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WEEKLY ECONOMIC AND MONETARY REPORT

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The travel restrictions caused by the Icelandic volcano eruption looked like disrupting the IMF/World Bank Spring meetings, as well as a resolution of the Greek crisis, but it does appear that things are now almost back to normal, and that there will be little or no lasting economic damage. That said, the Meetings turned out to be unusually significant, since they provided a focus for discussions of issues only peripherally related to the Fund and Bank, but which are crucial to the health of the global economy.

I SPRING MEETINGS

As noted, the Spring Meetings of the IMF and World Bank (and G7 and G20) have provided a focus for most of the key concerns obsessing global policy-makers.

A THE GLOBAL ECONOMY: The IMF's latest *World Economic Outlook* is notable chiefly for including revised 2010 forecasts that are markedly more optimistic than those issued in January. For the world as a whole, economic growth is now projected at a fairly healthy 4.2% this year, up from 3.9% in January. However, this is still very much an emerging economy recovery:

IMF:GDP forecasts (2010-2011)

	2010	2011
Developing countries	6.3%	6.5%
China	10.0%	9.9%
India	8.8%	8.4%
Advanced economies	2.3%	2.4%
US	3.1%	2.6%
Eurozone	1.0%	1.5%
Japan	1.9%	2.0%
World	4.2%	4.3%

Moreover, the WEO also includes a number of warnings. In particular, it warns against "a full-blown and contagious sovereign debt crisis" – a warning that appears increasingly prescient. According to the IMF, the debt:GDP ratio of the G7 economies this year will be 112.5%, the highest since 1950 – and the possibility of default by one or more countries (not just Greece) is real. As the Fund puts it, faith in government guarantees is being steadily eroded.

Other points in the WEO include a bullish forecast for commodity prices in the short term, though there is a warning that OPEC may increase production – and thereby keep oil prices lower than the pace of economic recovery might lead one to expect.

There has also been a lot of talk (particularly at the International Monetary and Financial Committee) about "exit" strategies from fiscal and monetary easing. The G20 has now tasked the IMF with coming up with 'credible' exit strategies.

B **BANKING REFORM**: In its *Global Financial Stability Review*, the IMF predicted that banks will end up having booked total losses for the 2007-10 period of US $2.3 trillion – of which US $1.6 trillion has already been written off. This is down from an October 2009 estimate of US $2.8 trillion, but it suggests that the crisis is still far from over.

That, however, was far from the only contribution to the debate over banking made by the IMF ahead of the Meetings. It also produced a 56-page paper, requested by the G20, on what sort of contribution the financial sector ought to make the cost of reform – and particularly to reduce the possibility of future crises. Controversially, the IMF is now proposing two new taxes on all banks (not just on those deemed to by systemically-important):

- a "financial stability contribution" – a flat rate tax on bank liabilities that would go some way to cover the cost of future government intervention; and
- a "financial activities tax" (or FAT tax) that would be levied on profits and pay.

Equally controversially, the Fund suggested that, taken together, these taxes – which would have to be imposed globally to escape the threat of regulatory arbitrage – could be set so as to raise 2-4% of GDP. Not surprisingly, the global banks are up in arms. In their view, these are "punishment taxes" which would do nothing to avert the next crisis. Moreover (they say), the main impact would be to stop banks from lending.

The banks have some support for their position within the G7/G20. Canada, Australia, India, and Japan, for instance, are all thought to be against the new taxes because they feel their banks (which did not have to be bailed out) should not be penalized. France is also said to be against – though that probably has more to do with President Sarkozy's increasingly acrimonious row with IMF MD Strauss-Kahn (who is his likely challenger in the next French Presidential elections). On the other hand, the UK's "lame duck" government is said to be in favour – as is (or may be) the Obama Administration (which, however, has its own plans). Whatever, the IMF has now been asked to rethink its proposals, and to submit a revised version.

C **GREECE**: At the end of last week, the Greek government finally accepted defeat, and asked the eurozone and IMF to activate the €40-45 billion emergency aid package that was promised three weeks ago. It is widely expected that this will be approved this week – and that (despite objections from France) the IMF will be given the key role of imposing ever tougher conditions on Greece. Just how quickly money can start to be disbursed is, however, still unclear – though Greece faces a €8.5 billion debt repayment on May 9, which provides a sort of deadline. The Fund can probably release money fairly soon from one of several quick-disbursing facilities. But it is important to realise that the €28-30 billion which is likely to come from the eurozone will in fact be 16 separate bilateral loans – all conditional on the others being approved. That could be tricky. While some eurozone governments can simply write a cheque, others (notably Germany) may have to get Parliamentary approval. In Germany, there is also the threat of a challenge in the Constitutional Court. With key regional elections coming up that could jeopardize the CDU's majority in the Bundesrat (Upper House), Chancellor Merkel

is in a very delicate situation. Indeed, her Finance Minister and the head of her coalition partner, the CSU, have both indicated in the last day or so that approval of the aid package cannot be taken for granted.

If so, that is really bad news for Greece.

Its latest troubles may well have been caused by an important article in last Wednesday's *Financial Times* (by Wolfgang Munchau), which pointed out:

- that Greece now has a debt/GDP ratio of 125%, more than double the Maastricht limit;
- that it needs to raise €50 billion a year for each of the next five years just to roll over its debt;
- that GDP will fall 3-5% this year; and
- that, if it is to have any hope of satisfying its creditors and avoiding default, it must run a primary budget surplus (ie before interest payments) of 5%, compared with a current deficit of 7%.

Munchau's point (which must be correct) is that a restructuring/rescheduling or default is inevitable – if not this year, then in 2011 or 2012. That is also the view taken by the (increasingly) influential former chief economist of the IMF, Simon Johnson – whose estimate is that Greece needs US $200 billion over the next three years if it is to avoid default. With no possibility of a devaluation as a (relatively) painless way of achieving adjustment, his recommendation is that Athens should "restructure before a default". Even Bundesbank President Axel Weber (who will play a crucial role in any eurozone bailout) seems to agree with Munchau, Johnson *et al.* Last Monday, he claimed that Greece needs at least €80 billion over the next year – much more than the €45 billion pledged to date.

Bizarrely, the markets seem more optimistic than economists or central bankers – despite another downgrade of Greek paper by Moody's on Thursday.

Last Tuesday, for instance, Greece was able to sell €1.95 billion in 3-month bills at a rate of 3.65%. True, that is twice the 1.67% cost on January 19, but it still shows some faith in the short-term outlook. At the longer end, the 10-year yield on Greek paper was 7.63% at the beginning of last week – compared with around 3.08% for German *bunds*. By the close on Thursday, it had hit a high of 9.37% - with CDS protection rising to US $650,000 (per year to protect US $5 million). This is obviously very high – but not high enough to cover the possibility of a restructuring if Munchau, Johnson *et al* are right. Moreover, once it became clear that Greece would activate the eurozone/IMF agreement, the cost of CDS protection fell back to 570 basis points, and the 10-year yield dropped to 8.35%.

The current expectation is that negotiations with the IMF and eurozone will last as long as two weeks - though money may start to flow before a final text is agreed. Apparently, the Greek populace is ready to accept IMF-mandated austerity – but that should not be taken for granted. The pain that will be imposed on Greece (by the IMF, the ECB or its fellow eurozone members) will be far worse than anything visited on other developed economies in the last 20 years. The real parallels will be with Latin America – where the IMF is still a dirty word.

And, in the meantime, the ECB and the IMF have to keep an eye on Portugal, Spain and Ireland. CDS spreads are now 270 bp in Portugal – and rising.

II BANKING

A **GOLDMAN SACHS**: The SEC's decision to press civil charges against Goldman for its role in selling synthetic CDOs (based on sub-prime mortgages) has changed the entire debate on financial reform in the US. Most analysts are cynical about the SEC's timing – which has undercut the efforts of Congressional Republicans to block Sen Dodd's banking bill. But the charges are not just a political ploy.

Essentially, the SEC charges that Goldman colluded with Paulson & Co (a US hedge fund run by John Paulson, who has not yet been charged) to put together packages of synthetic CDOs, which referenced real sub-prime mortgages that were, in Paulson's opinion, almost bound to fall in value. These were then sold to end-investors, notably Germany's IKB bank – which lost US $150 million on one investment in the so-called Abacus AC1 fund.

The problem is that Paulson made no secret of the fact that he was bearish on the US housing market, and that he was betting sub-prime CDOs would fall in value. Plus, he wasn't the only third party involved in choosing what went into the CDOs; ACA – a monoline insurer that subsequently bought its own reinsurance from ABN Amro (which is now part of RBS) was also involved, and lost almost US $900 million on its investment, presumably because it genuinely expected the CDOs to increase in value. Even Goldman claims to have lost US $100 million on Abacus – though it now turns out that was only because it failed to find buyers when it was trying to dump its share of the fund.

All of this will mean a field day for lawyers. However, the SEC has released a number of damaging emails suggesting that the Goldman executives most closely involved with Abacus either didn't understand what was being sold or actively disparaged the product. Plus, senior executives apparently sold Goldman stock heavily as soon as the SEC told the firm (confidentially) that it was looking at the Abacus transaction.

Goldman's CEO, Lloyd Blankfein, is due to testify before the Senate Investigations Sub-Committee this week – along with the 31-year old executive who actually handled Abacus. Blankfein claims the SEC's action is "political" and that it "hurts America". However, he will not get an easy ride – particularly given that Goldman reported first quarter profits of US $3.46 billion on Tuesday, up 91%.

B **REGULATORY REFORM**: Goldman's problems have been a godsend for Obama – whose efforts to push through real reform had appeared to be floundering (not

least, because of a vast lobbying operation, led by Fidelity, Goldman and the industry's lobby group, the Investment Company Institute). Thanks to Goldman's problems, Obama was able to make an important speech in Manhattan, in which he accused Wall St. of a "failure of responsibility" and of "misleading arguments".

Thanks to Goldman, the Senate Agriculture Committee (which oversees derivatives) also got a lot tougher – unexpectedly approving a new derivatives bill on Wednesday. As a result, it seems likely that most (though not all) US derivative transactions will be forced on to formal exchanges. Sen. Dodd's Finance Committee also seems likely to approve a watered-down version of the so-called "Volcker rule" – and chances that this will also be approved by the House of Representatives have improved.

That said, financial reform is still not a certainty in the US. As noted, the industry now has 1,500 lobbyists fighting against real reform in Washington. According to former Fed vice-chairman Alan Blinder, the acid test will be:

- whether the proposed Consumer Finance Protection Agency survives; and
- whether the exceptions to the rule that derivatives must be traded on-exchange are so significant as to undermine the entire bill's impact.

Nevertheless, the mood on Capitol Hill has changed radically.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

The IMF's warnings about a global sovereign debt crisis have struck a chord. It was reported (by Fitch) on Thursday, for instance, that Japan's public debt is now 201% of GDP – though, in this case, strong domestic savings means the debt can be funded (for now). In addition, it was reported last week that the UK's public sector borrowing hit a record GBP 23.5 billion in March – with borrowing for the year to March 31 also a record GBP 152.8 billion. So far, Britain has had no difficulty funding this, though it is worth noting that the yield on 10-year gilts is now 4.04%, or 100 bp more than *bunds*.

A **<u>THE US</u>**: The more optimistic picture of global growth in the *WEO* is reflected in the US as well. Over the last week, it has been reported:

- that the Conference Board's index of leading economic indicators was up 1.4% in March – or 11.7% year-on-year, the biggest annual increase since 1984;
- that existing home sales rose 6.8% in March, or 16% year-on-year, with the median price up 0.4%;
- that new home sales were up 27% last month;
- that durable goods orders rose 2.8% in March; and
- that first time jobless claims fell 24,000 in the latest week.

In addition, GM announced that it had repaid the US $8.22 billion that it had borrowed from the US and Canadian governments five years early – and with interest. Just about the only dissonant note was an unexpected 0.7% rise in producer prices last month – though, ex-food and energy, the core increase was just 0.1%.

On top of that, most quarterly corporate earnings were better than expected, particularly (as noted) in the banking sector. Citi, for instance, earned US $4.4 billion in the first quarter, after two years of losses.

<u>Not surprising, therefore, that US stocks were up</u>. Week-on-week, the DJIA was up 185 points (1.7%), the S&P500 was up 24 points (2.0%) and the Nasdaq was up 49 points (2.0%). Not even the IMF's warnings on sovereign debt had much impact, with the benchmark yield on the 10-year Treasury rising from 3.77% to just 3.81% and the 30-year yield actually falling from 4.67% to 4.66%.

B **<u>EUROPE</u>**: Notwithstanding its problems, <u>the eurozone is also picking up</u>. According to Markit, private sector output is now at a 32-year high, with the Composite PMI jumping from 55.9 to 57.3 in April. Consumer confidence also rose. For the

eurozone as a whole (despite Greece's problems), the Commission's confidence index rose from -17.3 to -15.2 last month; for the EU-27, it rose from -13.9 to -12.5.

This optimism carries through to the key eurozone member states.

In Germany, for instance, it was reported last week that the ZEW investor confidence index hit a six month high in April, and the IFO index rose from 98.2 to a two-year high of 101.6. The same is true in France – where it was reported that consumer spending rose 1.2% last month.

There is, however, one serious political problem – besides Greece. For the umpteenth time, it appears possible that Belgium might split into its Walloon and Flemish halves. This crisis has been around for years, and disaster always seems to be averted. But the collapse of Yves Leterme's five-party coalition, because of the defection of the (Flemish) Liberals, is yet another example of how fragile Belgian unity really is.

The UK, too, faces a very uncertain political future.

At the moment, it looks as though the (centre-left) LibDems will end up with the balance of power following the May 6 election. Owing to Britain's "first past the post" electoral system, they will almost certainly trail the Conservatives and Labour in terms of seats won – but they may be very close to Labour in terms of actual votes, which would give the party's leader, Nick Clegg (half-Dutch, quarter Russian, wholly European) enormous clout in negotiating a coalition with Labour or the Conservatives.

In the meantime, it was reported last week that the UK economy is slowing down again. GDP growth was just 0.2% in the first quarter (-0.3% year-on-year), after a rise of 0.4% in the fourth quarter of 2009. In addition, inflation is picking up (it was 3.4% in March, far higher than the BofE's 2% target) and, as noted, public finances are in disarray.

C **JAPAN**: As noted, Fitch has warned Japan on its debt level. However, PM Hatoyama is not in a position to do much. His popularity has fallen from 71% at the time of his inauguration to just 25%. The only good news (for him) is that the opposition LDP is splitting. The popular former Health Minister, Yoichi Masuzoe, is apparently about to announce his own party; this is significant because he leads in the polls as a possible successor to Hatoyama.

Given all this uncertainty, it is no great surprise that Japanese equities are bucking the global trend. Week-on-week, the Nikkei-225 was down 88 points (0.8%).

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

The expectation at the beginning of last week was that foreign exchanges were in for a wild ride – with Goldman's problems potentially hurting the dollar, the euro being sensitive to the Greek situation, the yen susceptible to Hatoyama's slumping popularity, sterling under pressure as the UK election approaches, and the Canadian dollar likely to rise if the Bank of Canada moved to tighten.

At least, the last of these materialized. Although the BoC left interest rates unchanged at just 25bp when its policy committee met on Tuesday, the tone of the accompanying note was unexpectedly hawkish. As a result, it is now generally assumed that Canada (which was less affected by the financial crisis than other major economies) will be the first G7 member to raise interest rates. Reflecting this, the Canadian dollar broke parity with the US dollar, and is currently trading at Can $0.999/US $, having risen as high as Can $0.993.

Other than that, however, the US dollar has been fairly strong – with the FT's dollar index increasing last week from 83.9 to 84.6:

- Against the euro, the dollar strengthened from US $1.351/€ to US $1.330 on Thursday. Since then, it has weakened slightly as EU leaders have attempted

to cobble together a deal on Greece, but it is still trading at US $1.3384 – up 0.8% week-on-week.

- Against the yen, the dollar is up even more strongly – not least because of Fitch's (unexpected) warning about Japan's public debt. At the beginning of last week, it was trading at Y92.25/US $. It is currently at Y94.28 – up 2.0% for the week.
- Sterling has also been weak. It opened last week at around US $1.541/GBP, then fell as low as US $1.53 on fears of a hung Parliament. In the last couple of days, however, the pound has bought back, particularly against the euro, and is now trading up against the dollar at US $1.5436. The markets, at least, are learning to live with the likelihood of a coalition government.

Over the next month or so, the key to exchange rate movements is likely to be interest rates. In addition to the BoC's hawkish stance, the Swedish and Australian central banks also indicated last week that rates are likely to rise – and their currencies responded accordingly. There is also, however, the continuing issue of risk – with the US dollar the obvious beneficiary of problems in the eurozone, the UK or elsewhere.

V OIL

The two key characteristics of the oil market continue to be:

- the unusual (and unusually wide) premium of front month Brent over WTI – which was US $2.75 at the beginning of last week and US $2.17 in early trading today; and
- the steep price spread between June and July WTI, which reached US $2.15 a barrel on Thursday, the highest since December.

Both of these phenomena reflect the inventory situation in the US.

According to the EIA, total US crude inventories rose 1.9 million barrels in the latest week, compared with an expected drop of 300,000. However, that disguises a more acute oversupply in the key Midwest region thanks, in particular, to increased flows from Canada. US crude inventories in the Midwest are now around 90.6 million barrels – the highest since 1990 – and inventories at the key price point of Cushing, OK are 34.1 million barrels.

Despite this, however, prices are up overall week-on-week. WTI for May delivery, for instance, opened last week at US $83.24 a barrel (having fallen 2% over the week), while June Brent opened at US $85.99 (having fallen 1.6%).

The May contract for WTI expired last Tuesday at just US $83.45, with the June contract closing at US $84.80. June WTI fell as low as US $83.68 on Wednesday, but is currently trading at US $85.33 – up 2.5% from the front-month close a week ago last Friday.

June Brent is also up. It is currently trading at US $87.50 – up 1.8% for the week.

In part, this strength in oil prices reflects market perceptions of stronger economic growth – in particular, strong US home sales. It also reflects the end of the travel disruption caused by the Icelandic volcano, which took approximately 1.2 million b/d of jet fuel off the market. And it reflects the IMF's assertion that the oil price will continue firm until/unless OPEC chooses to ramp up production. In addition, the entire commodity sector has been strong this week, with the R/J CRB commodity price index rising from 276.02 to 279.05. That said, the level of US inventories does suggest that a price correction is quite likely in the short term.

VI THIS WEEK

The key US economic indicators due this week include:

- the Case-Shiller house price-index for February, expected to be up 1%;
- the consumer confidence index for April, expected to be up around 1.5 points;
- the first estimate of the first quarter GDP growth rate, now expected to be around 3.2%; and
- the Michigan sentiment index for April, expected to be about 71.5.

The FOMC will also announce its interest rate decision. Although US rates will probably remain unchanged, markets are anticipating a more hawkish tone in the accompanying note.

Elsewhere, key releases include:

- the GfK index in Germany (for May);
- eurozone consumer sentiment (for April); and
- Japanese industrial production (for March).

Regards,
GISE