WEEKLY ECONOMIC AND MONETARY REPORT

21 May 2010

The good news this week is that the Obama Administration has made a genuine breakthrough on the banking front, with Senate approval of the so-called Dodd Bill. This will now go to a House-Senate reconciliation committee, and it is still likely to be watered down (thanks to a massive lobbying effort by the US financial services industry). Nonetheless, it now looks as if there will be financial reform – and that it will be more radical than seemed likely a few months ago.

The bad news is – practically everything else.

Most of the US and European economic releases this week have been disappointing. The markets seem increasingly unimpressed with the massive €750 billion euro bailout package. There is more and more concern about the terrifying level of government debt on both sides of the Atlantic. And there is real concern that, as a result of these mounting problems, the US and Europe could drift back into recession – or worse. Meanwhile, there is increasing awareness that, in some sense, Asia and (to a lesser extent) Latin America and other emerging markets are detaching themselves from the crisis. The message from them is that "it's not our problem" – an attitude that could well split the G-20. Its next meeting is in Canada, which is (so far) largely untouched by the crisis; its November meeting is in Seoul. Both meetings will be chaired by the Koreans, who simply aren't that interested in the problems of Greece, Portugal, or even the eurozone.

I THE EUROZONE CRISIS

One thing is certain: The crisis is no longer just a 'Greek crisis' – or a Portuguese crisis, or even a Spanish crisis (though all three have been targeted over the last few weeks). It is now an existential crisis for the euro, and for the eurozone as currently constituted. It remains *constitutionally* impossible for a member to exit the eurozone; legally, the only way it can be done is by quitting the EU entirely. But, despite that, many intelligent commentators are predicting that Greece – or, indeed, Germany –

will drop out. There are also all sorts of rumours (most of which should be dismissed) that the Greeks are reprinting drachmae, that the Bundesbank is digging up stocks of old DM, etc etc.

The betting is still that the euro (and the eurozone) will hold together – but only just.

One of the big problems is the markets' lukewarm reaction to last week's €750 billion package – which was (apparently) designed to beat speculators into submission with its sheer size. Initially, this worked, but questions quickly arose over just how united the eurozone is. That came up at the Tuesday ECOFIN Ministerial meeting, where it transpired that there is no agreement whether the €440 billion loan guarantee component of the package should consist of a single facility guaranteed(jointly and severally) by all eurozone members – or whether the guarantees should be extended on a case-by-case basis (as Germany apparently insists).

There has also been scepticism about whether Chancellor Merkel could get the entire package (of which Germany's share will be €148 billion) approved by Parliament – particularly since the CDU/CSU no longer controls the Bundesrat. However, that concern has disappeared today with both the Bundestag and Bundesrat giving their approval (albeit, with the Opposition SPD abstaining). Even so, there is still a strong feeling in Germany that the ECB was railroaded into agreeing with the package – and, therefore, that its much-vaunted independence has been compromised. Moreover, there is a feeling that the institutional framework for the package was too sketchy. (Apparently, the EIB in Luxembourg will provide logistical support, but will not run the facility.)

Whatever, the best one can say is that market reaction was mixed. On the positive side, the euro – which hit an 18-month low of US$1.2359 last Friday – did stabilize. Indeed, it is currently trading around US$1.25 – which, it should be remembered, is still around 6% higher that it was when the euro was launched. In addition, several weaker eurozone members managed to get bond issues away this week on terms that were better than the markets had expected. In particular, on Tuesday, Spain sold €4.4 billion of 12-month notes at a yield of 1.7%, and €2.1 billion of 18-month notes at 2.1%. Although the comparable rates in April had been 0.90% and 1.2%

respectively, that was considered a success. Spain is also reported to have sold 10-year paper yesterday. In the meantime, Portugal sold €500 million of nine-month bills at 2.5% - again, a far higher yield than a couple of months ago, but well below what one would expect if a default was priced in.

On the other hand, 3-month dollar LIBOR has remained stubbornly high (and, worryingly, the spread between the various bank quotations has widened), pretty much unaffected by the 'shock and awe' package. And the Chicago VIX index (which measures volatility) has hit a series of highs this week, apparently on concerns about Europe.

The markets' scepticism about the package has clearly provoked EU politicians. On Monday, Merkel warned of an "existential threat to financial stability"; yesterday, German Finance Minister Schauble (who has been in and out of hospital for some weeks) insisted that "markets are really out of control". Reflecting this thinking, at the beginning of the week, BaFin (the Federal financial regulator) unilaterally imposed a number of temporary measures on banks operating in Germany. These include:

- a ban on so-called 'naked' short-selling of all European public sector debt and of shares in Germany's 10 biggest financial institutions; and
- a ban on shorting of any European sovereign CDSs.

There were immediate howls of outrage – not least, from other eurozone governments (which had not been consulted). French FM Lagarde was particularly scathing – pointing out that it is too easy for these bans to be circumvented by routing trade through other centres. However, it is worth noting:

- that the US itself bans naked shorting of equities;
- that the ban only lasts until March 2011; and
- that the move was largely designed to appeal to domestic political opinion in Germany – which is increasingly "anti-bank".

Given today's vote, it may have served its purpose. Plus, the short covering that it prompted meant that Germany was able to sell €5 billion worth of bonds this week at

the lowest interest rate since 1998. That said, the ban also prompted speculation that German banks are in much worse shape than they are admitting. There is certainly evidence from weekly ECB data that there was, indeed, a run on eurozone banks ahead of the €750 billion package. Although the general feeling is that French banks are more exposed to Greece than German banks (indeed, former Bundesbank President Poehl yesterday described the eurozone bailout as "protectionism for French banks"), it may be that German banks' exposure to Spain and Portugal made them extra-vulnerable.

Where do we stand now? Today's issue of *The Economist* is pessimistic. It claims that European leaders still suffer from three 'delusions':

- that "speculators" are really to blame (it calls this 'shooting the messenger');
- that "shock and awe" can work, despite the enormous size and reach of global financial markets; and
- that the eurozone can still avoid much deeper structural reform.

The magazine also worries that Germany, in particular, is following the wrong course. To head off domestic political opposition to the whole European project, it is now pressing other eurozone governments to adopt a version of the 'balanced budget' law that it adopted last year. This sets Germany the task of limiting its budget deficit to no more than 0.35% of GDP by the middle of this decade. Potentially, that could be devastating for Europe if other countries imposed the same rule.

What of Greece? While the eurozone's problems have attracted huge attention, Greece's problems seem to have slipped below the horizon. One reason is that, on Tuesday, Athens received the first tranche of the €110 billion eurozone/IMF package that was agreed two weeks ago. Of this, the eurozone put up €14.5 billion (€4.4 billion of which came from Germany). As a result, the government was able to make the €19 billion bond payment as it came due in full.

Nevertheless, most observers believe a rescheduling/restructuring of Greek debt is still both inevitable and desirable. True, Greece's foreign debt is enormous – around

€300 billion, which is almost twice the total amount of debt that has been rescheduled around the world since 1983 (US$183 billion, according to Moody's). But Greece has one big advantage: While 90% of Argentina's debt was governed by NY or English law, 90% of Greek debt is governed by local Greek law. That means Greece is much less vulnerable to so-called 'vulture' funds, who try to hold a defaulting government to ransom in foreign courts. Although Greek society has been (surprisingly) willing to accept austerity so far, it is simply crazy for Europe as a whole to expect Greece to accept the massive loss of welfare implied by a shift in GDP of more than 10%.

The EU's ECOFIN Council is meeting again today. Ostensibly, Schauble will use this meeting to push for tighter fiscal rules throughout the Union (including a role for the Commission in pre-approving national budgets). More likely, Ministers will discuss when and under what circumstances Greece can expect some debt relief.

II BANKING REFORM

As noted, the Europeans will push for bank reform to be high up the agenda for next month's G20 Summit in Toronto. However, the Koreans and Canadians are much less keen – which could lead to strains within the group. According to Merkel, Germany wants:

- support for a new European ratings agency (to break the power of S&P and Moody's); and
- a global banking levy (either on assets or profits), to 'punish' banks for their role in the recent crisis.

A **THE US:** As noted, Obama had a real victory this week.

To some surprise, the so-called Dodd bill passed the Senate last night by 59/39. It must now be reconciled with the bill already approved by the House, which may be tricky. Nevertheless, the White House will sign something into law within the next couple of months – and it is likely to be more radical than seemed likely. The main points in the Senate bill include:

- a new Consumer Financial Protection Bureau, located in (but independent of) the Fed;
- a requirement that all OTC derivative contracts should be routed through central clearing houses, except for non-financial contracts that are used for genuine hedging (e.g. agricultural commodities);
- a new Resolution Authority, which will permit US regulators to take over failing banks earlier, to wipe out shareholders and to fire bank executives;
- a new Financial Stability Oversight Council, which will identify and monitor signs of systemic weakness, and force systemically-significant institutions to have resolution plans in place; and, most significant,
- a ban on proprietary trading and hedge fund/private equity activity by deposit-taking banks – the so-called "Volcker rule".

It will be interesting to see how much of the Volcker rule remains after House/Senate reconciliation.

B **THE UK:** The new Conservative/LibDem government continues to backtrack on some of the more radical measures the Conservatives (in particular) had promoted while in Opposition. As it now appears, the BofE will have an enhanced responsibility for macro-prudential (i.e. systemic) regulation. Micro-prudential supervision will remain with the FSA – though there will be more formal cooperation with the Bank. An independent Commission will investigate the feasibility of 'breaking up the banks' – i.e. of reinstating a sort of UK Glass-Steagall. But (for better or worse) support for this appears to be eroding under pressure from the banks.

III RECENT ECONOMIC AND MONETARY DEVELOPMENTS

As noted, there is a growing sense that the obsessive focus on the crisis in Europe and (to a lesser extent) in the US is diverting attention away from the much more attractive prospects elsewhere. It isn't just Asia: Last weekend, the EBRD held its Annual Meeting in Croatia. Even though it accepted that the problems of the EU make Central and Eastern European prospects "exceptionally uncertain", the Bank also increased its 2010 forecast for regional growth from 3.3% to 3.7%. When one

considers that Japan – long assumed to be mired in something near recession – has just reported a 4.9% GDP growth rate in the first quarter, and that independent forecasters believe China's growth rate is now back up to 10.7%, we may be missing something by concentrating on the US and Europe. Nevertheless…

A THE US: This week's economic releases have generally been disappointing. In particular:

- the NY (Empire State) activity index fell in May from 32 to 19.1;
- first-time jobless claims rose unexpectedly, by 25,000 in the latest week;
- the Conference Board's index of leading economic indicators fell 0.1% in April, its first drop in over a year; and
- building permits fell 11.5% in April.

True, the Philadelphia Fed index rose from 20.2 to 21.4 – but even that was lower than expected.

On top of that, the US consumer price index fell 0.1% in April, bringing the year-on-year increase in core prices down to a 44-year low of just 0.9%. With producer prices also down 0.2%, Japanese-style deflation is becoming a real fear- particularly if the housing market is really poised for another slump (as many believe).

Despite this, it is worth emphasizing that the Fed does not seem too worried – at least according to the minutes of the April 27/28 FOMC meeting. These included an upward revision in the 2010 growth forecast from 2.8-3.5% to a range of 3.2-3.7%.

Equally worrying, though it still hasn't got the attention it deserves, is the Treasury's so-called TIC data, which covers long-term purchases of US securities by foreigners. In March, total purchases hit a record of US$140.5 billion – with private purchases outweighing foreign governments 3:1. Total foreign holdings of US Treasuries now exceed US$3.88 trillion.

All of this is starting to weigh on US equities. Last week, the DJIA was up 240 points (2.3%), while the S&P was up 2.2% and the Nasdaq was up 3.6%. This week, the

Dow was down 552 points (5.2%) through Thursday, the S&P500 was off 5.8% and the Nasdaq was down 6.1%. In early trade today, all three indices were off a further 0.4-0.6% - largely because of negative comments from the *über*-bear, Nouriel Roubini. Even though they have bounced back, they seem bound to close down for the week as a whole.

The main reason for this is a knock-on effect from the eurozone's problems – particularly after the unilateral German curbs on shorting. This has added to real fears of a double-dip recession. In addition, the markets are worried about what the *FT* called "a disorderly crackdown on banks and financial markets" – a crackdown that could result in further cutbacks in lending.

B **EUROPE:** While there are real fears that the eurozone may be coming apart, macroeconomic data paints a more nuanced picture. On the positive side,f or instance, it was reported this week that the eurozone's trade surplus widened in March to €4.5 billion. On the other hand, it was also reported:

- that the eurozone's consumer confidence index fell last month from -15 to -17.5, with the EU-26 index falling in parallel, from -12.3 to -14.7; and
- that the eurozone's PMI fell in May from 57.3 to 56.2, with manufacturing falling from 57.6 to 55.9.

It was also reported in Germany that the ZEW economic sentiment index fell in May from 53 to 45.8, while the IFO business climate index fell from 101.6 to 101.5. That clearly isn't good news – though at least Merkel doesn't have to worry about imposing new austerity measures.

Other countries have no such luck. In Spain, for instance, PM Zapatero (whose PSE now trails the centre-right PP by almost 10 percentage points) announced a €15 billion austerity package last week – and followed it up this week with new taxes (especially on the "wealthy"), coupled with cuts to Spain's aid budget. Equally, in Italy, the government is preparing a €25 billion two-year deficit reduction package. This is likely to include:

- a freeze on public sector wages; and
- a higher retirement age.

As for France, it too has to cut its deficit – and it has indicated that it will increase the retirement age and impose a new tax on high earners. However, details are not due to be released until June – which led *The Economist* to call its plans "too timid by half".

In the UK, the most interesting initiative launched to date by the new government is to set up an (independent) Office of Budget Responsibility, under a respected academic, Alan Budd. This will have responsibility for ensuring the integrity of UK economic statistics. It will also produce a definitive estimate of the country's fiscal deficit, which will drive the government's emergency budget – now scheduled for June 22.

Most people believe Budd *et al* will come up with an even more daunting estimate of the deficit – which will leave Cameron and LibDem leader Clegg with no alternative but to raise taxes sharply (possibly through an increase in VAT). In the meantime, it was reported earlier today that the budget deficit for April hit GBP 10 billion – up 10% year-on-year. With both the RPI and CPI now well above their ceilings (the RPI is running at 5.3%, the CPI at 3.7%), inflation is becoming a serious problem – and BofE Governor King's soothing words on the subject are being met with increasing skepticism.

Higher interest rates would, however, run the risk of choking off a fragile recovery. The only significant UK economic release of the week was retail sales volume for April – up 0.3%, or 1.8% year-on-year. With so much of the UK economy geared to housing (and with housing being extremely dependent on variable rate mortgages), higher interest rates would have a very rapid impact on activity. As a result, it is no great surprise that – despite the fact that the UK is not in the eurozone, and has therefore benefited from the (relative) weakness of sterling – the FTSE is so far down over 200 points for the week.

C **<u>JAPAN</u>:** As noted, GDP was up 1.2% in the first quarter – or 4.9% at an annual rate. Despite that, the Nikkei-225 has just closed at 9,785 – its low for the year, and down 6.5% for the week. The reason seems to be twofold:

- the lack of political support for PM Hatoyama; and
- a rumor that Japan is about to be downgraded (again) by one of the two big rating agencies.

D **<u>CHINA</u>:** As noted, the median private sector estimate is that the Chinese GDP growth rate accelerated in the first quarter from 10.2% to an astonishing 10.7%. The US Conference Board has just introduced its own estimate, which shows a growth rate of 'only' 7% for October-March, but most observers feel that is too low.

On the other hand, there are now real fears that the Chinese economy could blow up. Another big hedge fund, Eclectica, has suddenly turned bearish, and today's *FT* carried a worrying article about unregulated, informal lending (the so-called *minjian jeidei* market). The Shanghai stock exchange has already fallen 22% this year, and there are rumors that property sales in Beijing were down 80% month-on-month in the first half of May. All straws in the wind, maybe. But significant nonetheless.

Plus, stories like these seem certain to make the Chinese even less keen to drop the renminbi's dollar peg. The Chinese are aware the RMB has appreciated 14.5% against the euro in the last four months – and they are, therefore, increasingly dependent on dollar markets for their exports.

VI <u>FOREIGN EXCHANGE MARKET DEVELOPMENTS</u>

<u>FX markets have been on a roller-coaster ride</u> this week, following a steady decline for the euro over the last two weeks which saw it hit an 18-month low of US$1.2359 last Friday, down 5% from the high it reached (briefly) on Monday after the €750 billion package was announced.

This week, the euro fell as low as US$1.218 on Tuesday, but has since bought back – not least because of repeated rumors of coordinated central bank intervention. It is

currently trading around US$1.257 – up 1.2% from Friday's close. Despite that, most traders still seem bearish on the euro. Unicredit, for instance, has said it is "starting to look like a sinking ship" – even though it is still 6% above its launch value. Notwithstanding its latest mini-bounce, the euro is still a long way from credibility against the dollar – or against the yen.

Last Friday, for instance, the euro closed at Y1114.3/€. By Wednesday, it had fallen to Y112.7. Even though it is currently trading at Y113.1, it is still down 1% week-on-week.

The other currency that has come under pressure recently is sterling.

Last week, the pound closed at US$1.458. This week, it has been hit further – primarily by worries about the UK fiscal deficit. It fell as low as US$1.43/GBP at the close on Wednesday. Even though it has since recovered to US$1.445, it is still down 0.9% for the week.

The Swiss franc has also weakened – from SF1.128/US$ to a low of SF1.156, before firming to SF1.147. That, however, does not reflect the underlying strength of the currency. Rather, it reflects what is believed to have been significant intervention by the SNB, which was defending the SF1.40/€ rate. As a result, the central bank has beaten the cross down to a more comfortable SF1.442.

Meanwhile, commodity currencies have weakened significantly in the last couple of days on concerns about the global economy – and about China in particular. The Australian dollar, for instance, has fallen to A$1.2101/US$ - close to a 10-month low, and off 2.4% for the week. The Canadian dollar has also weakened, and is currently trading around Can$1.621/US$, having broken 'parity' only six weeks ago.

V OIL

It has been another difficult week for oil markets – primarily because of concerns about the sustainability of the global economic recovery.

At the close last week, WTI for June delivery was trading at US$71.61 – down 4.6% week-on-week. July Brent was at US$77.18 – down 1.4%. Both marker crudes fell again on Monday, with WTI hitting a low of US$69.27. By the close on Tuesday, June WTI was trading at US$69.41, while July Brent was at US$74.43.

On Wednesday, the June WTI contact expired at US$69.87 – having fallen as low as US$67.90, the lowest level for front-month WTI since September 2009. The new July marker contract opened at US $72.48. With July Brent at US $73.69, the spread in favour of Brent had narrowed to US $1.21. Yesterday and today, oil prices have fallen again, and, in mid-day trading today, July WTI is at US $70.42 – down 1.7% week-on-week. Front-month Brent is US $71.63 – down 7.2% for the week. In other words, the market is close to eliminating the (unusual) premium in favour of Brent.

That is despite the fact that, in the latest week, crude stocks at Cushing, OK rose again by 900,000 barrels to an all-time high of 37.9 million. Overall, US crude stocks rose 200,000 barrels week-on-week – though gasoline stocks fell 300,000 and distillate stocks were down 1 million. Again, fears over the overall level of economic activity are probably key.

Finally, it was reported this week that BP has formally waived the US $75 million legal cap on its liability for the continuing oil spill in the Gulf of Mexico. That may seem like a perverse step, since Federal law appears to cap individual company liability for oil spills at US $75 million – and the total cost of the Discovery Horizon spill is likely to be several billion dollars.

The catch is that BP would almost certainly not have been able to invoke the cap since there is an exception in cases where there are safety violations. It seems clear that there were many violations in this case – not all of them, admittedly, by BP.

VI NEXT WEEK

US Treasury Secretary Geithner is visiting Europe next week, with the eurozone crisis and bank reform top of his agenda.

As far as US economic releases are concerned, the most significant are likely to be:

- new and existing house sales for April (both expected to be up);
- the Case-Shiller house price index for March (which could see a cooling off);
- durable goods orders for April (expected to be up 0.9%);
- personal income and expenditure for April (expected to be up 0.5% and 0.3% respectively); and
- the second estimate of the GDP growth rate for the first quarter, expected to be revised up from 3.2% to 3.3%.

In Europe, key releases include:

- industrial orders for the eurozone in March, expected to be up 2%; and
- the GfK consumer sentiment index for June in Germany, expected to fall from 3.8 to 3.6.

Regards,

GISE AG