Αρχείο

<u>WEEKLY ECONOMIC AND MONETARY REPORT</u>

12 March 2010

Although a professional economist might worry that the wheels are coming off the global economy (again), <u>the markets seem remarkably optimistic</u>. The consensus today seems to be:

- that the crisis in the eurozone, caused by Greece's profligacy, is just about over;
- that global growth prospects are continuing to improve – with non-OECD countries (particularly in Asia) acting as the "locomotive" for the rest of the world; and
- that the global financial system is more or less back on track – although it needs a tweak here or there, it doesn't need the root-and-branch reform that seemed inevitable a few months ago.

Reflective of this, the euro has recovered, oil prices have continued to firm and the widespread assumption is that the US banking reform bill that Senator Dodd promises to offer on Monday will be a very damp squib indeed.

<u>The problem is that this optimism is very hard to justify</u>. In truth, the crisis in the eurozone is far from over; even German Economics Minister Schδuble (who had been urging that Greece's problems be used to justify a new European Monetary Fund) is now talking tough - warning that any eurozone member-state that fails to get its debt levels under control must face expulsion. Equally, the global economy is in a much more serious condition than Asia's recovery would suggest. In particular, a new debt crisis is emerging at the level of state and local governments in the US. More generally, debt problems and inflation will be adversely affected as central banks around the world "exit" from two years of unprecedented monetary easing. As for the banks... Well, it is true that most are now profitable again. But what they are <u>not</u> doing is lending, either to individuals or to productive investments in the SME sector.

I THE "CLUB MED" ISSUE

As noted, the consensus is that the Greek crisis is resolving itself.

It is true that next week's ECOFIN meeting in Brussels will almost certainly endorse the efforts of the Papandreou government to cut four percentage points off the Greek fiscal deficit this year. It is also true that Greece should be able to sell at least US $10 billion of bonds this month, with around half targeted at Asia. That should ease the immediate pressure on government finances. However, it is also true:

- that the level of strike activity in Greece (and the violence of strikers) continues to increase, particularly among public sector workers – whose cooperation is necessary if the government is to make the savings (and raise the tax revenues) that it has promised;
- that neither Merkel nor Sarkozy has actually made any commitment to underwrite or guarantee Greek debt – despite the continuing assumption that, in the end, some sort of deal will be cut (probably through KfW and Caisse des depтts); and
- that speculators are, once again, starting to focus on Portugal and Spain – with Portugal this week being forced to announce its own 4-year austerity plan designed to cut its deficit from 9.3% of GDP to 2.8%.

And, all the while, there is the danger that the deposit base of the Greek banks is draining away.

II BANKING ISSUES

A "CLUB MED" SPILLOVER: As noted before, one of the consequences of Greece's problems is a strong push on both sides of the Atlantic to tighten regulation of – or even to ban – the sovereign CDS market, particularly so-called "naked shorting" (where speculators take a speculative position without possessing the underlying

securities that are being hedged). There are many problems with this – particularly issues of definition, since sovereign CDSs are frequently used to provide a partial hedge for indirect exposure (eg through equities) to a particular country. But political support for action is considerable – especially in Europe, where it is possible that, if the Greek crisis can be blamed on hedge funds or other speculators, the "no bail-out" clause of the Lisbon Treaty could be circumvented.

Merkel, Sarkozy and European Commission President Barroso have all come out in support of restrictions on CDS shorting this week, and Barroso has pledged "a derivatives Directive" by summer. In the US, there is also support for more transparency, and for bringing CDS transactions on-exchange.

B **LEHMAN BROS.:** Yesterday – to the astonishment of most observers – the 2008 collapse of Lehman was back in the headlines, thanks to publication of a 2,000 page forensic investigation into the firm's failure by a court-appointed bankruptcy examiner.

The investigation cost US$38 million – but it may be money well-spent, since the examiner has come up with a lot of material that could be used in court proceedings. Among the key findings:

- There is evidence that JP Morgan and Citi unilaterally altered the terms of agreements that they had with Lehman to demand extra capital and/or guarantees – and that these changes (which, it is claimed, breached existing covenants) helped push Lehman into bankruptcy.
- There is evidence of poor quality audit work by Lehman's auditor – which just happens to be Ernst & Young, the most vulnerable of the remaining "Big 4" global audits practices. A major concern surrounds the treatment of so-called "Repo 105" transactions, which were (apparently) used to take US$50 billion off the investment bank's balance sheet – thereby understating Lehman's leverage.
- The "Repo 105" transactions were initially rejected as improper by Lehman's US legal advisors. The firm, therefore, turned to a major UK law firm, Linklaters – which provided a positive legal ruling.

- There is an *a priori* case that Barclays (which bought most of Lehman's US assets) took over around US$10 million of assets that it was not entitled to. (Actually, this finding favours Barclays, which had been accused in the press of transferring far more of Lehman's assets that it did not have a claim to.)

Finally, the examiner's report concludes that Lehman's Chairman, Dick Ford, and three of his top executives "certified misleading statements" about the firm's finances, and that Fuld was "at least grossly negligent".

The almost inevitable result will be a series of US lawsuits. The most dangerous possibility is that Ernst & Young's existence as a global auditor will be put at risk (as Arthur Andersen's was by Enron).

C REGULATORY REFORM: As noted, in the US, Chris Dodd (Chairman of the Senate Banking Committee) has said that he will submit his own regulatory reform bill early next week, following the apparent breakdown of negotiations with the Republican caucus (led by Sen. Bob Corker). Although the main stumbling block is reported to have been the Democrat's proposals for a consumer protection agency, cynics suggest that Dodd has been nobbled by Wall St. lobbyists, and that his proposals will be far weaker than even the White House wants. In particular, he is unlikely to endorse the so-called "Volcker rule" – which would forbid any institution that takes Federally-insured deposits from engaging in proprietary trading or private equity.

That said, Dodd may well go along with the Administration's proposal for an increased regulatory role for the Fed.

What is less likely is that he will endorse the proposal put forward at the beginning of this week by the FDIC's Sheila Bair. She called for large financial institutions to pay an upfront fee for a pre-funded "resolution authority" that would wind down insolvent institutions. That seems most unlikely to get much, if any, support.

In Europe, almost unnoticed, the French launched a new, integrated regulator for banks and insurers this week – the Autoritι de Controle Prudentiel. The first head is Christian

Noyer – also governor of the Banque de France (and also the new Chairman of the BIS, having taken over from Mexico's Guillermo Ortiz).

D **ICELAND:** As expected, the Icelandic electorate voted overwhelmingly this week to reject the deal that had been negotiated by its own government to compensate the British and Dutch for the US$5.3 billion that they paid out to depositors in Icesave – the internet-based Landsbanki subsidiary that crashed two years ago.

There was no surprise in that – though the 93% No vote was startling. The deal – which would have saddled each Icelandic household with a charge of around US$67,000, plus interest – was far too onerous. As the *NYT* put it, "It was as if American taxpayers were being required to pay US$5 trillion (plus interest) to reimburse customers of the Japanese branch of a failed private American bank". But, to avoid Iceland becoming "the Cuba of the North" (i.e. an international pariah-state), a new deal will have to be negotiated. Talks are already underway.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US:** Today's announcement that US retail sales rose 0.3% last month, despite fierce weather, was a surprise – as was the 0.8% rise in sales ex-autos. The fact that December and January sales were revised down took some of the shine off, but the sales data clearly supports those who argue the economy is back on track.

Is it? Well, it was also reported this week:

- that first-time jobless claims fell 6,000 in the latest week (though continuing claims rose 37,000); and
- that the trade deficit fell unexpectedly in January, from US$39.9 billion to (a still startling) US$37.3 billion.

However, the improvement on the trade side was almost exclusively the result of a 1.7% drop in imports of oil and automobiles; ex-oil, the 'core' deficit fell a good deal less.

That said, US equities are responding well. Even before the release of the sales data, all the key indices were up – and they are up again today. Over the last two weeks, the DJIA is up about 2.8%, the S&P500 is up 3.9% and the Nasdaq Composite is up 4.6%. This is the first anniversary of the bull market in US equities that began in March 2009, and it shows no sign yet of abating.

A final point: Bloomberg is reporting today that the President of the San Francisco Fed, Janet Yellen (who is married to the Nobel prize-winning economist, George Akerlof), will be appointed to succeed Don Kohn as Vice-chairman of the Fed (and, almost certainly, as the designated successor to Bernanke). If this is confirmed, it is felt that it would increase the influence of interest rate 'doves' on the FOMC.

B EUROPE: European equities have also been strong. Through late trading on Friday, the Xetra Dax is up 1.8% for the week, the CAC-40 is up 1.0% and the FTSE-100 is up 0.7% - quite a strong performance given fears about European interest rates.

Within the eurozone, as noted, there has been a great deal of talk about establishing a European Monetary Fund as a sort of fiscal equivalent to the (monetary) ECB. The idea is that the EMF would be modelled on the IMF, with a mandate to provide medium-term financing to member-states (eg Greece) that are facing the prospect of severe domestic deflation.

Sceptics say this would require a change to the EU Treaties, which could take 10 years or more. It would certainly arrive too late to help Greece. On the other hand, however, support for the idea is growing. Although Bundesbank Governor Weber and ECB Vice-president Stark have both come out against a new institution, ECD President Trichet seems to be more supportive.

As far as eurozone economic releases are concerned, this has been a fairly thin week. The most significant have been for industrial production – which rose strongly in the three major eurozone economies in January:

- in Germany, IP was up 0.6% after a fall of 1% in December;

- in France, IP was up 1.6% (albeit largely because of a 3% increase in automobile production); and
- in Italy, IP was up an astonishing 2.6% - more than three times what was expected.

That certainly supports the idea of European recovery. However, it is worth noting that, for 2009 as a whole, German retail sales fell 2.3%, and household spending rose just 0.4%.

Plus, there is a potential political backlash. Both France and Italy face regional elections this month – and, in each case, the incumbent party seems certain to do badly. There is still a marked absence of a so-called "feelgood" factor.

Ironically, in the UK, the latest polls show that the general election – now, almost certain to be held on May 6 – could result in neither Labour nor the Conservatives having an overall majority, giving the centre-left LibDems the balance of power. If that happened (and it is still hard to believe that the British electorate will not reject the incumbent Labour government decisively), PM Brown could cling to office – albeit only by doing a deal with the LibDems that would inevitably lead to a fundamental change in the British electoral system from "first past the post" to proportional representation. The latter appears "fairer", but, it is likely to hand the LibDems disproportionate power.

In the meantime, the incumbent Labour government will, indeed, produce a final budget – scheduled for March 24. (It had been thought likely that Labour would avoid having to present a budget by bringing the date of the election forward.) In theory, this could be a "giveaway" budget, designed to pander to the groups whose votes Labour needs at the election. In practice, the Chancellor, Alistair Darling, has made it clear that he will not countenance that kind of near-fraud. Nevertheless, there will be little or no time to debate the government's budget proposals before the election campaign formally begins – and other Ministers will be less punctilious than Darling. In fact, his own deputy yesterday pledged that, if re-elected, Labour would not raise personal taxes – an utterly dishonest and implausible commitment that could not be met (even though Labour is already pushing the top rate of tax up to 50% as of next month).

As for the UK economy, the news this week has been almost uniformly bad. In particular, it was reported:

- that the trade deficit rose from GBP 2.6 billion to GBP 3.8 billion in January, thanks to an unexpectedly sharp 6.9% drop in exports;
- that industrial production fell 0.4% in January (the first drop since August), with manufacturing down 0.9%; and
- that the RICS house price survey turned sharply negative in February.

On top of all that, the BofE's survey of inflationary attitudes showed that the British electorate is increasingly concerned about rising prices. Over the next year, prices are now expected to rise 2.5%, up from 2.4% in November.

Against this background, there is real fear of a new debt crisis. On Tuesday, Fitch warned that the UK's triple-A sovereign rating is at risk if the government does not take steps to cut the fiscal deficit faster. Yesterday, Unicredit put out a warning note suggesting that it will be impossible for the UK to raise revenue fast enough to avoid a downgrade. The markets seem to agree: the yield on 10-year gilts is already 4.14%, compared with 3.19% for Germany – and with 3.94% for Italy. Nevertheless, the FTSE 100 has risen again this week, and is now up 4.7% in the last 10 trading sessions.

C **JAPAN:** The Nikkei-225 is also up. Having risen 2.4% last week, it has just closed up another 3.7% this week. The reason appears to be confidence that the BoJ will find a way to reverse its decision to close down its programme of Quantitative Easing. As early as next week, the market expects the Bank's MPC to find another way to boost lending.

D **CHINA:** The big concern this week has been inflation. Yesterday, it was reported:

- that consumer price inflation was 2.7% year-on-year last month; and
- that real estate prices had accelerated, with the 70-city home price index up 10.7% year-on-year in February.

That may not yet be as important as the press suggests, but it could give Beijing the excuse it needs to push interest rates up – and to allow a modest revaluation of the renminbi. However, don't bank on it: while the odds probably favour a mini-appreciation, a senior PBoC official warned this week that Beijing intends to "keep (the renminbi) basically stable at an appropriate and balanced level".

That said, it can certainly live with a stronger currency. It was reported on Wednesday that Chinese exports were up 45.7% year-on-year in February, following a 21% rise in January. With imports up 44.7%, the trade surplus for the month was US$7.6 billion.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

The main trends this week have been:

- a modest recovery in the euro, which is poised to break a five-week high in part because of (perhaps unwarranted) optimism that the Greek crisis can be contained and because, according to chartists, it has broken a key chart point;
- further weakness for sterling, which began the week at a ten-month low and has barely recovered since; and
- a strong Swiss franc, which got another boost yesterday when the SNB left interest rates alone and boosted its GDP forecast for this year – suggesting that it is now resigned to a stronger currency (and, therefore, that it will not intervene to drive the SF down).

In addition, the Russian ruble hit a series of highs this week, primarily on the back of higher oil prices.

As for the US dollar, it has been under some pressure this week. In the first part of the week, that reflected fears over America's triple-A sovereign rating; today, it reflects the belief that, if Janet Yellen is confirmed as Fed Vice-chairman, the outcome will be a more doveish approach to monetary policy. Whatever, week-on-week, the dollar is down

against the euro and (marginally) against sterling and the yen. It is also down more dignificantly against the SF:

- US$/euro: At the close last week, the euro was trading at US$1.360, amid predictions that the dollar would recover. In fact, the euro has strengthened fairly steadily, and is currently trading at US$1.376 – up 1.2% week-on-week.
- US$/sterling: The pound closed last week at US$1.511. It fell to US$1.495 on Wednesday, but has since recovered to US$1.515 – barely changed week-on-week.
- Yen/US$: At the close on Friday, the dollar was trading at Y 90.37 – and the consensus was that it would firm further as the carry trade revived. In fact it fell to Y 89.9, before recovering. It is currently trading at Y 90.77 – up 0.4% for the week.
- SF/US: At the close last week, the dollar was trading at SF1.075/US$. As the market has come to expect the SNB to let the franc appreciate, the dollar has weakened. It is currently trading at around SF1.059/US$ - down 1.4% for the week.

Looking further ahead, Goldman Sachs has just released revised currency forecasts. Over the next three months, it expects the euro to firm to US$1.45, sterling to strengthen to US$1.67, the Swiss franc to firm to SF0.99/ US$ and the yen to remain broadly unchanged at Y92/US$.

V OIL

Oil prices have continued to strengthen this week, ahead of OPEC's March 17 Ministerial meeting in Vienna. In particular:

- WTI for April delivery closed last week at US$81.50 a barrel, and is now trading at US$82.28 – a gain of 1%; and
- April Brent closed last week at US$79.89, and is now trading at US$80.40 – up 0.6%.

This is well above the level that it is believed Saudi Arabia, in particular, feels is sustainable. It is, therefore, worth asking what is keeping prices so high. Among the reasons advanced this week, it has been suggested:

- that prices have been pushed up by very large speculative long positions in Chicago, now at their highest since January;
- that the outburst of sectarian violence in Nigeria (even though it is not in the oil-producing East) could be responsible;
- that China is pushing the price up rebuilding its strategic stockpile; and
- that higher prices reflect increased global economic activity.

On the last point, the IEA released its revised 2010 global oil demand forecasts today. For the second month in a row, it has pushed its estimate up – this time, by 70,000 b/d to 8.6 million. That is 1.8% higher than 2009.

There is also the question of inventories. World-wide, these are said to be high, but declining. In the US, the latest weekly EIA data show:

- that crude stocks rose 1.4 million barrels (a bit less than expected);
- that gasoline inventories fell 2.9 million (compared with an expected stock-build of 200,000); and
- that distillate stocks fell 2.2 million (compared with an expected fall of 900,000 barrels).

What is not a factor is the general commodity price level. Week-on-week, for instance, the R/J CRB index actually fell slightly, from 274.5 to 274.3.

It is worth noting that there is some concern about the flattening of the futures price curve. Some analysts believe it is about to flip from contango to backwardation – which would have the effect of rapidly running down surplus inventories.

VI TRADE

An encouraging report was released by the WTO this week.

Responding to a request from the G-20, the WTO carried out a survey of new trade restrictions imposed as a result of the economic/financial crisis. Its finding is that, at most, 0.7% of G-20 trade (or 0.4% of global trade) has been hit with new trade restrictions imposed in the last six months. That is a big improvement on the previous period. Moreover, the WTO could find no evidence at all of new restrictions on trade in services.

VII NEXT WEEK

As noted, there are regional elections in France this weekend and in Italy later this month. There are also regional elections in Russia. In Europe, it is expected that ECOFIN will approve Greece's latest austerity measures on Monday or Tuesday.

As far as economic releases in the US are concerned, the most important next week are likely to be:

- industrial production for February, likely to be flat;
- leading indicators, expected to be up 0.2%;
- housing starts, expected to be down slightly; and
- the Philadelphia and NY Fed surveys, both expected to be flat to down.

The FOMC also meets, and the Treasury's long-term TIC flow data will be released.

Elsewhere, key releases will include:

- the ZEW survey in Germany;
- eurozone investment data; and
- Japanese machine tool orders and the March Reuters *tankan*.

The BoJ's MPC also meets on Wednesday.

Finally, there will be another one-day public sector strike in Greece on Tuesday.

Regards,
GISE AG