WEEKLY ECONOMIC AND MONETARY REPORT

17 September 2010

As far as the global economy is concerned, this hasn't been a big week. Most of the news from the US has confirmed a slowdown – but not a catastrophe. In Europe, there is certainly a growing sense that problems are on the way – though, officially, things are said to be better than in the US.

The big news has probably come in the FX area – notably with Japan's intervention to drive down the value of the yen. For reasons that don't seem obvious, this caught the markets by surprise. It also provides China with another excuse not to accede to intense US pressure for it to let the renminbi appreciate sharply. For that reason alone, Washington is not pleased with Japanese PM Kan.

I POLITICAL DEVLOPMENTS

As noted last week, this is a busy time politically. In particular:

- Last weekend, Turkish voters approved 26 amendments to the Constitution by an unexpectedly wide margin. Bizarrely, this referendum had been promoted by the EU as a step towards Turkey's accession; in fact, however, by reducing the power of the military, and by making it easier to amend the (secular) Constitution in future, the referendum will increase the power of the religious-based parties.
- On Tuesday, Japanese PM Naoto Kan beat back a challenge for the DPJ leadership by the party's "fixer", Ichiro Ozawa, by an unexpectedly wide 721/491 margin. This is probably a good thing, given that Kan is much more of an internationalist than Ozawa. However, it prompted a modest Cabinet shake-up, with Foreign Minister Okada moving to be DPJ Secretary General (to be replaced by the Tourism Minister, Seiki Maehara) and Banri Kaieda coming in as Financial Services Minister.

Perhaps the most important political developments have been in the US – where, perversely, the victory of an inexperienced, extreme right-wing candidate in the Republican Senate primary in Delaware has given new hope to the Democrats.

Christine O'Donnell is a Christian fundamentalist, who got backing from the so-called 'Tea Party' movement and from ex-Governor Sarah Palin. Her success is indicative of how effective the Tea Partiers have been in 'capturing' the Republican party. The reason the Democrats are happy is because the polls say (strongly) that Tea Party Republicans will do far worse against the Democrats in November than conventional Republicans. Hence, although the Democrats are still likely to lose control of the House of Representatives, they are now much less likely to lose the Senate. That is good news for Obama.

This weekend, there is a general election in Sweden. Although the anti-immigrant Sweden Democrats are likely to do well, the centre-right governing alliance will win handily.

II BANKING REGULATION

A BASEL 3: As expected, the BCBS has agreed the basic set of rules that will be presented to the G20 for its formal approval in November. However, it is worth emphasising the "basic"; as we are already finding out, there is still quite a lot of important detail to be worked out.

The key points of Basel 3 are:

- that banks will have to maintain a minimum level of "core Tier 1" capital equivalent to 4.5% of risk-weighted assets – up from 2% at the present time under Basel 2 (and 4% in the US); and
- that banks will also have to keep a capital "buffer" amounting to 2.5% of RWA – otherwise, they will be subject to tough restrictions on the dividends and bonuses they can pay.

These requirements will be phased in. The new capital requirement will be 3.5% by 2013, 4.0% by 2014 and 4.5% by 2015. The 2.5% "buffer" will be imposed by 2019.

That's about it, as far as what has been unequivocally agreed. However, it is understood that the Committee has also agreed that there should be an additional

2.4-4% capital requirement for "systemically-important" banks – i.e. for banks that benefit from an informal understanding that they are "too big to fail". Details have not been released, however, and ECB President Trichet has admitted that Basel 3 is still "a work in progress".

The other big uncertainly is the definition of capital. "Core Tier 1" capital is, presumably, common equity. But to what extent will hybrids, "co-cos" etc. be accepted as capital above that level? Moreover, how rigorous will regulators' treatment of tax credits, goodwill etc. be? The *FT* suggests today that the new definition of capital may be 30% tougher than under Basel 2 – and, therefore, that commentators (and the markets) were wrong to assume, as they did initially, that the banks had "got away with it".

That was certainly the initial reaction – with stock markets around the world bouncing on Monday, primarily because of a surge in bank shares. The immediate reaction was that most banks already had comfortably in excess of the new "core Tier 1" capital, and that fears of a massive round of capital-raising (€105 billion by German banks alone, according to one estimate) were misplaced. It was accepted that a few German savings banks might still struggle, but – according to Goldman Sachs – only four out of 47 publicly listed European banks do not already meet the minimum requirement. That may prove to be over-optimistic.

In addition, it is worth noting that the definition of RWA is itself open to interpretation. And, of course, there is the issue of "dynamic provisioning" - ie the counter-cyclical imposition of higher capital charges at the top of the lending cycle.

B EU INITIATIVES: On Wednesday, the European Commission published its proposed new rules on derivatives and short-selling. For the most part, these are intended to bring the EU more into line with the US – though they do not go as far as, say, the Volcker rule. The main points are:

- that all derivative positions should be reported to a central database;
- that there should be common EU standards for all derivative products;
- that there should be a new derivatives regulator; and

- that rules on short-selling should be tightened, effectively banning "naked" shorting and requiring disclosure of all short positions above a certain threshold.

These will now have to be discussed in the European Parliament.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A INTERNATIONAL INSTITUTIONS: On Monday, the IMF and ILO released a joint report on the impact of the financial crisis on employment. In the words of Dominique Strauss-Kahn (who introduced the report), "the Great Recession has left behind a wasteland of unemployment". Thirty million jobs have been lost world-wide, and there has also been a dangerous loss of faith in public institutions – creating a serious danger that there will be an "explosion of social unrest". The report also noted that the gap between rich and poor is now at its widest since 1928-29.

On the same day, the OECD also released a report which reinforces the same point: Between 2007 and 2009, it said, youth unemployment within the group rose by a massive 4 million.

Finally – and as predicted – progress towards further reform of voting rights at the IMF has hit a bump. On Tuesday, it was reported that Germany intends to use the forthcoming G20 Summit to ask the US to give up its veto power at the Fund in return for Europe accepting a smaller say. (At present, EU members have nine seats on the 24-member board; while the US has 16.7% of the votes – enough to block the 85% super-majority needed for Board approval.)

B THE US: This is the second anniversary of the collapse of Lehman Brothers – which plunged the West into a deep financial crisis, for which many hold former US Treasury Secretary Hank Paulson personally responsible. As a result, Paulson has been interviewed repeatedly this week. His warning: If the US doesn't tackle its debt problem, it risks losing its superpower status. (According to the CBO, Federal debt will be US$1.34 trillion this year, and could be 185% of GDP by 2035.) In the battle between the neo-Keynesians (Krugman, SummerS etc.) and the Chicago School

(and the "bond market vigilantes"), Paulson has come down firmly in favour of the latter – though, given his reputation, they may not welcome his support.

In the meantime, US economic data has been all over the place this week. On the positive side, it was reported that total retail sales rose 0.4% in August. That was better than the 0.3% that had been expected (and up from 0.3% in July). It was also held down by a slump in auto sales as incentive programmes ended; ex-autos, sales were up 0.6%. In addition, first time jobless claims fell 3,000 in the latest week, to a two-month low.

On the other hand, however:

- the Empire State (NY) business conditions index fell from 7.1 to 4.1 last month, its lowest level in over a year;
- the Philadelphia Fed's index remained in negative territory, though it improved in August from -7.7 to -0.7;
- industrial production rose just 0.2% last month, after a 0.6% rise in July;
- business inventories rose 1% in July – more than the market was expecting, which suggests orders will be cut back; and
- the final Michigan sentiment index for August came in at a significantly lower than expected 66.6, down from 68.9 in July.

Plus, there is just a sign of concern about inflation. Import prices, for instance, were up 0.6% in August, and the PPI was up 0.4% (for the second month in a row). That has caused the interest rate curve to steepen – although, week-on-week, the 10-year Treasury benchmark yield has actually fallen from 2.80% to 2.74%. As for US equities, there have been (bizarre) rumours of the Treasury buying from its Stabilization Fund. Although this is almost certainly false, it is true that equities have continued to recover. Through early trading today, the DJIA, for instance, is up 124 points, or 1.2%, for the week, while the S&P 500 is up 1.3%.

The other rumour in the markets worth noting is talk (which apparently started with Goldman Sachs) that the Fed will use next week's FOMC meeting to announce

another round of quantitative easing, perhaps amounting to as much as US$1 trillion. This, too, seems unlikely.

B **EUROPE:** On balance, it has been a pretty good week for those who are trying to hold the eurozone together. In particular, Greek Finance Minister Papaconstantinou coupled a Western European roadshow with a new €1.7 bond sale on Tuesday, which went surprisingly well. In addition, Spain, Portugal and France were all in the market this week – and all got finer terms than a couple of months ago. And, today, the *WSJ* reported that the IMF is ready to lend Greece more money if necessary – i.e. if the €110 billion that has already been committed turns out not to be enough.

All of this sounds fine.

However, the IMF's Strauss-Kahn also warned this week that, in his opinion, the euro can only survive if there is what he called "fiscal federation" in the eurozone. In other words, Brussels must be given a role in national fiscal policies. It is hard to see Germany (or France) agreeing to that. And it is worth noting that a poll this week found that 60% of Greeks are "not willing" to make any further sacrifices to avoid default. It would, therefore, be imprudent to assume the crisis is over.

That said, the Commission has just raised its 2010 economic growth forecast for both the EU-27 and the eurozone, by 75 basis points, to 1.8% and 1.7% respectively – with Germany the main beneficiary. German growth is now put at 3.2% this year, up from just 1.1%.

Ironically, perhaps, the only significant economic release this week in Germany itself was the influential ZEW economic expectations index – which fell in September from +14 to -4.3.

Outside the eurozone, there is renewed concern about the UK. This week, it was reported:

- that the BDO business optimism index has hit its lowest level since July 2009;

- that (according to the claimant count measure), the unemployment rate rose from 4.1% to 4.5% in August; and
- that retail sales volume dropped 0.5% last month, the first fall since January.

There are positive signs. The CBI's *Industrial Trends Survey*, for instance, weakened a little this month, but is still quite strong. And construction activity rose sharply in July. But, on balance, the evidence suggest that the British economy is slowing down – at the same time as inflation is rising (core inflation went up from 2.6% to 2.8% last month) and as the trade unions are becoming increasingly militant.

C **CHINA:** The US has stepped up its attack on China's reluctance to let the renminbi appreciate.

As noted, the US House of Representatives held hearings this week on China, and the USTR filed two trade cases against Beijing. Perhaps even more significant, US Treasury Secretary Geithner testified to the Senate Finance Committee yesterday that the Administration is "very concerned" about the renminbi, and that it wants a "significant, sustained appreciation". He suggested that China is spending up to US$1 billion a day effectively to peg its currency. The threat is clear: unless Beijing does something significant, it will be formally indicted as a "currency manipulator" in the Treasury's next *Foreign Exchange Report*, due on October 15.

Will that matter? It would certainly make it easier for US companies (and unions) to launch trade suits against China – and that possibility has angered Chinese officials. The issue is one of power: Who has the upper hand – China, which holds US$2.4 trillion in FX reserves, and which ran a trade surplus in August of US$20.03 billion? Or the US – which controls the world's supply of dollars? The answer may seem obvious, but it is also worth noting that the Chinese have quietly increased the daily mini-appreciation of the renminbi.

In the meantime, it was also announced this week:

- that Chinese factory production was up 13.9% year-on-year in August, up from 13.4% in July; and

- that inward foreign investment hit US$7.6 billion in August, up from US$6.92 billion in July, and up marginally year-on-year.

IV FOREIGN EXCAHNGE MARKET DEVELOPMENTS

The big event of the week was MoF's decision to intervene on Wednesday, to drive the yen down.

This was a big surprise for the markets. Although there had been talk of intervention, the markets had (bizarrely) assumed that PM Kan's confirmation as DPJ party leader would rule out intervention. Instead, at MoF's insistence, the BoJ sold anything up to Y2 trillion – driving the yen down from Y82.88/US$ to Y85.6. This was the biggest yen move of the year, and it seems to have succeeded in shifting the currency's trading range. Indeed, thanks to a warning yesterday from Kan that Japan is ready to act again, the yen has eased further, and it is currently trading at Y85.78/US$.

It is worth emphasising that the Americans are not happy with this. After all, Japan already has a massive trade surplus. Moreover, its actions may provide cover for China not to allow the renminbi to appreciate.

In addition, unilateral intervention like this is usually unsuccessful. After all, the SNB sold €90 billion of Swiss francs in July in an effort to drive it down – and failed. Indeed, this Tuesday, while the yen was hitting a 15-year high against the dollar, the SF actually broke parity with the dollar for the first time in 10 months. (Since then, it has eased back to SF1.01 – despite the fact that, contrary to market expectations, the SNB held its reference interest rate unchanged yesterday at 0.25%.) So far, however, Japan's move appears to have been successful – perhaps because of the element of surprise, and because a lot of hedge funds are thought to have been caught out.

As a result, the yen has weakened 1.8% week-on-week against the US dollar (and 3.4% from its high on Tuesday). It has also fallen 4.2% against the euro, from Y107.22/€ last Friday to Y111.67.

As for the euro itself, it has strengthened this week against the US dollar by 2.5% from US$1.273/€ to US$1.305 – primarily because of lower risk aversion. Sterling has also strengthened – rising 1.7% against the dollar, from US$1.538/GBP to US$1.564.

The key issue for next week is whether the markets will try to test MoF and the BoJ. Recent history suggests that, given a daily volume of US$568 billion in the global FX markets this year (up 73% from 2004), official intervention is unlikely to succeed. After all, if Japan did spend Y2 trillion on Wednesday (which is the highest estimate), that amounts to just 4.1% of normal global trading volume.

V OIL

Week-on-week, prices of the key reference crudes have fallen significantly:

- WTI: October WTI closed last week at US$76.45 a barrel, up sharply for the day on reports of the closure of a key pipeline carrying Canadian crude to the US Midwest (and to Cushing, OK.). It then rose again on Monday, peaking at US$77.19. Since then, however, it has fallen steadily, and is currently trading at US$73.64 – down 3.7% for the week. In addition, the degree of contango has increased, with October WTI now selling at a US$3 discount to December.
- Brent: October Brent closed last week at US$78.16 a barrel. It then expired on Wednesday at US$78.91, with the November contract taking over at US$79.42. That contract is now trading at just US$77.78.

One factor that has caused prices to ease is the imminent reopening of the Canadian pipeline. More important, perhaps, is a conviction that the Chinese economy is slowing and that its demand for oil will drop. On the other hand, however, there is plenty of news in the market that might warrant an increase in prices. In particular, it was reported this week that, in the latest reporting period, US crude stocks fell 2.5 million barrels, with gasoline stocks off 700,000 barrels and distillate stocks off 340,000. In addition, Hurricane Karl remains a threat to production in Mexico and in the Gulf, and – according to *Oil Movements* – OPEC is set to cut its oil shipments by 1.2% this month.

Under these circumstances, it is perhaps no wonder that short-term price forecasts are all over the place. OPEC's Secretary-general, for instance, said he was "comfortable" with a range of US$70-80 - which is also Credit Suisse's best guess. Goldman, on the other hand, is still forecasting an increase to US$90 a barrel.

VI NEXT WEEK

In the US, markets will focus on the FOMC meeting – and on the possibility that the Fed may announce some new programme of QE. Other key economic releases include:

- home sales and housing starts for August – expected to be up, albeit from very low levels;
- durable goods orders for August, expected to be down 2.2%; and
- leading indicators for August, expected to be up 0.1%.

Regards,
GISE AG