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WEEKLY ECONOMIC AND MONETARY REPORT

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The expectation is (yet again) that some sort of rescue deal for Greece will be announced within the next couple of days – in time for enough money to be delivered before March 19 that Athens will avoid default. That is certainly a desirable outcome; as former IMF Chief Economist, Ken Rogoff, pointed out this week, the global economy is too fragile to deal comfortably with the ramifications of a Greek default – which (as discussed before) would be potentially devastating for European banks. (However, Nouriel Roubini – an equally eminent economist – argued equally strongly in today's *FT* that the EU should bite the bullet, and accept Greek rescheduling.)

But we have been here before – and a deal on Greece has proved elusive before. So, nothing should be taken for granted.

The same is true with regard to the other big story this week – banking reform. The Senate hearings organised by Sen. Levin's Permanent Sub-Committee on Investigations put Goldman Sachs on the rack this week, and turned out to be a potential "game-changer". The pretty dismal performance of Goldman's CEO and his senior staff has certainly made it more likely that the Obama Administration can push radical reform through. But it would be madness to ignore Wall St's lobbying power; the big Wall St. banks may still succeed in heading off legislation that would fundamentally change their business model.

I SPRING MEETINGS

There was one significant achievement in Washington that did not get the attention it deserved.

World Bank President Zoellick (a far better negotiator than his recent predecessors) managed to negotiate a US$5.1 billion capital increase for the Bank – the biggest increase since 1988. This means that the Bank will have available cash of around US$40 billion – which may turn out to be extremely important if the Greek situation does metastasize into another European banking crisis. The Bank has committed

US$105 billion since July 2008, and its new resources mean it will remain a major player. Plus, there will be a bigger "voice" for emerging markets – whose share of the Bank's total voting power will rise from 44.06% to 47.19%. China is a particular beneficiary, leap-frogging Germany into third place in the Bank's hierarchy.

II GREECE. AND THE THREAT OF 'CONTAGION'

The crisis over Greece has gone from bad to worse this week – but it is quite possible that a deal could be cut this weekend that would give Athens and the broader eurozone a year or so's breathing space, during which it might be possible to address Greece's structural problems.

Certainly, the shape of a deal seems fairly clear – and, if it happens, it is likely to be a lot bigger that the €45 billion package from the IMF and individual eurozone members that was on the table last week. Talks all week in Athens and Berlin *appear* to have resulted in a consensus that Greece should get as much as €120 billion (US$160 billion) over three years to avoid a default on its external debt. Contributions would be as before: specifically, individual eurozone members could lend bilaterally, although their loans would be coordinated, with the crucial German contribution coming via KfW. Indeed, a bill was introduced into the Bundestag this week specifically endorsing this approach. The hope is that it will be approved by May 7. The French also expect parliamentary approval for their contribution not later than May 6.

In return for this, the Greek government (which, it should be remembered, was elected on a platform of workers' 'solidarity') is reported to have agreed to astonishingly tough conditions. These include:

- a 200-300 basis point increase in Value-added Tax;
- an increase in the public sector retirement age from 53 (sic) to 67 – which just happens to be the age at which German civil servants retire;
- abolition of the "two salaries" bonus system for public sector workers (which amounts to a salary cut of over 14%);
- a reduction in the public sector payroll of 100,000 by 2013;

- a three-year public sector wage freeze; and
- the sale of state-owned assets.

Oh, and there will also be a crackdown on tax evasion in the (heavily self-employed) private sector.

Put together, all of this amounts to around 10% of GDP. It is not surprising that public sector unions are bitterly opposed; what is more surprising is that (so far) the Greek electorate seems willing to go along. However, the head of the public sector union, Adedy, has called the government's plan "savage, unprovoked and unjust", and has warned that "the answer will be given in the streets". Both public sector workers and shopkeepers have called strikes for next week.

Even this level of sacrifice may not be enough for Chancellor Merkel to sell a bailout package to her own electorate. She faces regional elections in NRW on May 9 – and the CDU could well take a hammering on the issue of Greece. Recent polls show that 76% of Germans believe Greece will never repay any aid it gets – and the IFO Institute's respected economist, Werner Sinn, confirmed this week that the money will almost certainly have to be written off. Even the FDP (Merkel's coalition partner) has doubts; one of its spokesmen insisted yesterday that "you don't help an alcoholic by putting a bottle of schnapps in front of him".

In the end, however, what may tip the scales in favour of a deal is a realization of just how badly exposed other European countries (and banks) are to Greece. Different sources have different figures, but one estimate of holdings of Greek government paper by other European banks, insurers and pension funds is roughly as shown below:

Greece: Main institutional creditors (€ billion)

Country	€ billion
France	41
Germany	27
Italy	27
Netherlands	15
Luxembourg	15
Belgium	14
UK	9
Austria	6

Other estimates are even higher. The *WSJ*, for instance, claims that French exposure is US$79 billion, with Germany at US$45 billion. What seems clear is that, among the French banks, Credit Agricole (which owns Emporiki bank in Greece) is the most exposed, followed by Fortis, Dexia and SocGen. In Germany, the two most heavily exposed banks are already basket-cases – Hypo and Commerz.

It is important to appreciate that <u>events are moving very fast</u>

Although the markets were a little quieter yesterday on hopes of a deal, Greek 10-year bond yields were close to 10% at the beginning of this week – or 700bp over *bunds*.CDS protection was well over 700 bp, and short-term interest rates were 15% or more – which effectively priced in a default.

Plus, as the OECD's Angel Gurria said on Wednesday, "Contagion has already happened." This comment was prompted by S&P's decision to downgrade Greek debt to BB+ (or junk), Portuguese debt two notches to A- and Spanish debt from AA+ to AA. By Wednesday, Portuguese debt was trading at 330 bp over *bunds* – forcing the government to rush through a new austerity package. There were even serious rumours that traders were going to target the UK, despite the fact that it is not in the eurozone.

Gurria (who handled several debt reschedulings in Mexico) actually went further. He likened the Greek crisis to "financial Ebola" – and suggested that Greece should leave (or be expelled from) the eurozone for a while. The same message came from an unexpected source today. Writing in *The Times*, Bill Emmott (the former editor of *The Economist*) urged that Greece be kicked out of the euro before the crisis destroys the European economic model. Emmott's former magazine also weighed in, warning of:

- a run on Greek banks;
- a "sudden stop" of capital to other eurozone countries (and corporates); and
- paralysis in the European interbank market.

Its conclusion: Germany must swallow its reservations and do a deal on Greece – not in Greece's interest, but in its own.

III BANKING

A GOLDMAN: The testimony that CEO Blankfein and other Goldman Sachs executives gave to the Senate Subcommittee this week was devastating – once again, shifting the political balance in the US in favour of reform (subject, of course, to the banking industry's huge lobbying effort). As the *NYT* put it, Goldman Sachs is "a villain at the right time". It "put a face on an economic calamity".

But what actually came out of the hearings? The most significant admission was probably Blankfein's assertion that Goldman felt it had no moral obligation to tell its clients that, as a firm, it was betting against the financial products it was selling to them. That was an extreme defense of what has come to be known as "transactional" banking – where the banker has no fiduciary duty toward the client. It may well have prompted today's decision by the US Attorney's office to launch a criminal case against Goldman. (The earlier SEC indictment was civil.)

B US REGULATORY REFORM: Blankfein's defense of 'transactional' (as opposed to 'relationship') banking seems to have galvanized support for regulatory reform. Even though Republicans won a procedural vote at the beginning of the week that blocked debate of Senator Dodd's bill on the floor of the Senate, that has been revised, and the general feeling is now that the bill will be passed in some form. It may even be toughened. One proposal that is seriously under consideration (as a direct result of Blankfein's testimony) is that banks should be prohibited from taking positions opposed to their clients on securities that they have sold to those clients.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: No surprise either way on growth... It was reported earlier today that the US GDP growth rate in the first quarter was 3.2% - down from a 5.6% rate in the fourth quarter of 2009, but pretty much as expected. What was less expected was the surge in household spending, which accelerated from 1.6% to 3.6%. The biggest

drag on growth – predictably - was state and local government spending, which fell at a 3.8% rate.

That probably deserves more attention than it is likely to get.

American states and municipalities face an increasingly severe funding crisis, as property taxes collapse and as the recession hits state income taxes. Most of the attention has been focused on California, but Harrisburg (the state capital of Pennsylvania) could become the first US city to declare bankruptcy. This is potentially very damaging since the US municipal bond (or "muni") market is a US$2.8 trillion market in which many US pension funds are heavily invested.

Other economic data released this week supports the picture of fairly robust US growth. In particular:

- the Conference Board's consumer confidence index rose in April from 52.3 to 57.9 – its highest level since the start of the financial crisis;
- the Chicago purchasing managers index jumped from 58.8 to a five-year high of 63.8%; and
- first-time jobless claims fell 11,000 in the latest week.

On the other hand, the Case-Shiller 20-city house price index fell for the fifth straight month in February, by 0.9% - though it is still up 0.6% year-on-year. And it was reported today that the Michigan confidence index fell from 73.6 to 72.2 in April – though that was actually a bit higher than expected.

It may well be the fragility of the US housing market that stops the Fed from tightening. This week's FOMC meeting left the Fed funds rate unchanged at 0-0.25%, despite a modest improvement in the economic outlook. Moreover, in its accompanying notes, the Fed maintained its view that rates would stay low for an extended period. The appointment of Janet Yellen (currently, President of the San Francisco Fed), to succeed Don Kohn as Vice-chairman of the Fed Board, probably means that the bias towards lower rates will continue, since she has long been known as an economic 'dove'.

Almost lost in hubbub over the Goldman hearings, President Obama formally launched his 10-member Fiscal Commission on Monday, under the joint Chairmanship of former Senator Alan Simpson and former White House chief-of-staff Erskine Bowles. This is a (probably hopeless) attempt to depoliticize the issue of the US budget deficit; the Commission, which is admirably bipartisan, is tasked with coming up with a medium term strategy to resolve the deficit – i.e. to cut spending and/or to increase revenues.

Finally, what impact has all of this (including the problems of Greece) had on US markets?

Well, equities are generally down this week. Despite fairly strong quarterly earnings (notably Ford, GM and Caterpillar), the DJIA is off around 75 points (0.7%) through mid-day Friday, the S&P500 is off 1% and the Nasdaq is down 1.1%. As for Treasuries, however, they appear to have benefited from a flight to quality, with the benchmark 10-year yield falling over the week from 3.83% to 3.73%.

B **EUROPE:** Surprisingly enough (given Greece's problems), the Commission's latest economic sentiment index for the eurozone was up. Overall, the index rose from 97.9 to a two-year high of 100.6 this month. In Germany, it rose from 100.4 to 104.7; in France, from 100.5 to102.5. However, the index for Greece fell from 69.6 to 69.1 – and it may well have further to fall.

That said, economic confidence in Europe is still fragile, and it remains worrying that demand for bank credit is falling once again. Having risen throughout last year, it turned sharply negative in the first quarter – suggesting that a "double dip" is still a possibility.

That said, the outlook in Germany remains quite positive. This week, for instance, it was reported that unemployment had fallen more than expected last month. In addition, the GfK consumer confidence index rose from 3.4 to 3.8 in May – possibly because of the very strong performance of German exports. Nevertheless, it is worth

noting that the Xetra Dax has just closed down around 2.9% for the week – a reflection of the Greek crisis.

It is a mixed picture elsewhere in the eurozone:

- in France, for instance, it was reported that the consumer confidence index for April dropped from -34 to a very low -37;
- in Spain, it was reported that unemployment hit an astonishing 20.1% in the first quarter – by a long shot, the highest rate in the eurozone; and
- in Italy, on the other hand, the ISAE confidence index rose this month from 106.3 to 107.9.

The situation in the UK is entirely dominated by next Thursday's general election. The current feeling is that the Conservatives have started to pull away. However, they are still unlikely to have an overall majority. Meanwhile, Labour – which forms the current government – has seen its share of the vote collapse to only around 26-28%, which is below the share of the (traditionally weak) Liberal Democrats. However, because of how votes are distributed, Labour is still likely to win more seats in Parliament than the LibDems – which could produce a major constitutional crisis.

What seems certain is that Prime Minister Brown will step down as leader of the Labour party after the election – to be succeeded, probably, by Alan Johnson or the current Foreign Secretary, David Miliband.

Whoever emerges as PM (probably David Cameron) will have a very tough time. Indeed, it has been reported that BofE Governor Mervyn King told a visiting American economist that the next government could find itself out of office for 10 years or more in retaliation for the very tough decisions that it will have to take. On that score, the various party manifestos are meaningless. The key is going to be to close the budget gap – which the (relatively independent) IFS insists will mean tax increases and/or spending cuts amounting to GBP 71 billion a year for the next five years. The National Institute has estimated that this is roughly equivalent to increasing the rate of income tax by six percentage points.

C **<u>JAPAN</u>:** PM Hatoyama has announced that he will present (yet) another plan in June to produce faster growth. What precipitated this was the BoJ's latest projections. Although these see Japanese GDP rising 1.8% in the year ending March 2011, the Bank is also suggesting that deflation will continue. Consumer prices are projected to fall 0.5% this year, before rising just 0.1% in 2011/12.

That is despite stronger household spending (up 4.4% in the year to March) and wages (up 0.8%). However, it also reflects the fact that consumer prices (ex-fresh food) were down 1.2% year-on-year. Not surprisingly, the Nikkei-225 is also down – off 1.0% week-on-week.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

The main factors in the market this week have continued to be:

- the Greek crisis, which has generally weighed heavily on the euro;
- the UK election – and the prospect of a 'hung' Parliament, in which neither main party has a majority - which has hit sterling; and
- 'safe haven' concerns – which have forced the SNB to intervene against the Swiss franc.

There is also increasing concern about the volume of speculative foreign exchange trading – and, specifically, concern about the so-called 'carry trade'. According to today's *FT*, the authorities would like to clamp down on what is seen as an activity that has no "social value-added".

Whatever, week-on-week (through late trading on Friday), the dollar is:

- up slightly against the euro, having firmed from US$1.338/€ last Friday to US$1.316 on Wednesday, and to US$1.329 at the present time;
- broadly flat against sterling, having firmed from US$1.538/GBP to US$1.518, before falling back to US$1.531;
- up slightly against the yen, from Y93.91/US$ last Friday to Y94.1; and

- flat against the Swiss franc, which eased from SF1.072/US$ to SF1.083, before firming again to SF 1.078.

Clearly, sterling is likely to benefit as/when it becomes clear that the Conservatives will win an overall Parliamentary majority. Although UBS argued that the biggest threat to the pound would be a Conservative majority that tempted Cameron to try to cut the deficit too fast, it is clear that what markets don't want is the LibDems holding the balance of power. As for the dollar, it stands to gain from further chaos in Europe. However, if there is a deal to bail Greece out, the euro should recover – at least for a while.

VI <u>OIL</u>

It seems unlikely to have a significant impact on the global oil supply/demand balance, but the blow-out of BP's exploration well in the Gulf of Mexico - likely to become the worst oil spill in history – could have an important effect on the international oil market by making it far harder for the Obama Administration to open up other off-shore areas of oil exploration. It is also likely to hit BP hard. Although it was not the operator of the well (that was Transocean), it was the owner of the concession – and, under US law, is legally responsible for the cost of making good. Nor surprisingly, its share price has come under severe pressure. (It is also worth noting that the explosion will push up the cost of well insurance, which will increase the cost of offshore drilling around the world.)

As far as the key marker crudes are concerned, the price of front month WTI has risen this week, while Brent is broadly flat:

- <u>WTI for June delivery</u> closed last Friday at US$85.12 a barrel. It then fell as low as US$82.44 on Tuesday, prior to bouncing back. In late Friday trade, it is US$85.83 – up 0.7% week-on-week.
- <u>Brent for June delivery</u> closed last week at US$87.25, fell as low as US$85.78 and then bounced back. It is currently trading at US$87.19 (down 0.1% for the week), having touched US$87.44 earlier today.

What this means is that the price spread in favour of Brent (which is itself unusual) has narrowed from US$2.13 a barrel to US$1.26. In part, that reflects uncertainties about the Gulf oil spill and its impact on deliveries of crude into Louisiana and Texas.

However, US prices are still being depressed by excess domestic inventories. According to the EIA, total US crude stocks rose a further 2 million barrels in the latest week. More significant, stocks at Cushing, OK were up 450,000 barrels. It is going to take some time to work those down.

VII NEXT WEEK

In the US, the main economic release due next week is non-farm payrolls for April. It is expected that payrolls (which rose 162,000 in March) will be up about 100,000, but that the unemployment rate will remain unchanged at 9.7%. Other releases next week include:

- personal income for March, expected to be up 0.3%;
- durable goods orders for March;
- construction spending for March;
- the ISM for April; and
- factory orders for March.

Elsewhere, the most significant releases are likely to be:

- eurozone and UK purchasing managers indices for April; and
- German industrial orders for March.

Most markets (except the US) are closed on Monday, for the May Day Holiday. Japan is closed for most of the week. The UK holds a general election on Thursday.

Regards,

GISE AG