WEEKLY ECONOMIC AND MONETARY REPORT

28 May 2010

Although it started badly, with the Spanish government being forced to bail out a small regional lender (owned, ironically, by the Catholic church), this week has turned out to be quieter and calmer than most observers had expected. Greece has remained fairly quiet, the markets have reacted positively to austerity measures in both Italy and Spain, the euro (though still weak) has stabilised, stock markets across the world have generally rallied and oil markets have recovered after three weeks of heavy losses.

And yet… Nothing has really changed. There is still a fairly general acceptance that, at some stage, Greece will have to restructure its €300 billion sovereign debt - and that, when it does, it could set off a chain reaction that could destroy the eurozone. The euro itself is also under threat. True, it is still well above its initial launch rate of US $1.17/€, but there have been reports this week that Chinese SWFs are considering dumping euro assets. Though they have been denied, the assumption is that there is some truth in them. Plus, there is a general "smell of fear" in the markets – a worry that we are on the verge of a major sovereign debt crisis. As today's issue of *The Economist* put it, there is a fear that "governments may become the problem that will drag the world economy down".

This is reflected in a steady increase in LIBOR (though the three-month dollar rate is still barely one-tenth of where it was when Lehman collapsed), in the so-called VIX (volatility) index, and in rumours that certain European banks are being shut out of the interbank markets altogether.

It is not easy to explain this – and it is worth emphasising that it is largely a US/European concern. (Asia, in particular, is far more confident – despite the recent problems of Thailand, where the Chinese may have played a destabilising role, and the prospect of disruption on the Korean peninsula.) But it seems to stem from a lack of policy consensus.

At the risk of gross oversimplification, Western governments are being pulled in two contradictory directions:

- the conventional Keynesian analysis (which is particularly influential in the US, not least through pop economists like Paul Krugman) is that increased public spending is crucial to make up for weak private spending – and that this is no time to turn off the tap; while
- the "post-Keynesians" (more influential in Europe, particularly in Germany) argue that what governments must do first is cut public spending to keep interest rates low and financial confidence high.

Until very recently, the Keynesians have had the better of the debate (and they still run the Obama White House, which is pushing another US $145 billion spending package through an increasingly suspicious Congress). Indeed, Treasury Secretary Geithner has been in Germany and the UK this week, urging Merkel and Cameron not to lose their nerve. However, the crisis in the eurozone has indicated just how important it is to retain market confidence. As a result, the UK, Spain, France and Italy are all following the lead of Greece and Portugal with tough austerity packages – and Germany has gone even further, demanding changes to the Lisbon Treaty that would strip eurozone members of agricultural subsidies and voting rights if they break the 3%/60% deficit/debt rule.

I OECD

In the middle of this genuinely scary crisis of confidence, the OECD has just come up with substantially more optimistic short-term growth forecasts. As shown below, its latest *Economic Outlook* is now projecting global growth of 4.6% this year and 4.5% in 2011, up from previous estimates of 3.4% and 3.7% respectively. Growth in the OECD itself is now put at 2.7% and 2.8%, up from the previous forecast of 1.9% and 2.5% :

OECD: short-term GDP growth forecasts

	2010	2011
US	3.2%	3.2%
Japan	3.0%	2.0%
China	11%	10%
Eurozone	1.2%	1.8%
(Greece	- 3.8%	-3.2%)
UK	1.3%	2.5%
Global	4.6%	4.5%

The biggest upward adjustment is for the US. In its previous *Outlook*, the OECD was projecting growth of just 2.5% this year and 2.8% in 2011. All in all, the picture is generally encouraging – though the OECD also warns about the build-up of inflationary pressures as a result of loose monetary policy, and about the problem of government debt.

II EUROZONE CRISIS

As noted, things have gone quieter this week – but the crisis is far from over.

In particular, there is a great deal of concern about Spanish banks following the government's decision to pump €500 million into CajaSur, a small regional lender in Cordoba. It is widely assumed that the entire *caja* sector (which has funded Spain's property bubble) is in trouble. As a result, even the big banks (Santander, BBVA) are apparently having trouble raising money (and even renewing lines) in the interbank markets. The government is also having the same trouble: it raised €3.06 billion in three and six-month bills on Tuesday – but saw the interest rate on the latter almost double to 1.32%.

As a result, Madrid seems determined to convince the market that it is serious about reform. Yesterday, the Zapatero government pushed a supplemental €15 billion austerity package through Parliament by just one vote. It also announced a new policy on transparency – forcing banks and *cajas* to reveal the full extent of their bad loans, and to write them down within one year.

Based on the immediate reaction of the stock market, this proactive stance may work. Certainly, the markets are not attacking Spain as hard as they did Greece. Reflecting that, the ECB revealed this week that, since it went into the Quantitative Easing business on May 10, it has bought "only" €26.5 billion of government and corporate bonds – suggesting that <u>there has been less panic selling of "Club Med" paper by EU banks than most had expected</u>.

III **<u>RECENT ECONOMIC AND MARKET DEVELOPMENTS</u>**

A <u>THE US</u>: As noted, the Obama Administration is trying to push through yet another "jobs bill" – this time, a US$145 billion stimulus package. The feeling is that the stimulative effect of last year's massive Federal spending boost is wearing off. This time, however, Congress is distinctly reluctant – particularly as the spending bill also contains targeted tax increases for "the rich".

The main reason for Obama's move is the revelation that M3 (which, officially, the Administration does not look at) has been shrinking since last Summer – and fell at an annual rate of 9.6% in the February-April quarter. This is frightening; there is no precedent for a contraction on this scale since the Great Depression – and it suggests that the Administration is getting very little "bang" for its (fiscal) "buck". Indeed, it was reported this week:

- that the first quarter GDP growth rate was revised down from 3.2% to 3.0%, largely because of lower business investment;
- that personal spending was flat in April, compared with an expected rise of 0.3%;
- that the Case-Shiller 20-city house price index fell for the sixth straight month in March, dropping 0.5%; and
- that the Chicago PMI fell in May from 63.8 to 59.7.

All of that sounds pretty dreadful. However, the picture is actually rather better than that. It was also reported:

- that existing and new home sales jumped very sharply last month, by 7.6% month-on-month and 14.8% respectively – albeit, in large part because of a tax credit that has now expired;
- that housing starts also rose sharply, by 10.2%;
- that durable goods orders were up 2.9% in April;
- that personal income rose 0.4%; and
- that the (final) revision of the Michigan confidence index for May was 73.6, up from 73.3 in April.

Admittedly, the combination of higher income and flat consumption meant that the savings rate rose in April for the first time in four months. At 3.6%, it is still low by historic standards – but the fact that it is rising may be one of the reasons why the Treasury is pushing for more stimulus. The parallel with Japan's "lost decade" (when Japanese simply stuffed their earnings under the mattress) is a little worrying.

Despite that – and despite global equity weakness earlier in the week, triggered in particular by fears over Korea – the DJIA was up 65 points (0.6%) through Thursday, and the S&P 500 was up 15 points (1.4%). Although the yield on the benchmark 10-year Treasury bond has risen from 3.18% to 3.32%, there is no evidence as yet that investors are shunning dollar assets – though it should be noted that all the major US equity indices are down modestly in mid-day trade on Friday (and it seems certain that the Dow will have had it worst May, traditionally a strong month, in over 40 years).

B **<u>EUROPE</u>:** The markets are a good deal more negative on the eurozone than on the US – particularly on the "Club Med" countries. Indeed, while the German 10-year *bund* yield has barely moved from 2.7% this week, as noted, Spain has had a lot of trouble selling its paper.

Again, this is despite the fact that economic news out of the eurozone has mostly been positive. In particular, it was reported this week:

- that the eurozone services sector grew at its fastest pace in three years in May, with the Markit PMI rising from 55.6 to 56.0; and
- that eurozone factory orders jumped 5.2% in March , the biggest increase in three years.

As a result, governments across the eurozone have felt the need to announce and/or to implement significant austerity packages. In Germany, for instance, Merkel has announced plans to cut €10 billion a year from public spending. As noted, in Spain, PM Zapatero just managed to win Parliamentary approval for a €15 billion package, including a 5% cut in public sector wages. And, in Italy, Berlusconi announced €24 billion in cuts over two years. Although unions are pledging mass demonstrations, there seems to be reluctant acceptance that the eurozone has been living beyond its means.

The new Conservative/LibDem government in the UK is also pressing ahead with its own austerity package, announcing GBP6.2 billion in immediate public sector spending cuts on Monday – and laying out a more radical programme of cuts and tax increases in the so-called Queen's Speech on Tuesday. As the new Chancellor, George Osborne, pointed out, "the days of public sector plenty are over". However, although the fiscal situation in the UK is dire, the political consensus for austerity is even more fragile than it is in the eurozone. In particular, the government has provoked a major revolt among its core "middle England" supporters over the issue of extending a penal rate of capital gains tax to second homes and to equities held as pensions. It may have to back down on this emotive issue.

In the meantime, the UK also reported last week:

- that bank lending to businesses fell again in April – and has now fallen for seven straight months;

- that the GfK confidence index hit a five month low this month, falling from -16 to -18; and
- that, according to the CBI's distributive trades survey, sales volume in May hit a 14-month low, with new orders also down sharply.

Adam Posen – the newest member of the BofE's MPC (and a well-known US economist) – warned on Monday that the UK is at risk of sliding into "Japanese-style deflation". Indeed, he warned, it may be worse off than Japan in that:

- unlike Japan, the UK cannot count on domestic investors to buy its debt – it has to sell to foreigners;
- it has a manufacturing base that is effectively "failing" (if not "failed"); and
- the UK banking sector is very weak.

Not an encouraging picture for the new coalition government. Nevertheless, it is worth noting that UK equities are up around 3% this week, while gilts yields are still well below Southern European levels.

C **JAPAN:** More realistically, perhaps, Japanese equities have been flat this week – despite an acceleration in the GDP growth rate to an extremely robust 4.9% in the first quarter. Moreover, that growth was largely fuelled by exports – which ought to be good for major manufacturers.

The problem seems to be the perennial issue of Japanese household spending – which was down 0.7% year-on-year in April. In addition, unemployment rose unexpectedly from 5.0% to 5.1%. As a result, Japan continues to find itself in a deflationary trap; consumer prices (ex-fresh food) were down 1.5% year-on-year in April – even worse than the 1.2% drop in March.

D **CHINA:** The latest high-level meeting of the US-China Strategic & Economic Dialogue – which took place in Beijing last weekend – appears to have made no more progress than previous such meetings. President Hu Jintao pledged some kind of "currency reform" – but was cryptic both on the substance of what this would mean and on the timing. One day, he seemed to say, the renminbi/dollar link will be broken – but not yet.

In the meantime, China has been sending out distinctly mixed messages on its foreign currency holdings.

Last week, it appears, several Chinese sovereign wealth funds held talks with investment bankers about the problems of the eurozone and what that meant for the euro itself. As a result, CIC – one of the biggest – admitted that it was "very concerned" about prospects for the euro. That prompted a near-panic in FX markets, with rumors that SAFE (the official agency for managing China's reserves) was dumping euros. Although that has been (strongly) denied, what seems clear is that China is monitoring the situation very closely.

E **GCC:** It was reported yesterday that the long-running negotiations between the EU and the GCC on a Free Trade Agreement have been "suspended". Apparently, the EU's position had not changed, and the Gulf side felt there was "no point in negotiating".

IV FOREIGN EXCHANGE DEVELOPMENTS

Last week, the euro showed the first signs of recovery in quite a while. Although it hit a four-year low against the US dollar on Wednesday, for the week as a whole it was up 1.7% against the dollar, 2.2% against sterling and 3.1% against the Swiss franc. This week, however, the dollar has bounced back.

For the week, through mid-day trading on Friday, the euro has eased from US$1.265/€ to US$1.237 – a drop of 1.6%. The euro has also fallen marginally aginst the yen, from Y112.9/€ to Y112.6. Over the same period, the dollar has been mixed against other major currencies:

- it has fallen 0.7% against sterling, from US$1.443/GBP to US$1.453;
- it has strengthened 1.4% against the yen, from Y89.80/US$ to Y91.04; and
- it has strengthened 0.5% against the Swiss franc, from SF1.147/US$ to SF1.153.

The dollar has also fallen against most commodity currencies this week – dropping 2% against the Australian dollar (which rose almost 7% last week) and 1.3% against the Canadian dollar. In both cases, the main factor appears to have been the surprisingly upbeat short-term economic forecasts from the OECD – particularly for China (which tends to determine demand for key commodities).

As far as the euro is concerned, the problems of the Spanish *cajas* have weighed it down. In addition, rumours that the Chinese were selling have been a problem – even though they were quickly denied. Moreover, there have been reports that it is now the funding currency of choice for the so-called carry trade. The result is that <u>the euro will end May down for the sixth month in a row</u> – even though it is still up on its inaugural valuation against the dollar.

Finally, it has been reported that there are big short sterling positions on the Chicago exchanges. Even after the apparently successful start to the Cameron premiership, traders believe that the UK's debt overhang makes sterling vulnerable.

V OIL

After three weeks of heavy losses, <u>this week has seen oil markets bounce back</u>. They have also seen the unusual situation in which front-month Brent is trading at a premium to front-month WTI come to an end.

At the close last Friday, WTI for July delivery was trading at US$70.04 a barrel – having been as low as US$65 earlier in the week. At the same time, July Brent was trading at US$71.68 – a premium of US$1.64, down from over US$3 for most of the last month.

On Monday, prices were mixed. But they fell again on Tuesday, with WTI closing at US$68.75 and Brent closing at US$69.55 – its lowest close since last October. Prices picked up sharply on Wednesday and Thursday, however. By the close yesterday, July WTI had recovered to US$74.55 and July Brent was at US$74.66. In mid-day trading today, WTI is at US$75.33 – a seven cent premium over Brent. That means front-month WTI is up 7.6% for the week, while Brent is up 5.0%.

What has been driving prices?

First is probably the relatively strong outlook for global growth, as evidenced in the latest OECD *Economic Outlook*. In addition, the US meteorological office is predicting an unusually disruptive hurricane season – which may put pressure on supplies. There is also talk that OPEC will convene an extraordinary Ministerial meeting to review quotas. And, of course, oil is caught up in a bull market for commodities more generally.

In addition, there is the issue of US inventories. According to the EIA, US crude stocks (already high) rose a further 2.4 million barrels in the latest week. That *ought* to have been bearish for prices. However, the key point is that stocks in Cushing, OK. fell 300,000 barrels - and are finally thought to have peaked.

That said, there is little confidence that prices will remain strong. BofA Merrill Lynch, for instance, has cut its forecast for the second half of this year from US$92 a barrel to US$78, and OPEC is said to be concerned that the price could fall below US$65.

One imponderable is the supply situation in the Gulf of Mexico (and elsewhere in offshore US waters) as a result of BP's problems. Longer-term, the oil spill will undoubtedly constrain US efforts to produce more from off-shore wells, but it is unclear whether existing wells might be shut in.

VI BANKING

A **THE US:** The House and Senate regulatory reform bills are currently being reconciled, and a single bill is likely to be brought to a vote within the next couple of weeks.

The consensus seems to be that the intense lobbying efforts by the banks have paid off. As a result, the Senate's proposal to put banks' swaps desks in separately-capitalized subsidiaries seems likely to be dropped – or, at least, heavily diluted. The idea of a pre-funded Resolution Authority is also likely to disappear. On the other hand, there will be some kind of Consumer Protection Agency, possibly located within the Fed, and there will be restrictions on the activities that deposit-taking banks can enter into in the fields of private equity, hedge funds and proprietary trading.

The Fed is also likely to get an enhanced role as the lead regulatory institution for systemically-significant banks.

B **THE UK:** This week's Queen's Speech (in which the new government lays out its legislative programme) repeated the Conservatives' commitment to give the BofE responsibility for macroprudential (i.e. systemic) supervision of the financial services sector, and an "oversight" role of the FSA's activities. What "oversight" means was, however, not spelled out. It is, therefore, widely assumed that day-to-day responsibility for bank supervision in the UK will remain with the FSA.

C **INSTITUTE OF INTERNATIONAL FINANCE**: Rather surprisingly, the Washington-based IIF (which is the global lobby for big banks) came out this week in favour of an international regime for shutting down failing banks. It doesn't want a pre-funded scheme (as, for instance, has been suggested by the European Commission), but it is proposing that the G20 – which meets next week at Ministerial level and later in June at Summit level) – should create a Working Group to lay down the rules on bank resolution.

VII NEXT WEEK

As noted, G20 Finance Ministers meet in Busan, Korea on June 4-5. Their agenda will include:

- bank supervision;
- the danger of a sovereign debt crisis; and
- the continuing problems of the eurozone.

It is worth emphasising, however, that the two G20 hosts for this year (Korea and Canada) are far less interested in bank reform than are the US and EU.

As far as economic releases are concerned, the key US data that is due next week includes:

- non-farm payrolls for May, expected to be up over 400,000;
- purchasing managers indices for May, likely to be mixed; and
- factory orders for April, expected to be up 1%.

Regards,
GISE AG