on banks to pay for the cost of the recent bailout. The IMF is to offer a firm proposal on this in April. In addition, attendees pledged to maintain fiscal and monetary stimulus measures in place "as long as necessary". As for Greece, all US Treasury Secretary Geithner said was that the Europeans had assured him that "it could be handled".

II THE "CLUB MED" PROBLEM

As noted, Greece's problems have now become the biggest crisis that the eurozone has faced since it was launched in 1999. It threatens to tear the 16-member currency union apart, pitting the "rich" North (notably Germany) against the poorer Southern states (the so-called PIGS) – who (it is said) have been living beyond their means as the result of unrealistically low interest rates and unconstrained access to capital markets. Last week, the main fear was that Greece's problems would spread to Portugal; this week, the focus is on Spain – which already has a 19% unemployment rate and a PM who (*The Economist* claims) is "out of his depth".

Despite the talk about Spain, the immediate problem remains Greece – which has to roll over €54 billion in foreign debt this year, of which €30 billion falls due by April/May. Ironically, Greece's net foreign liabilities (estimated by Barcap at €208 billion, or 87% of GDP) are lower that those of Portugal (108%) or Spain (91%). But that isn't what the markets have focused on. Instead they are looking at the government deficit as a percentage of GDP (12.7% this year, compared with 11.4% for Spain and 9.5% for the US) – and at the structural problems of the Greek economy. These include massive tax evasion (estimated to cost over €15 billion a year), the most generous welfare system in Europe (retirement at 59, for instance), a bloated public sector (one in three Greeks has a civil service job "for life"), and a public sector that (according to the chief economist of Alpha Bank in Athens) includes "casinos, lotteries, hotels, marinas, ski resorts..." – all of which have a total market value of over €9 billion - plus huge amounts of state-owned real estate.

So far, Greece has promised to cut its fiscal deficit to 8.7% this year, and to below 3% within the next four years. To do this, it has promised to freeze most salaries and pensions, cut salaries (and allowances) for the CEOs of state-owned companies, impose higher fuel taxes and clamp down on tax evasion. It has promised a progress report in March. It has also agreed to reform its statistical agency, and there has been speculation that Lucas Papademos (Vice-chairman of the ECB, who is stepping down in the summer) will be sent to Athens as an economic *gauleiter*, to ensure that the Greeks live up to their promises.

The problem is that very few people really believe that PM Papandreou – a decent man, who was born and grew up in the US - can impose a programme that would be (according to the respected historian, Niall Ferguson), "the most excruciating fiscal squeeze in modern European history". Already, farmers and civil servants (including the all-important tax inspectors) have been on strike. Even though polls show 2/3 support for Papandreou, it is widely expected that – without assistance from the rest of the eurozone – that support will crumble when the Greek electorate really starts to experience the squeeze.

That – plus the fear of contagion – was why most observers were confident that yesterday's EU Summit would lead to a bailout – despite the fact that the Maastricht and Lisbon Treaties make no provision for a rescue. Indeed, there were press reports on Tuesday that German Finance Ministers Schauble had ordered his staff to come up with a rescue plan, and on Wednesday it was reported that the EU itself was finalizing a €20 billion standby. Papandreou then met French President Sarkozy in Paris, apparently to finalize a deal.

In fact, however, the Summit produced nothing more than a "political statement". The EU backed the Greek government (which claims not to have asked for anything more than general support_)– but it made no specific promise of aid. The reason seems to have been that German Chancellor Merkel could not sell a rescue package to her coalition partners – or to the German electorate. (There was even talk that a rescue package would have been challenged in Germany's Constitutional Court.) As *FAZ* put it, a deal would imply that "Germany is meant to take responsibility for Greek debts – that's not how the euro was sold to the Germans".

So, what happens now? The immediate reaction of the markets to the Summit communiqué was to sell the euro and buy the dollar (see below). However, the markets now appear to be having second thoughts. As the *WSJ* put it, "If Berlin guarantees Athens's debt, investors will understandably conclude that the EU stands behind the debt of Italy, Portugal, Spain and the rest" – which means that there would, essentially, have to be a single economic government for Europe. Since the German electorate is clearly not ready for this, support is going to have to be disguised. Nevertheless, no one really doubts that support will be forthcoming if the

crisis gets worse: at this point, Greece will not be allowed to default. Instead, the government will be given time to press ahead with its programme – and perhaps to propose the privatization of state holdings as well. However, the sovereign CDS market will be well worth watching; it is rumoured that there are some big speculative positions betting against Greece.

A couple of other points:

- Greece is far from being alone. Simon Johnson (the former chief economist at the IMF) joined Jim Rogers and Bill Gross this week in warning that the UK could be next.
- The IMF is angling for a role. Although the EU (apparently) sees involvement by the Fund as an admission of weakness, there will be a team of IMF "experts" in Athens to assist EU officials in monitoring Greek performance.
- One potential problem is capital flight. On Tuesday, for instance, it was reported that "wealthy" Greeks had already shifted €7 billion out of Greek banks for fear of capital controls. Given present uncertainty, this would appear to be commonsense.

III BANKING CRISIS

The most significant news item this week was probably an interview that former Fed Chairman Volcker gave to the *FT*, published today. In it, he expounds on what he means by the "Volcker rule". The key takeaway is probably his comment that "the implication for Goldman Sachs or any other institution is 'do you want to be a bank?'". In Volcker's view, any US institution with a banking license should be prohibited from proprietary trading – and the implication of his response is that it would not be possible for Goldman (or Morgan Stanley) to do prop trading, even through a separately-capitalized subsidiary, unless it gave up its banking license.

Elsewhere, it was reported on Tuesday that Hector Sants, chief executive of the UK's FSA, will step down in August. Although the significance of this is being downplayed, it is understood that Sants is unhappy with the Conservative party's plans (should it

win the next election) to fold UK banking regulation back into the BofE – out of which it was taken ten years ago.

Other than that, there continues to be political outrage at the level of executive remuneration at banks that were (directly or indirectly) bailed out by governments on both sides of the Atlantic. Goldman's Lloyd Blankfein appears to have felt he could deflect this by paying himself a bonus of "only" US$9 million (compared with US$68 million in 2007), but – not surprisingly – that didn't impress too many outsiders. (Goldman's overall compensation ratio was 36% of revenues – a historic low, though sky-high by the standards of any other industry.) In comparison, JP Morgan's Jamie Dimon got US$16.6 million and Wells Fargo's John Stumpf got US$18.4 million. Citi's Vikram Pandit, however, was paid only US$1 to reflect the government's continuing stake in the bank.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

The IMF published an interesting staff paper this week, co-authored by its chief economist, Olivier Blanchard, in which it tried to lay out guidelines for macro-economic policy after the crisis. The *WSJ* parodied its message: "The IMF urges more inflation." In fact, it was more nuanced. The main suggestions:

- an increase in central bank inflation targets from around 2% (as now) to around 4%, so as to be able to counter deflationary pressures more effectively;
- automatic lump-sum payments to "the poor" if unemployment goes above a threshold level;
- more active foreign exchange market intervention on behalf of smaller, trade-dependent countries; and
- new regulatory powers for central banks to help smooth economic policy-making.

In the meantime, the OECD's composite leading indicator for December rose from 102.2 to 103.1 – not enough to counter a suspicion that the global economy may be

starting to slow down again (though that may be undermined by today's stronger than expected US economic data).

A **<u>THE US</u>:** Although it has been a thin week for economic releases, most of the news has been a bit better than expected. In particular, it was reported:

- that retail sales rose 0.5% last month, following a drop of 0.1% in December (itself revised from -0.3%), which was substantially better than the 0.3% that had been expected;
- that the index of small business optimum jumped from 88 to 89.3 in January; and
- that first time jobless claims fell a much bigger than expected 43,000 in the latest week.

On the other hand, however, a new (and interesting) indicator points to a downturn in January. The so-called <u>Pulse of Commerce Index</u> – which measures gasoline/diesel purchases by truckers, almost in real time – fell at an annual rate of 36.8% last month, compared with an annualized increase of 7.3% in December. And the preliminary Michigan confidence index for February fell unexpectedly from 74.4 to 73.7.

In addition, the US trade deficit jumped again in December. The markets are still not interested in this statistic (and it is true that the US is having no trouble funding its deficit), but the trade gap widened from US$36.4 billion to US$40.2 billion, thanks to a 4.8% increase in imports. True, the bilateral deficit with China fell 10.3%, but this is not good news. The (surprising) strength of the dollar is clearly a problem for exporters.

The impact of this on the markets has been mixed. On Monday, for instance, the problems of the eurozone affected New York, and the DJIA fell though 10,000 to close at its lowest level since November 4. After that, however, equities bounced back, and at the close on Thursday, the Dow was up 1.3% for the week, the S&P 500 was up 1.1% and the Nasdaq Composite was up 1.5%. Today, however, the news that China has tightened bank reserves again (see below), coupled with concern

about the absence of a firm commitment on Greece, means the DJIA was off 140 points in early trade, with the S&P down 14 points and Nasdaq off 23 points. The yield on the benchmark Treasury 10-year Note has, however, eased to 3.67% - a reflection of the US's role as a safe haven at a time of political and financial uncertainty.

B **EUROPE**: As noted, the EU this week has been obsessed with the Greek problem – which dominated the European Summit, even though the agenda was ostensibly focused on the Union's longer-term strategy. However, it is worth noting that the EU's new (permanent) President, Herman Van Rompuy, did succeed in making the Summit – held in the Bibliotheque Solvay – a more informal affair than usual.

More important, the new Commission was finally approved by the European Parliament (by 488/137 votes) on Tuesday – following months of delay. This means, in particular, that Olli Rehn takes over as Economics Commissioner and that Michel Barnier takes over at the Internal Market. In the meantime, the Commission has just published its estimates of fourth quarter growth for the eurozone. As shown below, with the notable exception of France, there was considerable slippage from the third quarter:

European Commission: eurozone growth

	4/4 2009	3/4 2009
Germany	0.0%	+0.7%
Italy	-0.2%	+0.6%
France	+0.6%	+0.2%
Greece	-0.8%	-0.5%
Eurozone	+0.1%	+0.4%

One warning note: This morning, SocGen's chief strategist (admittedly, a Brit) published a research paper warning that the "eurozone is headed for breakup". It is not (yet) a majority view, but it is becoming an increasingly respectable one.

As far as individual eurozone member states are concerned, there were two German releases of note – both of which ought to cause concern. It was reported:

- that industrial production fell a very sharp 2.6% (seasonally-adjusted) in December; and
- that manufacturing orders also fell, by 2.3%.

Nevertheless, for the week as a whole, the Xetra Dax was up approximately 40 points (0.7%).

Outside the eurozone, the big issue in the UK has been whether the BofE's programme of Quantitative Easing is really over. Last week, the Bank said it would not extend the programme beyond the GBP200 billion already spent; this week, Governor King hinted that it could be restarted. The reason is to be found in the Bank's *Quarterly Inflation Report*, which projects that UK inflation will undershoot the 2% target.

In addition, it was reported this week that UK retail sales were down 0.7% year-on-year in January, which was substantially worse than expected. True, manufacturing output was up sharply, rising 0.9%, while industrial output was up 0.5%. And house prices have continued to firm. But the Bank is clearly worried about deflation.

It ought also to be worried about the trade gap. The deficit on goods and services hit an 11-month high of GBP7.3 billion in December – suggesting that the 25% depreciation of sterling that has taken place since mid-2007 has not had the impact on British export performance that one might have expected.

C **JAPAN:** For the first time in four months, consumer confidence rose in January – with the index improving from 37.6 to 39.

D **CHINA:** Today, China's decision to raise bank reserves by 50 bp – the second time it has done this in the last month – seems to have spooked Western markets. The reason is that Beijing is increasingly concerned about overheating. Indicative of this, it was also reported this week:

- that, in the important province of Eastern Jiangsu, wages have had to be increased by 13% to offset inflation;

- that the 70-city index of house prices was up 9.5% year-on-year in January (compared with 7.8% in December); and
- that factory gate inflation increased from 1.7% to 4.3% last month.

According to the Academy of Science's Centre for Forecasting, if the economy is not cooled down, GDP growth is likely to be 11% in the first quarter. The catch is that, if it does slow down, China's appetite for imports – up 86% year-on-year in December – will crumble.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

Goldman Sachs has just published its latest short-term exchange rate forecast – which, it says, reflects "the risk premium linked to the situation in Greece". Despite that, Goldman still expects the dollar to fall, albeit not by as much as was anticipated last month:

Goldman Sachs: Short-term FX projections

	3 month	6 month	12 month
US$/euro	1.45	1.45	1.35
US$/GBP	1.73	1.73	1.61
Y/US$	92.0	94.0	98.0
SF/US$	1.01	1.01	1.11
Can$/US$	1.00	1.00	1.08

It is worth noting that Goldman anticipates a short-term weakening of the dollar, followed by a significant strengthening in the second half of the year.

This week, however, the dollar has confounded Goldman by continuing its recent appreciation – albeit at a more modest rate:

- US$/euro: At the close last week, the euro was trading at US$1.367, with the euro under pressure as a result of Greece's problems. By Tuesday, it had strengthened to US$1.378 as a bailout seemed near. Since then, however, the euro has eased. In early trading today, it hit a low of US$1.353/€. It is currently around US$1.363 – down slightly week-on-week.
- US$/sterling: The pound hit a series of eight-month lows against the dollar this week. It closed last Friday at US$1.564/GBP, and was trading at US$1.559

earlier today. Now, it has recovered a bit to US$1.564 – effectively unchanged for the week, despite some fears in the market that the forthcoming election (likely to be on May 6) may result in a so-called "hung Parliament" (ie no clear majority).

- Yen/US$: The dollar closed last week at Y89.4/US$ – having lost 1.3% against the yen week-on-week (the yen being the only major currency that has been able to outrun the dollar in recent weeks). It is currently trading at Y 89.99 – suggesting that even the yen is now having to bow to the dollar.

Going forward, the key factor is obviously the Greek crisis. In addition, there is speculation about China's latest policy moves towards the renminbi. It is also worth noting that there have been press reports suggesting that China is now putting a higher proportion of its FX reserves into secure government securities – essentially US Treasuries. If confirmed, that will tend to underpin the dollar.

VI OIL

Crude oil prices fell today – for the first time this week – following the tightening of bank reserve requirements in China, which is expected to cut Chinese demand. Nevertheless, both front-month WTI and Brent crude contracts are likely to end the week up.

How relevant that is, however, is open to question, following Iraq's decision to join several other Middle East oil exporters in pricing its crude on the back on Argus's new ASCI index. This means that over 1.6 million b/d of Middle East crude will now be based on ASCI.

Other than China (which also reported that its oil imports fell from 5 million b/d to 4 million in January), the main factors in the oil market this week have been:

- a sharper than expected 2.42 million barrel increase in US crude inventories in the latest week (reported today);

- an 800,00 b/d reduction in OPEC's global oil consumption forecast for 2010, reported on Wednesday – which was only partially offset by an increase of 120,000 b/d in the IEA's latest forecast; and
- the cold snap in the US.

In addition, the general commodity sector has been fairly strong this week, with the R/J CRB index rising from 263.4 to 265.8.

On balance, the cold snap and the strength of commodities more generally seem to have prevailed. Based on mid-day prices on Friday, March WTI is trading at US$73.15 a barrel, up 2.8% for the week. The March Brent contract expired on Thursday (at US$73.05), but the April contract, currently trading at US$72.12, is up 3.7% from last Friday's close.

VII NEXT WEEK

In the US. Monday is Presidents' Day and many markets will be closed. For the rest of the week, the key releases are likely to be:

- housing starts for January;
- industrial production for January;
- leading indicators for January; and
- the Philadelphia Fed index for February.

Elsewhere, the most significant release is expected to be the fourth quarter GDP growth rate in Japan. predicted to be 3.6% (up from1.3% in the third quarter). The BoJ's MPC also meets.

In Europe. Germany's ZEW survey will be published on Tuesday. In the UK, the BofE's MPC minutes will be released on Wednesday.

Regards,
GISE AG