WEEKLY ECONOMIC AND MONETARY REPORT

24 September 2010

As far as the global economy is concerned, this week has been a mixed bag. The same is also true with regard to the simmering problems of the eurozone – which continue to bubble along just below crisis level. Perhaps more worrying is the escalation of trade tensions between China and Japan – particularly the message that Beijing has no compunction about using economic tools to achieve political ends. The US will view that with concern, given the pressure President Obama has been trying to put on Chinese PM Wen Jiabao this week to let the renminbi appreciate.

But the real puzzle (and pointer to future problems) may be the rally in global bond markets. Week-on-week, the yield on the benchmark 10-year US Treasury bond has fallen from 2.75% to 2.54%, while the yield on the10-year German *bund* has dropped from 2.44% to 2.27%. Even the UK has benefited, with the 10-year gilt yield falling from 3.13% to 2.98%. In part, this reflects a perceived lack of options on the part of chronic surplus countries (notably China). But there is also a flight to quality involved. Among the weaker eurozone members, yields continue to rise. This week, for instance, Greek 10-year (euro-denominated) bonds were yielding 11.44%, while Irish bonds were at 6.39% and Portuguese paper was yielding 6.35%.

I INTERNATIONAL INSTITUTIONS

A UN: The New York Summit on the UN's Millennium Development Goals attracted the usual array of speakers – some deliberately abrasive (e.g. Iran's Ahmadinejad), most bland. IMF Managing Director Strauss-Kahn (who is now more interested in running for the Presidency in France than he is in the Fund itself) made a bit of a stir by arguing that the recent financial crisis means 70 million fewer people will have escaped poverty worldwide by 2020 than would otherwise have been the case. WTO Director-General Lamy, however, was more upbeat – arguing that global trade will increase by a record 13.5% this year – admittedly, after a 12.2% fall in 2009.

The most important speech, inevitably, came from Obama – who launched a new US development policy. In general, this has been fairly well received, but it is worth emphasising that it is really just an admission that Congress will continue to squeeze the aid budget. The main element in this new policy is a shake-up of the US Agency for International Development (USAID), which involves bringing its head on to the National Security Council as an *ad hoc* member. In addition, Obama pledged to refocus the US development effort where it is most needed (and where it is of more direct benefit to the US), and pressed – yet again – for more progress on the Doha round.

B **IMF:** Over the weekend, the South Korean Presidency of the G20 insisted that a deal is near on increasing emerging market representation on the Fund's Executive Board. However, it is hard to see the US agreeing to the latest proposal from German Finance Minister Schauble, that the 'supermajority' required for significant decisions at the Fund should be decreased from 85% to 75% - which would eliminate the US veto, and make it much harder for Washington to block change.

II EUROZONE CRISIS

At one level, things are under control.

After all, Ireland, Greece and Portugal all managed successful debt auctions this week – though Ireland and Portugal had to pay sharply higher interest rates:

- Ireland sold €1.5 billion in 4 and 8-year notes at average interest rates of 4.78% and 6.02% (up from 3.63% and 5.09% two months ago);
- Greece sold €300 million of 13-week paper at 3.98% (down from 4.05%); and
- Portugal sold €750 million in 4 and 10-year notes at 4.7% and 6.2% (up from 3.6% and 5.3% respectively).

In other respects, however, it has been a very difficult week – one which appears to validate last week's warning by Citigroup's chief economist, Willem Buiter, that (notwithstanding the role of the ECB, the creation of the EFSF and the fact that the main problem countries in the eurozone are said to have met their funding

requirements through 2011) there is still a serious danger that Greece, Italy, Portugal and even Spain will default.

In particular:

- there were reports at the end of last week that Portuguese banks are still finding it impossible to raise money abroad;
- the *Irish Independent* warned over the weekend that Ireland is "perilously close" to calling in the IMF;
- it was reported on Monday that Greece had delayed release of stress test data on its own banks; AND
- yesterday, the ECB released its quarterly survey of liquidity in the eurozone interbank market – which revealed that more than half the 105 banks surveyed claimed that interbank liquidity is harder to come by than it was a year ago.

In addition, there have been major political demonstrations – particularly in Greece (where, so far, the government is toughing it out) and in France (where public sector workers are surprisingly united). That prompted the ECB's former Vice-President, Otmar Issing, to warn a conference in Berlin yesterday that <u>the risk of a popular backlash against austerity is growing</u>. As he put it, the "big challenge for responsible parties…is to explain to people why these hardships are necessary". (The term "responsible parties" reflects the current concern of European politicians with the rise of far-right, anti-immigrant parties – whose latest success was in Sweden, where Jimmie Akesson's Sweden Democrats now hold the balance of power.)

Spanish PM Zapatero insisted on Tuesday that "the debt crisis is over" – but as his latest budget (unveiled today) reveals, that is clearly not the case. Spain – like other "southern tier" eurozone countries – can no longer follow an autonomous economic policy. Every step it takes is dictated by the markets.

<u>One warning note</u>: At the beginning of this week, the *WSJ* published a critical analysis of the new (triple-A rated) <u>European Financial Stability Facility</u>. This pointed out:

- that the (much-vaunted) €440 billion that it is said to control is its total "guarantee capacity" – not its lending capacity;
- that, since Greece would (presumably) be its first borrower, it would be wrong to include Greece's share of the guarantee – which brings the total funds in the EFSF down to €428 billion;
- that the total capacity must be cut further, since the facility has to maintain 120% loan coverage – bringing its lending limit down to €356 billion; and
- that even this has to be reduced because the Facility has to keep a 0.5% cash reserve and additional cash buffers because nine of its guarantors are not triple-A rated.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US:** This week began badly for the Obama Administration, with a tough warning from the OECD that millions of Americans are falling out of the jobs market. The Organisation noted that the long-term unemployment rate (i.e. those out of work for more than six months) in the US is now 4.5% - twice what it has been after previous recessions.

This was the first OECD survey of the US economy since 2008, and its recommendations are interesting, even if they will not be implemented in full. They include:

- introduction of a Federal value-added tax (of which there is no chance);
- a radical reshaping of housing policy – including an end to mortgage tax relief (equally, no chance);
- tax incentives for firms to take on new staff (possible); and
- a gradual end to monetary stimulus by the Fed.

On the last point, the FOMC met this week. To no surprise, it left the Fed funds rate unchanged at 0.25%. More significantly (and contradicting the OECD's recommendation), it hinted at a new round of monetary easing – pledging that it will "provide additional accommodation if needed". The reason for that is the continued fragility of the US economy. This week, for instance, the good news was:

- that housing starts jumped 10.5% in August – far more than expected;
- that sales of previously-owned homes rose 7.6%; and
- that orders for new capital goods rose a higher than expected 4.1%.

On the other hand, however, total durable goods orders (of which capital goods are a part) fell 1.3% last month – largely because of a 10% slump in transportation orders. In addition:

- first time jobless claims jumped 12,000 in the latest week;
- mortgage loan volume slumped last week to a six-week low; and
- the housing contractors index was flat in September.

Even though the National Bureau of Economic Research (NBER) confirmed this week that the US economy exited the recession as long ago as June 2009, it still isn't clear how strongly recovery has taken hold. That may be one factor behind the continuing decline in US interest rates, noted above. The stock market, on the other hand, continues to be buoyed by cost-cutting. Following the better than expected capital goods data this morning, the DJIA jumped sharply, and is now up around 2.1% for the week. Over the same period, the S&P 500 is up 1.7% and the Nasdaq Composite is up 2%.

Meanwhile, Obama's economic team continues to see changes. This week, for instance, it was announced:

- that Larry Summers, director of the National Economic Council, will return to Harvard at the end of the year; and (less-noticed, but still important)
- Herb Allison is stepping down as Assistant Treasury Secretary for Financial Stability.

Allison (who used to run TIAA-Cref) was essentially in day-to-day charge of the TARP. Summers provided the intellectual muscle behind the Administration's aggressively Keynesian approach to deficit spending.

It is unclear whether Summers was forced out, or whether the decision to return to Harvard (where he has a prestigious University professorship) was his. Whatever, he would have hated having to share Obama's ear with another opinionated academic, Austan Goolsbee. It is likely that he will be replaced by someone with a stronger industry background – possibly Anne Mulcahy, the former CEO of Xerox.

(One correction: Contrary to earlier reports, Rahm Emanuel has not quit as White House Chief of Staff – yet. However, it is widely assumed that he will leave in the next few weeks to run for Mayor of Chicago.)

B EUROPE: At the eurozone level, economic data has been only mixed this week. On the positive side, the consumer confidence index for the euro area recovered a bit this month, rising from -11.4 to -11.2. On the other hand, however, it was reported:

- that new industrial orders were off 2.4% in July; and
- that the eurozone Purchasing Managers Index fell this month by more than expected, from 56.2 to 53.8 – with both manufacturing and services down.

At the member state level, Germany's PMI also fell, dropping to an eight-month low of 54.8. However, it was reported today that the IFO business confidence index jumped unexpectedly in September, from 106.7 to a three-year high of 106.8 – which gave the market a strong early boost, before analysis appreciated that the expectations component had fallen sharply.

Elsewhere, French GDP growth in the second quarter was revised up from 0.6% to 0.7%, mostly because of stronger exports. However, the big story in France is political. Aside from the growing anti-government demonstrations, Sarkozy himself remains embroiled in the financial scandals surrounding his UMP party. In addition to the so-called Betencourt affair, he has now been sucked into a row over the disposition of the fortune of Daniel Wildenstein.

Meanwhile, as noted, the fear in Ireland is that – following the announcement that GDP fell 1.2% in the second quarter (after rising 2.2% in the first) – the country is

tipping back into recession. And, in Spain, today's budget – which raises taxes on high-income groups and cuts spending by 3% - virtually guarantees that growth will undershoot the official 1.3% target.

Outside the eurozone, the backlash against what is seen as the Conservative/LibDem Coalition's "culture of cuts" is picking up speed in the UK. The (Opposition) Labour party appears to be rallying round the idea that there is no need for the degree of austerity that the government is promoting – and that view will, no doubt, pick up speed next year, as the increase in VAT bites.

This is dangerous nonsense – but, so far at least, the markets are not putting pressure on the UK (or sterling), despite the fact that the PSBR hit a record for the month of GBP 15.3 billion in August. However, it is likely to have some appeal, given:

- that bank lending to UK business fell GBP 2.5 billion in July (or 5.7% year-on-year);
- that mortgage approvals slumped in August; and
- that net lending to consumers fell GBP 1.6 billion last month.

Even though the CBI has raised its growth forecast for this year to 1.6% from 1.3%, the general feeling is that the UK economy is slowing down again. Unfortunately, the government has very little room for manoeuvre given the need to keep the markets on-side.

C JAPAN: The big issue in Tokyo continues to be the government's intervention to drive down the yen. There are rumours that it did the same again today – but this has not yet been confirmed, and the yen has, in any case, recovered most of its initial losses. The real issue is motivation: The conventional wisdom is that MoF and the BoJ acted at the behest of Japanese exporters. In fact, however, it may be that the motivation was to give domestic inflation a boost. In an environment of chronic deflation, individuals and corporates are sitting on cash balances; the government is desperately trying to encourage investment.

D **CHINA:** The spat with Japan, over Japan's arrest of the captain of a Chinese ship that strayed into a disputed area in the South China Sea, is potentially a big deal.

It has led Beijing to break off negotiations with Tokyo on a range of trade issues. More worryingly, it appears to be the reason China has banned exports of so-called "rare earths" – minerals (in the production of which it has a virtual monopoly) that are vital for electronic devices, catalytic converters etc. Japan has substantial stocks of most of these, but China is sending a message – to Washington as well as Tokyo – that it will not be pushed around. That is especially important because the US Congress has to decide imminently on the so-called Ryan-Murphy bill – which would classify the renminbi as officially undervalued and would require the US to set duties on Chinese imports to reflect this. Obama's meeting with PM Wen yesterday in New York was an attempt to head this off by encouraging China to make a gesture on the renminbi.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

The big concern for most of this week has been whether Japan's FX market intervention last week means that we are entering into a new era in which intervention becomes more common. So far, others have not followed suit – but there were rumours this morning (so far, not confirmed) that MoF and the BoJ had been in the market again, buying dollars for yen.

That has obviously concerned the US – which has long been trying to convince China to let the renminbi revalue. However, Japanese PM Kan insisted on Tuesday that he was only trying to stop 'drastic' currency movements, and that "the issues of China's renminbi and Japan's yen are completely different".

Whatever, the fear of competitive devaluation is one reason for the continuing run-up in the gold prices. At the end of last week, gold was trading at US$1,283/oz. – up 17% year-to-date. Today, it is at a record US$1,300 – and silver is trading at a 30-year high. That same pressure has also pushed the Swiss franc through parity with the dollar. Last Friday, it closed at SF1.01/US$; it is now trading at SF0.982.

As for the yen, has intervention worked?

At the close last week, the dollar was trading at Y85.78/US$ - up from Y84.5 – and the euro was trading at Y112.0. By the close yesterday (i.e. before today's rumoured second round of intervention) the dollar had fallen back to Y84.33. However, the euro had strengthened slightly to Y112.4 – though that was more euro strength than yen weakness. In mid-day trading today, the dollar has fallen further, to just Y84.22, while the euro is trading at Y1134.66. What this means is that:

- the yen is up 1.8% against the dollar for this week – but it is down 1.6% since the initial intervention; and
- the yen is down 1.5% against the euro for this week – and down 6% since the beginning of last week.

The implication of this for dollar/euro is clear. The dollar has fallen sharply – dropping 3.3% this week, from US$1.305/€ to US$1.348.

What has driven dollar weakness? One factor has been the better than expected Treasury auctions within the eurozone. More significant, however, were the hints in the FOMC's note that the Fed might be willing to countenance another round of QE.

V OIL

As noted, the 8-day shutdown of the Enbridge pipeline from Canada to the US Midwest has helped normalize oil supplies in North America. For its part, the Brent price was supported this week by lower Russian and Iranian shipments into the Mediterranean basin:

- WTI: Last week, the price of WTI for October delivery closed at US$73.66 a barrel, down 3.6% week-on-week. The October contract expired on Tuesday at US$73,52, with the November contract taking over as the reference crude at US$74.97. November WTI is currently trading at US$75.32 (having briefly broken below US$75 this morning) – up 2.3% for the week.

- Brent: November Brent closed last week more or less flat, at US$78.21. It is currently trading at US$78.14, having traded in a very narrow range all week.

The strength of WTI is hard to explain. In addition to increased supplies from Canada, weekly EIA data reported that US crude stocks rose a further 970,000 barrels in the latest week, which was far more than expected. Gasoline and distillate stocks were also up.

One possible explanation is the threat from Tropical Storm Matthew, which is headed towards Mexico's Yucatan peninsula. Another is a general rise in commodity prices, particularly gold. Whatever, JP Morgan has just increased its price forecast for WTI in the fourth quarter of 2010 to US$83.

V BANKING

Probably the most significant announcement this week came from German Finance Minister Schauble, who has called all the *landesbank* Presidents to meet with him on Monday to discuss the "reorientation" of the sector. It is already understood that BayernLB (based in Munich) and WestLB (Dósseldorf) are negotiating a merger; WestLB is also talking with Helaba, DekaBank and BerlinerLB.

Other than that, former UK PM Gordon Brown gave a lecture at Harvard's Kennedy School yesterday, in which he called for:

- closer coordination of global economic and fiscal policies; and
- a "global financial constitution", which would set out clear rule for the cross-border activities of major banks.

VI NEXT WEEK

There are important Parliamentary elections in Venezuela this weekend, which are being seen as referendum on the 11 years of Hugo Chavez's Presidency. Although the polls suggest that the result is too close to call, it is hard to imagine that Chavez will allow an outcome that would cripple his regime.

In the US, the main releases next week are:

- the ISM (purchasing managers) index for September, expected to be flat;
- the final figure for the September Michigan confidence index, expected to be up;
- personal income and consumption for August, both expected to be up 0.2%; and
- the third estimate of the second quarter GDP growth rate (1.6%).

The September employment data will not be released until the following Friday.

Elsewhere, markets will focus on PMI data for China.

Regards,

GISE AG