WEEKLY ECONOMIC AND MONETARY REPORT

19 March 2010

There is talk that the Fed may increase the US discount rate before the next FOMC meeting on April 28 – despite real concern that economic recovery in the US (and elsewhere) is faltering. There is talk that Greece will be forced to apply to the IMF for emergency assistance – thereby (at least, in the eyes of committed Europhiles) putting EMU itself at risk. As a result, the euro is under pressure – even though it would surely strengthen if Greece were to drop out (an eventuality that is, however, still extremely remote). There is also talk that the US should slap a unilateral import charge on China if it does not revalue the renminbi – a breach of WTO rules that is publicly supported by two very well-known US economists (Paul Krugman and Fred Bergsten).

There is a lot of what appears to be topsy-turvy thinking in the world today.

I GREECE/'CLUB MED'

This is a particularly challenging issue – even if it is very hard to see why such a small country (less than 3% of the European economy) can pose such a big threat. Nevertheless, it remains true that the failure of the eurozone as a whole to resolve Greece's problems threatens, not only the euro as a currency, but also any pretensions the EU may have to being a global economic power.

What has happened this week is that the issue of Greece has split the eurozone apart.

On the one hand, the French are insisting that Greece's problems should be treated as an internal eurozone matter, and resolved accordingly. That view is supported by most of the smaller/poorer eurozone members, and by the EU (and eurozone) institutions. ECB President Trichet, for instance, has made his position very clear – as have eurozone group President Juncker and EU Commissioner Rehn. Their view appears to be that, if the eurozone cannot handle this problem, it cannot expect to be taken

seriously. However, they also have to acknowledge that the Treaties of Lisbon and Maastricht (which underpin EMU) have no provision for bailing a member state out – and that this was a conscious decision to stop any eurozone member state from doing what Greece has done (ie using membership to go on a credit binge, while effectively destroying its own economy).

On the other hand are those who think that the only answer is for Greece to turn to the IMF – as Latin America did 20 years ago. That view is increasingly popular in Germany and The Netherlands – not least because there is enormous popular opposition (particularly in Germany) to bailing the Greeks out. (It is not just "popular": in today's *FT*, Otmar Issing has a column insisting that the Greeks must be made to pay for their folly in letting their productivity fall so far behind that of Germany over the last ten years.) Chancellor Merkel may personally want to help Athens, but her own coalition partners are opposed – and have, indeed, launched cases in the Constitutional Court to block German participation in any proposed bail-out.

There are other factors. French President Sarkozy, for instance, is adamant that Greece must not be permitted to turn to the IMF because he fears that would legitimise its MD, Dominique Strauss-Kahn, as a competitor for him in the 2012 Presidential elections. (DS-K already leads Sarkozy in the polls.)

Whatever, at the beginning of this week, it was widely assumed that an intra-eurozone solution would be found. It still may. However, the eurozone Finance Ministers' meeting on Monday failed to reach any agreement – beyond a few general words of comfort that helped (briefly) to push Greek funding costs down. Since then, the markets have become increasingly sceptical that a deal can be done. As a result, spreads have widened again (the 10-year Greek-*bund* spread is now over 330 basis points, its widest since last February), and the odds seem to favour a deal with the Fund.

If the IMF is involved, what could Greece expect? Given its quota and the precedent of previous deals, the feeling is that Greece might get around US $15 billion from the Fund

– and that the average interest rate would be about 3.25% (much lower than anything likely to come from the ECB). That, however, is not enough, since Greece apparently has about €20 billion that has to be refinanced in the next two months. One way to help close the gap might be for the European Investment Bank to provide what it calls a 'global' (ie structural adjustment) loan of around €5 billion. The Greek government could also sell assets. Its shares in OPAP, the PPC, the Agricultural Bank and Hellenic Petroleum are jointly valued at around €5.5 billion.

All of this would take time – and the markets may not give Greece that time (though it is worth noting that EU threats to ban "naked" shorting in the sovereign CDS market seems to have scared off speculators, at least for now). There is also the fear that markets may start to target Portugal – or (even worse) Spain.

The next headline date is the ECOFIN Summit on March 25. However, some sort of deal should have been put together by then – otherwise Greek FM Papaconstantinou may have no choice but to announce a debt moratorium.

II BANKING

A THE DODD BILL: When it was released on Wednesday, the US banking reform bill proposed by Sen. Chris Dodd turned out to be a lot bigger and a lot more radical than cynics had expected. However, it does not have bipartisan support, Dodd himself is retiring in November, and, in the House, Rep. Barney Frank (who chairs the Financial Services Committee) has his own views – which do not always coincide with those of Dodd. So chances that it will be passed in anything like its present form are slim. It is just an opening shot – though, at 1,336 pages, a powerful one.

The key proposals in the bill are the following:

- Supervision of all US banks and bank holding companies with assets of over US $50 billion (of which there are about 35) would be given to the Federal

Reserve. There would also be a second Vice-chairman of the Fed, who would be responsible for supervision. The OCC would regulate national banks with assets less than US $50 billion, and any thrifts. The FDIC would regulate state banks and thrifts with assets of less than US $50 billion. The OTS (which currently regulates thrifts) would be abolished.

- A new Consumer Financial Protection Bureau would be set up inside the Fed, with an independent director (appointed by the President).
- A new Financial Stability Oversight Council would also be set up. This would be chaired by the Treasury Secretary and would include the heads of the various agencies, plus an independent member. It would focus on systemic risk – and would impose strict rules on size, complexity etc. This apparently extends to imposition of the so-called "Volcker rule" – prohibiting firms that take Federally-insured deposits from engaging in proprietary trading and/or private equity. It also covers so-called "living wills" and (more controversially) collection of a US $50 billion up front fee to cover the orderly liquidation of troubled institutions.
- There are several proposals that affect regional Feds. In particular, the President of the NY Fed would cease to be appointed by member banks, and would instead be appointed by the President (subject to confirmation by the Senate). For the other Fed Boards, member banks with assets over US $50 billion in assets would not have a vote.
- A new Office of National Insurance would be created within the Treasury Department to monitor the insurance industry.

The OCC (which would lose out to the Fed if the bill were approved) has already attacked the Dodd bill as being excessively focused on the consumer, to the detriment of the industry's safety and soundness.

B UK: The FSA's chairman, Adair Turner, continues to talk tough. He has just announced that the Authority will hire another 460 regulators – around 15% of its staff.

C **LEHMAN REPORT**: More details have emerged this week about the two thousand-page report into the collapse of Lehman Bros, by Anton Valukas (a Chicago lawyer).

As we suggested last week, the big issue is whether Lehman acted properly in using complex repo transactions (known as Repo 105 deals) temporarily to move up to US $50 billion off its balance sheet at the end of reporting periods dating back to 2001. The key to these transactions was that they were booked at 105% of the value of the securities – which meant they were treated as sales of assets, rather than loans. Apparently, Lehman's US lawyers refused to validate this approach. The deals were, therefore, booked through London – where Linklater's (one of the UK's "magic circle" law firms) had no problem endorsing them.

The consensus (at the moment) is that Linklater's is probably safe from shareholder suits. However, there is a lot of concern about Ernst & Young – Lehman's auditors, who should have queried the transactions. The problem is that, if E&Y is sued into bankruptcy (as happened with Andersen after Enron), there would only be three global audit practises remaining – and everyone accepts that is too few.

What happens now? In the UK, the Financial Reporting Council has announced an investigation into E&Y's approval of Repo 105 deals. In the US, the House Financial Services Committee will hold hearings on the full Valukas report. Already, the House Appropriations Subcommittee has heard testimony from the SEC's Mary Schapiro, in which she admitted that her agency had been unaware of the Repo 105 transactions.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **GREENSPAN PAPER**: Today, former Fed Chairman Greenspan is presenting a paper at Brookings. Entitled '*The Crisis*', it is his attempt to explain both his own actions and those of the Fed in the run-up to the credit crunch.

The main point he makes is that it remains virtually impossible to identify an asset bubble while it is developing. As a result, "preventing bubbles will in the end turn out to be infeasible". As he also insisted at the time (when critics warned that a housing bubble was developing), the best the Fed can do is prepare to clean up afterwards. In his view, in any case, the Fed had very little leverage since the reason for the housing bubble was the drop in long-term US interest rates after 2000 – which was in large part a result of China's trade surpluses. The Fed's overnight rate, he argues, can have little influence on mortgage rates.

That said, Greenspan acknowledged that the Fed was "lulled into a sense of complacency" after the 1987 equity crash.

Looking forward, his paper points out that, when he was chairman, the Fed was unable to identify significant economies of scale in the banking industry – which appears to suggest that he might support breaking up the banks. He also advocates more aggressive use of capital and liquidity measures as a regulatory tool in the future.

B **THE US**: How things change... In early trading today, all the key US equity indices are down – and the reason being given is an unexpected increase in interest rates by the Reserve Bank of India (responding to a sudden jump in inflation). The idea that US equities should rise or fall on decisions taken in Delhi would have been unthinkable a few years ago. Now, however, the BRICs are king.

That said, US equities still seem likely to close the week up modestly. Through mid-day Friday, the DJIA is up 1.2% for the week, the S&P500 is up 1% and the Nasdaq Composite is up 0.3%. Over the last year, the S&P is up almost 70% - its biggest jump ever.

What is driving this? One factor is clearly the belief that the Fed will keep US interest rates low – a belief reinforced this week by the FOMC's unexpectedly doveish tone

when it left the Federal funds rate at 0-0.25%. Only one member dissented, arguing that the Fed should tighten.

As for the US economy, that continues to send mixed messages. On the positive side, the Philadelphia Fed's activity index rose from 17.6 to 18.9 this month. In addition, leading indicators rose 0.1% in February, as did industrial production. On the other hand, however:

- manufacturing output fell 0.2% in February;
- housing starts slumped 5.95, with permits down 1.6%;
- the NAHB's real estate sentiment index fell from 17 to 15 in March; and
- the Empire State (NY) business index dropped from 24.9 to 22.9 last month.

There is also the issue of the Treasury's so-called TIC data. In January, net foreign purchases of US bonds, notes and equities dropped from US $63.3 billion to just US $19.1 billion. The Chinese were notable absentees, cutting their holdings of Treasury securities by US $5.8 billion – the third monthly drop in a row.

This leaves the Fed walking a fine line. It wants to keep US interest rates down to help the faltering recovery – but it cannot afford to scare off foreign creditors. Fortunately, perhaps, there is little or no sign of inflation in the US. This week, for instance, it was reported that producer prices fell 0.6% last month (after a 1.4% increase in January). Nevertheless, as noted, there are rumours in the market today that the Fed intends to send a (modest) message to the markets by raising the less-important discount rate before the next FOMC meeting.

B **EUROPE**: The more one looks at the European economy, the more one sees a potential disaster. The fundamental issue is one of different priorities. Is the priority to cut spending and raise taxes to drive deficits down closer to the 3% ceiling agreed at Maastricht? Or is it to maintain fiscal and monetary stimulus long enough that growth

can become self-sustaining (even if the long-term sustainable growth rate will inevitably be held down by the massive accumulation of public debt)?

On top of that, there is the issue of exports. Other EU member states (not just Greece) are increasingly intolerant of a German growth strategy that they see, rightly, as being based on exports. French FM Lagarde, in particular, has been very vocal in demanding that Germany boosts its domestic economy (and holds down exports) to help the rest of the eurozone. Germany's "cult of austerity" is now seen as a serious danger to the eurozone as a whole.

This problem was highlighted yesterday by the latest trade figures for the eurozone. At the broadest level, the trade balance showed a deficit on trade in goods of €8.9 billion in January – compared with a surplus of €4.1 billion in December. More significant, however, was the national breakdown for 2009 as a whole. Including intra-eurozone trade, Germany ran a trade surplus of €136 billion last year. In comparison, France ran a deficit of €54.5 billion, Spain a deficit of €49.5 billion, Greece a deficit of €28.5 billion and Italy a deficit of €4.2 billion.

Now, the Commission has weighed in. On Wednesday it warned that Germany, France, Spain, Italy and The Netherlands are all too optimistic on GDP growth over the next three years, and that they will have to be more proactive on fiscal policy if they hope to cut their overall indebtedness. It is clearly keen to put Maastricht targets ahead of economic stimulus.

The problem is that there is not much appetite for further austerity. In France, for instance, President Sarkozy's UMP faces an electoral drubbing in this weekend's second round of regional elections – losing votes both to the left and to the far-right. In Germany, it was reported this week that the ZEW expectations index fell again in March (the sixth straight drop), from 45.1 to 44.5. Neither Sarko nor Merkel is feeling very *communautaire* at the moment.

As for the UK, there is the bizarre prospect of a budget next week, barely one month before a general election (that is almost certain to be held on May 6). The sensible course would have been a US-style "continuing resolution" to fund the government. Instead, Labour will proceed as though it will continue in office.

In fact, its chances of doing so are slim – and, if it did squeak in, it would probably be in a coalition with the LibDems (who have their own views on economic policy).

Nevertheless, Labour does have one card. To some surprise, UK government revenues picked up in February – which meant that the fiscal deficit, at GBP 12.4 billion, was a bit smaller than expected. For FY 2009-10 as a whole, the deficit seems certain to undershoot the official forecast of GBP 178 billion – perhaps by GBP 20 billion or more. That *might* justify a modest giveaway in the budget.

That said, the BofE's minutes of the March MPC meeting show the Bank is increasingly concerned about inflationary pressures – which suggests it is moving closer to pushing interest rates up. It may have some room to do this in the next couple of month given better employment data. The number of benefits claimants fell 32,000 in February, to 1.59 million, while the overall unemployment rate was unchanged at 7.8%.

Other than that, UK economy data continues mixed. On the one hand, there are more signs that the housing sector is sliding back into recession; the Rightmove index, for instance, was up just 0.1% year-on-year in March. On the other hand, CML data showed mortgage lending up 6% month-on-month in February. However, the most significant – and depressing – release of the week was the report from the BofE that bank lending to UK businesses fell in January to just GBP 6.5 billion – down 9.3% year-on-year. Either banks are making it impossible to lend, or (more likely) there just isn't the demand for loans.

C **JAPAN**: Week-on-week, the Nikkei-225 has just closed up 0.7% - its sixth straight weekly increase.

The main reason for this is the BoJ's policy on extending liquidity. On Wednesday, it was reported that the Bank will double its programme of special 3-month fixed rate (0.1%) loans to Y20 trillion – which is as near to printing money as any central bank gets. Will that have much impact? Most observers are sceptical. However, the Reuters *tankan* index of business sentiment did rise this month – albeit only from -13 to -8. Still, that is its best reading since June 2008.

D **CHINA**: A major row between the US and China seems virtually certain.

On Monday, more than 130 US Congressmen signed a letter to Treasury Secretary Geithner, demanding that China be labelled a "currency manipulator" – which would open it up to retaliatory trade measures. Normally, such moves are just political theatre. This time, however, they seem to have attracted support from odd places. Two leading US economists – Paul Krugman and the Peterson Institute's Fred Bergsten – have, for instance, come out in support. Krugman has urged the Obama Administration unilaterally to impose a 25% emergency tariff on imports from China until and unless Beijing revalues the renminbi.

This would be illegal under the WTO, and Krugman has been widely attacked (eg by Morgan Stanley's Stephen Roach). However, the US is clearly taking a tougher line; its Ambassador to Beijing, Jon Huntsman, for instance, has been pressing the Chinese leadership on the renminbi. The World Bank has also called for a revaluation – while at the same time, increasing its Chinese GDP growth forecast for this year from 8.7% to an astonishing 9.5%.

Will this pressure work? Over the weekend, PM Wen Jiabao defended China's policy on the renminbi, while deploring foreigners' complaints as "finger-pointing… for purposes of increasing their own exports". However, Asian economies are now being hit by the undervalued renminbi as much as the US is, and it may be significant that China has

again been reported as stress-testing selected industries for the impact that a stronger currency would have on them.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Greece's problems continue to hit the euro – which looks like having its worst week since February.

Against the US dollar, the euro has fallen this week from US $1.376/€ to US $1.353 – or 1.7%. Against the yen, it has fallen from Y124.5/€ to Y122.38 – also a drop of 1.7%.

The dollar has also risen against sterling – which fell from US $1.517/GBP to US $1.502 – or 1%. The pound has been hit across the board by weak economic data and fears of a hung Parliament. However – at least for the moment – the fear that the UK will lose its triple-A rating has been lifted (at least, by Moody's – which reaffirmed its rating on Monday).

As for the dollar itself, it has been broadly stable week-on-week – despite the unexpectedly doveish tone of the release accompanying the FOMC's decision to hold interest rates unchanged. However, it is worth watching the Canadian dollar. An unexpected increase in Canadian inflation has pushed it closer to parity. It is currently trading at Can $1.016/US $, having been as strong as Can $1.014.

V OIL

Week-on-week, the price of front-month WTI has fallen, while that of Brent remains broadly unchanged:

- April WTI closed last week at US $81.24 a barrel, having eased 87 cents on Friday. Although it rose as high as US $82.93 on Wednesday, it has fallen back and is currently trading around US $80.36 – down 1.1% for the week.

- April Brent closed last week at US $79.39 a barrel. It then expired on Tuesday at US $79.02. The new May contract was trading at US $78.63 on Monday, but jumped to US $81.96 on Wednesday. It is now trading at just US $79.71 – essentially unchanged for the week.

The main factor in the markets this week was probably the OPEC meeting in Vienna.

This produced no surprises. Saudi Arabia's Oil Minister confirmed that "we have been sailing very well", and that producers are broadly comfortable with a price of around US $80. That said, there is still a considerable problem of non-compliance with recent quota cuts, and that will tend to hold prices down. Nevertheless, OPEC is sufficiently comfortable that it has not scheduled another Ministerial meeting for seven months.

Other than that, US crude inventories rose 1.01 million barrels in the latest week, which was a bit lower than expected. At the same time, there are still said to be substantial speculative long positions on the CFTC.

VI NEXT WEEK

In the US, the major economic releases next week are expected to be:

- existing home sales for February, expected to be down 0.2%;
- durable goods orders for February, expected to be up 0.3%; and
- the final reading for the March Michigan index, likely to be unchanged at 72.5.

The third estimate of fourth quarter GDP growth will also be released.

In Europe, the composite eurozone PMI for March will be released, along with consumer confidence. In Germany, the GfK index for April is due.

In Japan, minutes of the latest MPC meeting will be released on Tuesday, along with consumer price inflation.

Regards,
GISE