WEEKLY ECONOMIC AND MONETARY REPORT

18 June 2010

This week began with real fears that the eurozone was about to face a full-fledged crisis over Spain – whose GDP is four times that of Greece.

It hasn't happened - so far. Indeed, it looks as though the euro will end the week up – for the second week running. And Spain managed to sell €3.5 billion in 10-year bonds at a reasonable interest rate of 4.80% - 'only' 220 basis points over *bunds*. In addition, global equities are up sharply this week, and there is a feeling (yet again) that we have dodged the bullet. This may yet turn out to be a fool's paradise: the Spanish problem has not gone away, there are growing concerns about Italy, and today's issue of *The Economist* has (belatedly) turned its attention to the fiscal problems of the American states. Former Fed Chairman Greenspan has also weighed in: he warned today that the US could easily reach its borrowing limit – and that, when it did, long-term interest rates would increase "with unexpected suddenness".

Greenspan's comments reflect the continuing split between those (notably in the US Treasury and the IMF) whose concern is that monetary and fiscal stimulus is not turned off "prematurely", and those (like Greenspan and most Europeans) who insist that government spending must be cut (and taxes increased) to keep interest rates down – and thereby to maintain positive growth. In Greenspan's view, the US and Europe need a "tectonic shift in fiscal policy" to convince the markets that macroeconomic policy is under control.

I G-8/G-20 SUMMITS

Both the G-8 and G-20 meet in Canada next week – in two separate meetings that are being heavily criticized domestically for the costs involves. (The G-8 is meeting at the Muskoka resort in Huntsville, North of Toronto, on June 24; the G-20 meeting is in Toronto itself on June 26-27.)

There has been surprisingly little speculation about the agenda for either meeting – though the Chinese have been unusually vocal, insisting:

- that the main discussion should be on the global response to what it explicitly sees as a European sovereign debt problem; and
- that they will resist the anticipated pressure to allow a substantial appreciation of the renminbi (the *People's Daily* has gone so far as to argue that the renminbi should be *weaker*, not stronger).

Sarkozy and Merkel are also reported to have sent a letter to the Canadian PM, Stephen Harper, urging faster progress on global financial reform. That is clearly an issue that will get a lot of attention, particularly given the various initiatives in the US and UK, but it is hard to see what either the G-8 or G-20 can add. It has also been reported today that President Obama has sent a letter to other G-20 participants, urging that they "reaffirm unity of purpose" on fiscal and monetary policy. His focus is on growth, which will inevitably put the US at odds with Europe.

Other than that, much of the debate in Canada itself has focussed on forcing climate change on to the agenda. The next climate change Summit is in Mexico in the Autumn, and activists want to use Toronto as a curtain-raiser.

II **THE EUROZONE CRISIS**

As noted, things looked pretty scary at the beginning of this week – with Spain apparently being targeted, just as Greece was a few months ago.

What seems clear is that the Spanish were (and perhaps still are) being frozen out of the interbank market. As a result, they have been forced to borrow from the ECB - €85.6 billion in May alone. There was also a very strong rumour (first reported in Germany, but picked up by *El Economista*) that Spain is negotiating a €200-250 billion rescue package involving the IMF, the EU (through its new €440 billion facility) and the US Treasury. This would dwarf the €110 billion that Greece has agreed. It is said that IMF MD Strauss-Kahn called a 'secret' meeting of the Fund's executive board to discuss this package, and it is true that he is currently in Spain holding talks

with the Zapatero government. Despite that, everyone involved denies that there has been any deal.

Plus, the panic seems to have abated. On Tuesday, for instance, Spain was able to raise €5.2 billion in 12 and 18-month notes at around 2.3%. Although this was up from 1.6% last month, demand was quite strong. Madrid followed this up yesterday, by raising €3.5 billion in 10-year bonds at 4.86%. That is 217 basis points over the current *bund* yield – but the issue was covered almost two times. Spain has to raise €25 billion through July to cover obligations falling due, so the problem hasn't gone away – and it may well need a deal with the IMF eventually. But, in the short run, the markets seem satisfied.

Where will they turn next? There were rumours on Tuesday that the next target would be Belgium – where interest rates have risen sharply since last week's election reawakened fears that the country would break-up. (The big winner was the Flemish Separatist party, the NVA, which won 29% of the vote; however, it is likely that the next PM will be Elio di Rupo, the leader of the French-speaking Socialists – which will be hard for the Flemish North to accept.)There have also been concerns about Italy – particularly because opposition to austerity seems more deeply rooted there than in other eurozone members. On Wednesday, for instance, one hundred Italian economists published a letter warning that EU austerity may well tip Southern Europe into a downward spiral that would destroy EMU. It deplored "the politics of sacrifice", and criticized Germany for misunderstanding the causes of the crisis.

The most likely target, however, is (as usual) Greece.

The good news is that both the Commission and the IMF insist that Greece is meeting its targets as far as tax revenues and deficit reduction are concerned. The bad news is that Greece's sovereign rating was cut to junk status by Moody's on Monday – pushing the yield on 10-year paper back up to 9.06%. (Only Fitch now maintains an investment-grade rating on Greece.) The ECB has also announced a 'haircut' on Greek government paper that is presented for discount.

That may be important. BIS data, published on Tuesday, made it uncomfortably clear that what was originally presented as an (altruistic) bailout of Greece by the eurozone was in fact a bailout of French and German banks that had lent to Greece – and to the other PIGS as well. Their total exposure to the PIGS was put at US$950 billion as of end-2009 – which suggests that they are still grossly undercapitalized.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, Greenspan is the latest to weigh in against the US failure to take its fiscal problems seriously. As the *FT* pointed out on Tuesday, the US is now unique among developed economies in not laying out a medium-term strategy for deficit reduction. This, it argued, reflects the dollar's role as the global reserve asset. It is, however, "a privilege that can too readily be abused". In contrast, France has found itself under some pressure this week from the IMF for what the Fund sees as a less than wholehearted commitment to austerity. On the face of it, that seems unfair. France has, after all, committed to cut the deficit by €45 billion over three years, *inter alia,* by:

- imposing new business and wealth taxes;
- closing tax loopholes;
- cancelling temporary spending programmes; and
- increasing the (politically sacrosanct) retirement age from 60 to 62.

In comparison, the US has done nothing.

A **THE US:** The reason the US has dome nothing is twofold. First, key policy-makers (Geithner, Summers) are genuinely committed Keynesians who have a great deal of support within mainstream US academia for a policy of continuing stimulus. Second, they are deeply concerned that, although data at the Federal level still seems quite buoyant, the acute fiscal problems of the individual states (almost all of whom have balanced budget amendments that require them to lay off workers as revenues fall) mean that a double-dip recession is still on the cards.

At the Federal level, there are some positive signs. Auto sales, for instance, were up 17% year-on-year for the first five months of the year. And leading economic indicators were up 0.4% in May. On the other hand, however, builders' confidence fell in June, housing starts hit a five-month low last month, and the Philadelphia Fed's economic activity index fell this month from 21.4 to just 8.0. Plus, first time jobless claims rose unexpectedly, by 12,000, in the latest week. Reflecting this weakness, it was also reported that consumer prices dropped 0.2% in May.

One might expect that this would hit US equities hard. In fact, through Thursday, the Dow (which had risen 2.8% last week, after a six-month slide) was up a further 2.2%, the S&P 500 was also up 2.2% and the Nasdaq Composite was up 2.8%. Markets are also up modestly today. Moreover, the yield on the benchmark 10-year Treasury bond has fallen from 3.28% to just 3.19% - testimony to the 'safe haven' status of the dollar.

B **EUROPE:** Politically, as noted, two key eurozone countries – Belgium and The Netherlands – are still without a stable government. That hasn't, however, stopped the eurozone inviting Estonia to join as of January next year. Nor has it stopped the EU-27 deciding to initiate formal accession discussions with Iceland – subject, of course, to settlement to its continuing dispute with the UK and The Netherlands over the collapse of the Icelandic banking sector.

Plus, the crisis *may* have given the process of European integration a modest boost, in that Merkel and Sarkozy (who met in Berlin on Tuesday) issued a (rather vague) declaration this week proclaiming their commitment to an EU economic "government" – without spelling out what they mean. Their Summit meeting did, however, reach one other, more specific decision: they agreed that, in future, breaches of eurozone rules (eg. the 3% limit for budget deficits) should entail a loss of votes by the offending country in eurozone meetings. This is potentially important - but it would require a treaty change (and, therefore, may never happen).

Economically, it does appear as if the eurozone economy is in somewhat better shape than the US, even if the euro itself is in trouble.

For instance, it was reported on Tuesday that industrial production for the eurozone as a whole rose 0.8% in April. However, that covers a wide variation. The Dutch, for instance, saw IP rise 1.4% for the month, Italy was up 1% and Germany 0.8%. On the other hand, Spanish production fell 0.3%, Greek IP fell 3.4% - and Ireland dropped a massive 10.9%.

Inflation, though still low, is also picking up. The eurozone CPI rose 0.1% month-on-month in May – but it was up 1.6% year-on-year, which is an 18-month high.

At a national level, the eurozone member state that has generated most concern this week is France – largely because of the scepticism expressed by the IMF (in its regular Article 4 consultation) about the government's fiscal forecasts. The Fund predicts sluggish growth and suggests the government is underestimating the difficulty of fiscal consolidation. As noted, that might be unfair. PM Fillon has committed to cut public spending by €45 billion over three years, and to cut the deficit by €100 billion. There will be problems implementing the changes – particularly to retirement. But the will seems to be there.

As for Germany, Merkel's popularity continues to slump – and she will not be encouraged by the only significant economic release of the week. The ZIW investor sentiment index fell in June from 45.8 to 28.7 – far worse than the 42 reading that had been expected.

Outside the eurozone, the new Conservative/LibDem government in the UK is still finding its feet. Next week will be a crucial test, with an emergency budget scheduled for Tuesday.

This will undoubtedly be very tough – going well beyond the public sector spending cuts already announced. A key indicator was the first report from the independent Office of Budget Responsibility, published on Monday. Although the OBR actually upgraded the UK's GDP forecast for 2010 (from 1.25% to 1.3%) , it cut it for the next year (from 3.25% to 2.6%) and for 2012 (from 3.5% to 2.8%). As a result, although the deficit for this year will be a bit lower, it will be substantially higher in the-out years.

The consequence of this is that the government will have no choice but to announce tough new measures, amounting to around GBP34 billion a year. These are likely to include cuts in the child tax credit, elimination of children's trust funds and (perhaps) a rise in VAT to as much as 20%.

In the meantime, it was reported this week:

- that UK inflation fell more sharply than expected in May, from 3.7% to 3.4%;
- that unemployment rose 23,000 in the March–May quarter, pushing the total up to 2.47 million, or 7.9% of the labour force; and
- that retail sales were unexpectedly strong in May – up 0.6% (or 0.5% ex-fuel), 2.2% year-on-year.

That is a mixed picture – but what could tip the UK back into recession is the fear that the MPC will have to push interest rates up again, a prospect that was strongly hinted at by BofE Governor King in an important speech on Wednesday. Despite that, it is worth noting, the FTSE-100 is up around 2.1% for the week through mid-day Friday. This is probably more a testimony to sterling's residual "safe haven" role than it is to the buoyancy of the UK economy.

C **JAPAN:** The Nikkei-225 has just closed up 290 points (3.0%) for the week – which is probably as much a reflection of the market's relief that Hatoyama is gone as it is a vote of confidence in the new PM. Nevertheless, Naoto Kan does seem willing to take tough decisions. Despite the imminence of Upper House elections, he insists that taxes must be increased as a way to head off a "Greek-style" debt crisis. Given that Japan has a captive domestic market for its government paper, that might seem like hyperbole. But the fact is that Japan's public debt is now 180% of GDP – far higher than any European country. A "buyers' strike" is unlikely – but possible.

D **CHINA:** As noted, China is trying hard to head off criticism of its FX policy at next week's G-20 Summit. Nevertheless, it may be significant that renminbi forwards are sharply up this week – suggesting that the market expects continuing pressure

on Beijing. Indeed, the World Bank weighed in yesterday – insisting that a more flexible currency policy would be in China's own interest.

That was also the message put out earlier today by Governor Shirakawa of the Bank of Japan. He warned that the undervalued renminbi is creating a "bubble economy" in China. It is also probably contributing to a (most unusual) wave of strikes that has hit the auto manufacturing sector. In order to buy off increasingly militant workers, Honda, for instance, has apparently had to promise wage increases of 24-32%.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

There are many in Southern Europe who believe that the eurozone's problems could be significantly eased if the euro were to depreciate significantly against the dollar in particular. This belief appears to persist despite the evidence that the main beneficiary of a weaker euro tends to be Germany – whose economy is driven largely by exports.

Unfortunately (to those who want to depreciate their way out of their problems) the euro has actually rallied over the last two weeks. Indeed, this week, it has risen from US$1.209/€ to US$1.239 (or 2.5%) and from Y110.9/€ to Y112.5 (1.4%).

The main reason for this appears to be the success that Spain has had in selling its debt. Ireland, also, was able to raise money in the markets. As a result, the euro is currently trading at a two-week high.

The other winner this week has been the Swiss franc. At the close last week, the SF/US$ rate was SF1.149/US$. In late trading today, it is SF1.1094 – a rise of 3.5% for the week. The reason is a decision on Thursday by the SNB to stop intervening in an increasingly futile attempt to hold the SF down – a policy that it had been following intermittently for 15 months. Yesterday, the Bank gave the markets the green light to bid up the SF – which they promptly did.

As for sterling, the pound closed last Friday at US$1.455 – but it then hit a one-month high of US$1.478 on Monday on hope that the new government is really serious about cutting the deficit. It strengthened further on Wednesday, though it fell back slightly yesterday. In late trading today, the pound has bounced again. It is currently trading at US$1.483 – up 1.9% for the week.

The big issue for next week is whether the euro's rally will continue. That clearly depends on whether the markets decide to target Greece, Spain or even Italy. If they do – in particular, if Spain is forced to call on the liquidity facility that many believe it has already negotiated – the euro could easily come under pressure again.

V FINANCIAL REGULATION

This has been an important week. In the UK, the new government has announced a major shake-up of the regulatory system which was only put in place 10 years ago; in the US, House and Senate conferees are close to announcing a "reconciled" version of the reform bills originally put forward by Rep. Frank and Sen. Dodd.

A THE UK: On Wednesday (in the Chancellor's annual Mansion House speech), George Osborne made a series of important announcements that – at least according to the press – will radically change the way the UK regulates financial services. In fact, he wasn't quite as specific as he might have been, and there may still be some room for 'fine-tuning'. As a result, although a lot seems about to change, the end-result may be less cataclysmic than it seems. Nevertheless, Osborne has made good on the Tories' electoral pledge to dump the system originally put in place by the last Labour government, which gave massive power to the monolithic Financial Services Authority (FSA).

In future (i.e. after a transition period of two years), the UK's financial regulatory system will be, once again, centred on the BofE. The Bank will be given exclusive responsibility for macro-prudential, or systemic, stability (actually, it already has this responsibility, though it has tended to ignore it), which will be exercised through a new Financial Policy Committee, to be chaired by the Governor. The so-called

'tripartite agreement' (with the Bank, the Treasury and the FSA) will be abolished – though it now appears that the Treasury will have the right to overrule the Bank on supervisory issues 'in a crisis'. This Committee will publish minutes, and will issue a quarterly report.

The FSA will be split into two:

- There will be a new 'prudential' regulator, which will be responsible for micro-prudential supervision of UK financial institutions (as now). It will be headed by the FSA's current CEO, Hector Sants, who will also be a Deputy Governor of the BofE and a member of the FPC.
- There will also be a separate Consumer Protection and Markets Authority, which will focus on consumer-facing firms and conduct of business rules.

Beyond that, the "crime-busting" powers of the FSA (such as they are) will be merged with those of the Serious Fraud Office and the Office of Fair Trading, to create a new financial crime agency.

The obvious winner in all this is BofE Governor King – which is ironic, since it is widely accepted that he was seriously at fault for ignoring his responsibility for systemic stability ahead of the crisis. The loser is the FSA's chairman, Lord Turner – who was largely blameless.

In general, the City of London did not want any major change in regulatory structures. It didn't very much like the FSA, but it had got used to it. However, the moves have been generally welcomed on the grounds that there is a lengthy transition period – and that the new prudential regulator will probably end up looking a lot like the old FSA.

The other important announcement was the creation of a new five member Banking Commission, under the chairmanship of Prof. John Vickers, which will take a longer-term look at:

- ways of reducing systemic risk in the UK financial sector; and

- the feasibility of splitting retail and investment banking.

The odd thing about this Commission is the membership – particularly inclusion of the *FT*s (highly opinionated) columnist, Martin Wolf, who has written in favour of breaking up the banks.

B **THE US:** The aim is to have a single bill hammered out by June 26 (though there is talk that this may slip to July 4). This requires tough negotiations on a number of difficult issues. The current feeling is:

- that the plan by Sen. Blanche Lincoln to insulate banks from risky swap dealings (which the industry fought hard to eliminate) will remain in the bill – though it may be watered down;
- that the Treasury will get a much bigger role in supervising systemically important firms through a new Systemic Risk Council, to be chaired by Secretary Geithner; and
- that there will probably not be a pre-funded pot (the so-called Orderly Liquidation Fund) to cover the cost of liquidating failing banks that are deemed to be systemically important.

However, it is worth emphasising that this is a very fluid situation, and that no one yet agrees on what will be in the final draft.The US banking industry is pouring huge amounts of money into a campaign to gut the reform bill. But bankers are unloved – almost as much as the oil majors.

C **OTHER ISSUES:** The other big issue of the week was the – reluctant – agreement of the Swiss Parliament to the bilateral US-Swiss deal that will force UBS to reveal the names of 4,450 US citizens who were using the bank to evade US taxes. This is an enormous blow to Swiss bank secrecy– and to Switzerland's financial independence. Given UBS's global reach, the government probably had no choice – but the Parliament nearly torpedoed the deal. The Lower House, for instance, approved the arrangement – but then passed a separate bill demanding a referendum (which would never pass). That threw the issue to the Upper House – which also approved the deal, this time without the referendum.

Since the Lower House did not tie its approval of the UBS deal and the referendum together, UBS will now go ahead and release the names. The issue then will be whether the US decides to pick off other Swiss banks in the same way.

VI OIL

The big issue of the week has been the continued evisceration of BP as a result of its problems in the Gulf of Mexico.

It is fianally dawning on commentators that the company will probably not be able to survive in its present form. In response to massive pressure from the Obama Administration (and from the President himself, who has flatly accused the firm of criminal negligence), BP took two deeply controversial steps this week:

- it suspended its dividend for 2010 – which is particularly important given the firm's significance to UK pension-holders; and
- it pledged to set up a US$20 billion fund to compensate Gulf residents for loss of earnings and for health-related expenditures, and to contribute towards the cost of clean-up.

The key point, however, is that there is no cap on BP's liability; the US$20 billion is just a beginning. As a result, S&P has downgraded BP from AA- to A, and there is increasing talk that BP America will be put into Chapter II bankruptcy. (BP is apparently reluctant to do this because BP America includes a number of non-US assets that are among the company's "crown jewels".) In the meantime, the fractured well now seems to be pumping out up to 60,000 b/d – and BP's efforts to capture most of this appear to have stalled. There are also reports (allegedly from Russian sources) of other leaks in the deep ocean floor that may suggest an even wider issue.

Obviously, the problems of all the Gulf producers are starting to have a knock-on effect on supplies on the mainland. As a result, oil prices have notched up again this week:

- WTI for July delivery , for instance, closed last Friday at US$73.78 a barrel – but jumped sharply On Monday, Tuesday and Wednesday, to close at a high of US$77.67. Yesterday, it eased to US$76.79, and it has fallen further today. However, it is currently trading at US$76.14 – up US$2.36 (or 3%) for the week.
- Brent for July delivery closed last week at US$74.35 – again, showing an unusual premium to WTI. By the Tuesday close (when the August contract took over as the front-month reference), it was trading at US$77.36, and it is now trading at US$77.88 – a premium of US$1.74 to front-month WTI.

Other than the problems of the Gulf, what is driving prices up?

One factor is the general level of commodity prices, which is largely conditioned by strong global growth (especially in Asia). The R/J CRB index, for instance, has risen from 254.9 to 264 this week. Another in the threat of hurricanes in the US; the National Weather Service is predicting the fiercest season since 2005 (which produced Katrina and Rita).

What is not driving prices higher is the US stock level. According to the EIA, in the latest week, US crude stocks rose by a much higher than expected 1.7 million barrels – with stocks at Cushing, OK. up 200,000. That does suggest that prices could be vulnerable, particularly if fears of a 'double dip' recession increase.

VII NEXT WEEK

Next week will almost certainly be dominated by the G-8 and G-20 Summit meetings.

As far as economic releases are concerned, the key US data for next week includes;

- new home sales for May (expected to be down sharply);
- durable goods orders for May (expected to be down 1.4%); and
- the final reading for the Michigan Sentiment index for June (expected to be virtually unchanged).

The FOMC also meets on Wednesday; it is not expected to change interest rates.

In Europe, the key releases due are;

- the IFO index for June in Germany;
- eurozone consumer confidence for June; and
- eurozone industrial orders for April.

The UK's emergency budget will also be announced on Tuesday.

In Japan, the key release is the all-activities index for April.

Regards,
GISE AG