# WEEKLY ECONOMIC AND MONETARY REPORT

8 October 2010

Today's US employment data was disappointing – but not catastrophic. A bigger concern is the continuing drift towards competitive currency depreciation – which, in turn, could trigger a new round of protectionism.

## I IMF/WORLD BANK ANNUAL MEETINGS

We have already submitted a Briefing Note on the Meetings, which start today. However, there is a lot more to be said about the agenda than we were able to cover two weeks ago.

The main topic for discussion will almost certainly be the suggestion that (as Dominique Strauss-Kahn warned yesterday) international economic cooperation is "falling apart" and that we are in danger of a "currency war".

This has been DSK's biggest concern for some time – highlighted by the BoJ's decision this week to revert to a zero interest rate policy. As he put it, "it is fair to say that many (countries) do consider their currencies as a weapon" – and he noted that, in recent weeks, Japan, Switzerland, Brazil, Taiwan, South Korea, Thailand, Malaysia and the Philippines have all intervened to push their currencies down. In addition, the US seems to be trying to talk the dollar down (particularly against the Chinese renminbi) and the BofE appears to be encouraging a fall in sterling. About the only dissident is ECB President Trichet – who is bucking the global push for easier monetary policies. However, even in Europe, it is clear that Southern tier eurozone members are pressing for a weaker euro. The Fund's main concern at the Washington Meetings will be to stop international currency cooperation from breaking down, and to head off the danger of competitive devaluation.

Also high on the agenda will be the macroeconomic outlook.

On Wednesday, the Fund released its latest *World Economic Outlook* – with updated forecasts for the global economy. As shown below, revisions from the Spring are substantial – but by no means uniform. In particular, European growth looks stronger (thanks to Germany), but the US economy is weaker:

**IMF: World Economic Outlook 2010 (GDP growth)**

| | 2009 (actual) | 2010 (forecast) | (Spring 2010) | 2011 (projected) | (Spring 2010) |
|---|---|---|---|---|---|
| US | -2.6% | +2.6% | (+3.3%) | +2.3% | (+2.9%) |
| Eurozone | -4.1% | +1.7% | (+1.0%) | +1.5% | (+1.3%) |
| Germany | -4.7% | +3.3% | (+1.4%) | +2.0% | (+1.6%) |
| UK | -4.9% | +1.7% | (+1.2%) | +2.0% | (+2.1%) |
| China | +9.1% | +10.5% | (+10.5%) | +9.6% | (+9.6%) |
| India | +5.7% | +9.7% | (+9.4%) | +8.4% | (+8.4%) |
| Russia | -7.9% | +4.0% | (+4.3%) | +4.3% | (+4.1%) |

The message of the WEO is, generally, that the emerging markets are recovering strongly, but that the advanced economies are in poor shape and that the global recovery is threatened by the major countries' failure to tackle the problem of imbalances. It puts the chance that global growth (which it projects as 4.2% for 2011) will be below 2% as less than one in 20, but it deplores the failure to tackle fiscal and trade imbalances.

The third big issue for Washington will be the process of internal Bank/Fund reform – particularly at the IMF.

Over the weekend, the Belgian Presidency of the EU presented a plan for giving emerging economies a bigger 'voice' in IMF affairs. Although it has been presented as a major concession by the Europeans, it doesn't really amount to very much. The EU is proposing:

- that Europe should give up two of its seats on the 24-member Executive Board (with Switzerland, it currently has nine);

- that there should be two new constituencies for emerging markets (ie two new Board seats);
- that any constituency with more than nine member countries should have two Alternate Directors;
- that there should be a further quota shift of at least 5% in favour of 'dynamic' emerging economies;
- that the US and Europe should give up their 'right' to nominate the heads of the Bank and Fund; and
- that the IMFC should be given greater power over Fund activities (which would mean that it would have an effective veto over further reform measures).

As for banking reform, the Fund published its *Global Financial Stability Report* on Tuesday.

This warned that the banking system remains the 'Achilles's heel' of economic recovery, and that "progress towards global financial stability has experienced a setback since April". It noted, in particular, that nearly US $4 trillion of bank debt will need to be rolled over in the next 24 months, and warned that the US real estate market could fall again. It also emphasised the danger of another liquidity disruption, and questioned the markets' reliance on credit rating agencies.

On the same lines, the head of the IMF's Monetary and Capital Markets Department warned this week that Basel 3 is not enough to ward off another banking crisis, and that "many of the structural characteristics that contributed to the build up of systemic risks are still in place today". He emphasised the continuing danger posed by 'TBTF' institutions, and warned that there still exists a 'shadow' financial system that has avoided appropriate regulation. Plus, he said, there is still no adequate cross-border bank resolution regime.

There were two important interviews ahead of the Annual Meetings that are worth noting.

The first (in the *WSJ*) was with World Bank President Bob Zoellick. In it, Zoellick warned of a 'tepid' economic recovery, which could well lead to competitive devaluation, protectionism and more asset bubbles. He also emphasised the danger of growing food price volatility, which he said could lead to serious social problems in developing countries.

The second (on the *Foreign Policy* website) was with the former Bank President, Jim Wolfensohn. In it, he predicted that the US and Europe would give up their claim to be able to nominate the heads of the Bank and Fund. He also warned that states are increasingly by-passing the World Bank, in favour of lending directly to poorer countries - using China as a model. This, he said, is a pity because it undervalues the experience of the 10,000 or so Bank staff. Ironically, when it comes to its own development, Wolfensohn emphasised that China puts a high value on that expertise – even if it is now less dependent on money from the Bank.

Wolfensohn also defended the (much-derided) Millennium Development Goals as a way of forcing richer countries to focus on development. Finally, he acknowledged that both Zoellick and DSK have political ambitions in their home countries, and that they might well move on. In his view, that could be a good thing, in that it always helps to have someone in government who understands the Bank and Fund. The problem, he said, is that national officials usually tend to "have very little interest in and very little knowledge of the multilateral institutions".

## II RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, the big issue (in the markets, as well as in Washington) is whether the increasing willingness of governments to intervene in the FX markets, or to achieve the same by restricting capital inflows, presages a full-scale currency ‘war’ – or even the long-feared return to protectionism.

**A** **THE US**: Today’s employment data for September was a bit of a shock – and the markets are bound to interpret it as further evidence that the Fed will opt for another round of Quantitative Easing at (or even before) the next meeting of the FOMC on November 2.

Overall, non-farm payrolls fell 95,000 last month – compared with expectations of an increase only a couple of weeks ago, and worse than the flat figure anticipated by Wall St. analysts. The focus is now on private sector jobs – and these also disappointed, rising just 64,000 (down from a gain of 93,000 in August). Although that was better than the ‘flash’ estimate from ADP (which reported a drop of 39,000 for the month), it is not enough to make much of a dent in the US unemployment rate – which remained unchanged at 9.6%.

As noted, this will reinforce the position of those on the FOMC who believe the Fed must do more to counteract the possibility of a ‘double dip’. These include, in particular, Bill Dudley from the NY Fed and Charles Evans from Chicago – who have even hinted that the US might benefit from (deliberately induced) higher inflation. Bernanke also appears to be in this camp. Indeed, he went further – treading on the Treasury’s turf - by warning on Tuesday, that “premature fiscal tightening could put the recovery at risk”.

Lined up on the other side are St Louis Fed President Bullard (who said today that he sees no ‘obvious’ case for further stimulus, and that the risk of recession is receding) and former Fed Chairman Greenspan, who called the build-up of debt as a result of QE ‘scary’.

Regardless of who is right, there seems little doubt that the Fed will act. However, it is worth emphasising that, although the employment data was disappointing, it was also reported this week:

- that pending home sales were up 4.3% in August (though they were still down 20.1% year-on-year);
- that the ISM Services index jumped in September from 51.5 to 53.2; and
- that, according to the Thomson Reuters survey, same-store retail sales rose 2.8% year-on-year in September – considerably better than the 2.1% that had been expected.

It is also worth emphasising that those who are concerned about the US economy's longer-term future, given the build-up of debt, have a point. It was reported this week (by the CBO) that <u>the total budget deficit in FY 2010 was US $1.291 billion</u> – down 9% year-on-year, but still the second highest on record.

The impact of this on the markets has been mixed. Through Thursday, the DJIA was up 1.1%, the S&P500 was up 1.0% and the Nasdaq Composite was up 0.5%. Although trading volumes remain unusually low, this means stocks were at or close to five month highs. In early trade today, it appears that the weaker-than-expected jobs data is going to pull US equities lower – even though it also increases the likelihood of further Fed easing. As for Treasuries, the yield on the 10-year Treasury benchmark bond closed last week at 2.53%, and fell to a low of just 2.40% yesterday. In early trading today, it has fallen still further – and is currently trading at just 2.37%.

<u>One final point</u>: The Labor Department published a breakdown of consumer income and saving this week that goes a long way to explaining what appears so wrong with the US economy at the present time – and why support for President Obama has evaporated. It compared pre- and <u>post-crisis post-tax income and spending for each quintile of the US population</u> (defined in terms of income). What is most worrying about the table below is:

- that the middle quintile (ie the rock-solid middle class) saw its income unchanged between 2007 and 2009 – but chose to cut its spending by 3.1% in favour of increased saving; and

- that the bottom quintile saw its income fall 5.5% - but had no choice but to increase spending by even more than that as the price of food and necessities increased.

The result was an effective drop in wealth for the poorest tranche of US society of more than 10% over two years:

**US Labor Dept: Breakdown of net income/consumer spending (2007-2009)**

| | Net (post-tax) income | Spending |
|---|---|---|
| Top quintile | -0.65% | -2.65% |
| Second quintile | +1.7% | -0.7% |
| Middle quintile | u/c | -3.1% |
| Fourth quintile | -0.5% | +0.7% |
| Bottom quintile | -5.5% | +5.6% |

**B** **EUROPE**: As noted, ECB President Trichet remains one of the few central bankers to reject pressure to depreciate the currency. Indeed, the Bank left its key overnight interest rate unchanged at 1% when its policy committee met yesterday – despite pressure from EU Monetary Affairs Commissioner Rehn, who has warned repeatedly that a strong euro could hurt European recovery. What Rehn is worried about is evidence that eurozone growth fell sharply in September – pulled down by falls in 'peripheral' countries, notably Spain and Ireland.

In Spain, for instance, it was reported this week that the number of unemployed broke 4 million in September – pushing the jobless rate above 20%. In Germany, on the other hand, it was reported that industrial production rose 1.7% in August, with manufacturing especially strong. However, it was also reported that German exports fell 0.4% in August – after a 1.6% fall in July – which suggests that not even Germany is immune to the impact of a rising euro. (Nevertheless, total German exports are still up 26.8% year-on-year, largely because of surging Asian demand.)

As for France, the BdF's business sentiment index rose in September from 101 to 102, with capacity utilisation jumping from 74.4% to 76.8%. However, the country has been hit hard by a series of public sector strikes, which are expected to worsen next week as civil servants protest at Sarkozy's attempts to reform pensions.

Coupled with similar strikes and demonstrations in Greece, this is further evidence that the eurozone crisis is not over.

This week, the bad news has been limited. True, both Fitch and Moody's downgraded Ireland again, after it raised its target for this year's budget deficit from 11.6% of GDP to 11.9% - indicating that (like Greece) it is having trouble delivering on its pledges to the European Commission and the IMF. And Spain had to pay 2.52% on its 3-year Note auction (up from 2.27% in August). But there has been no sign of panic. Moreover, Chinese PM Wen is reported to have offered to buy Greek bonds when Greece returns to the market, and to have promised that China will provide up to US $5 billion to help Greek shipowners purchase new ships from China.

Nevertheless, there is plenty of room for concern:

- First, the Greek government published its draft budget for 2011 this week. Even though this includes no further public sector salary cuts, it is bound to provoke political opposition. The aim is to raise an additional €5 billion in new taxes, and to cut spending by €1.5 billion. As a result, it is hoped the budget deficit (which was 13.6% last year) can be cut to just 7%. The problem is that this is less than the ECB/IMF had been demanding – and, given the government's record on raising revenues, it may not be achievable anyway.
- Second, the Irish government is likely to find itself in a fight with bondholders over its intention to seek a restructuring of the debt of Anglo-Irish Bank and Irish Nationwide. Vulture funds have apparently been buying bonds that were originally issued under English law, with the intention of holding the government to ransom if it tries to impose a 'haircut'. This is a strategy that

they used (very profitably) during the Latin American debt crisis, and it could thwart Dublin's efforts to cut the debt burden.

- Third, the ECB reported on Monday that it had increased its purchases of sovereign bonds last week by a factor of 10, to €1.4 billion – the highest weekly total for several months. Although the press has not focussed on this, it indicates how effectively Southern eurozone banks are still being shut out of the markets.

Recognising that the problem is not over, Germany is apparently intending to propose new crisis resolution measures next month. These are likely to be sweeping, and will require changes to the Lisbon Treaty. They will include a new insolvency mechanism, as well as new, detailed rules for emergency lending, for bond market restructuring and for some kind of permanent safety net (to replace the €440 billion EFSF).

Outside the eurozone, the UK has just seen the end of its political conference season. Broadly, the Conservative/Lib Dem coalition has survived its first test quite well – though there is intense opposition among middle class Conservative voters to the proposed abolition of (substantial) child benefit payments to higher-rate taxpayers. This was badly handled, and the backlash is a warning that PM Cameron is not popular with the right wing of his own party. Fortunately, the Labour Party's decision to appoint the left-wing Ed Miliband as its leader removes it as a credible political threat for the immediate future. That said, the announcement today that Miliband has appointed Alan Johnson – a more talented and charismatic centrist – as the Shadow Chancellor will give the Labour Party a more effective presence in Parliament.

Economically, there remain serious fears of a 'double dip' in the UK – not least, because of a surprise 3.6% fall in house prices last month (according to the Halifax). In addition, it was reported that automobile sales were off 8.9% for the month. On the other hand, however:

- both manufacturing and industrial production were up 0.3% in August, which was better than expected;
- the services PMI rose from 51.3 to 52.8; and
- producer prices jumped 0.3% in September, or 4.4% year-on-year.

Under the circumstances, it is no surprise that the BofE's MPC left its key interest rate unchanged at 0.5% when it met yesterday, or that it kept the existing QE programme at GBP 200 billion. However, it is understood that there is now a three-way split on the Committee – with one member (Adam Posen, an American economist) pushing for more aggressive easing and another (Andrew Sentence) urging higher interest rates. In the meantime, sterling has hit an eight-month high against the dollar – which won't help hard-pressed British exporters.

**C** **JAPAN**: In contrast to the ECB and the BofE, the BoJ cut the key overnight Japanese interest rate to a range of 0-0.1% this week - effectively, a return to its earlier "zero rate" policy. It also pledged a further Y5 trillion in asset purchases – which represented an unexpectedly decisive policy shift in favour of more QE.

In parallel with this, the Cabinet has also approved another US $60 billion supplemental budget, focusing on infrastructure spending.

This is a big commitment, but there is considerable doubt as to whether it will work. The Nikkei-DJ, for instance, rose sharply on Monday and Tuesday – but then fell back, and has closed up just 2.0% for the week.

In the meantime, Ichiro Ozawa – the DPJ party 'fixer' who recently lost to PM Kan in the election for party leader - is to be indicted on charges of violating Japan's campaign finance law. This *may* mean the end of his long political career.

**D** **CHINA**: The good news is that Moody's has announced that it is putting China on credit watch for an upgrade in its sovereign rating (currently A1). That triggered a

3.1% gain in the Shanghai Composite index – which reopened today after the National Day holiday.

The bad news is that there is no sign yet that the US and Europe have given up their campaign to force Beijing to accept an appreciation of the renminbi. As usual ahead of the Annual Meetings, China is trying to defuse the situation by permitting a modest strengthening. The renminbi is currently trading around RMB 6.6703/US $ - its highest rate since 1993. The question is whether that will be enough to ensure that China avoids a major fight in Washington.

## III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the euro hit a six month high against the dollar, rising 2.1% week-on-week, and closing at US $1.375/€. The dollar also fell more generally – even against emerging market currencies. Against the Brazilian real, for instance, it fell 1.8%, while it dropped 2.1% against the Korean won.

The weakness of the dollar also provoked a big rise in the gold price, which hit US $1,318/oz last Friday.

Nothing has really changed this week:

- US $/euro: As noted, the euro closed last week at US $1.375. It fell to US $1.369 on Monday, on fears about European growth, but since then the euro has strengthened steadily. It is currently trading at close to an eight month high of US $1.393/€ - up significantly after release of the US jobless data (and up 1.3% week-on-week).
- US $/sterling: The pound closed last week at US $1.581/GBP – the only major currency against which the dollar had not appreciated significantly. It has remained within a very narrow trading range this week as well, and is currently trading at US $1.594 (up just 0.8% for the week).

- Yen/US $: Last week, the dollar closed at Y83.3/US $. It hit Y83.98 on Tuesday, but has since fallen steadily – despite the BoJ's decision to cut interest rates and to redouble its efforts at QE. It is currently trading at just Y81.81/US $ - down 1.8% for the week.
- Swiss franc/US $: The Swiss franc has continued to trade just below parity with the dollar. Last week, it closed at SF0.976/US $. It strengthened to SF0.962 on Wednesday, before the dollar recovered slightly. However, the US jobless figures have given the SF another boost, and it is currently trading at an all-time high of SF0.9612/US $ - up 1.5% for the week.

The US dollar's weakness is pretty general. Week-on-week, it has also fallen from A$1.031/US $ to A$1.017 and from Can $1.024/US $ to Can $1.017.

In addition, analysts are increasingly bearish on its short-term prospects. On Wednesday, for instance, Goldman Sachs released new six and 12-month forecasts for both US $/€ and US $/GBP:

- US $/euro: 6- month – US $1.50/€
  12-month – US $1.55/€
- US $/GBP: 6-month – US $1.79/GBP
  12-month – US $1.85/GBP

Goldman's belief is that the US will be forced to engage in another round of QE – and that this will drive the dollar lower.

That belief is shared by gold buyers – who have continued to push the price up to record highs. At the close last week, as noted, the gold price was just below US $1,318/oz. Yesterday, it spiked as high as US $1,364.60 – up 15% since August 1. It has eased today, but, at US $1,340.40, it is still up 1.7% for the week.

Looking to the immediate future, the dollar is expected to remain under pressure because of the likely direction of Fed policy. However, the question is bound to be asked whether the dollar's decline is getting out of control – and that alone may stop the Fed easing too aggressively.

## IV <u>OIL</u>

Last week, oil prices firmed sharply:

- November WTI rose US $5.09, to close at US $81.58 a barrel; while
- November Brent rose US $5.64, to close at US $83.75.

On Monday, Brent hit a high of US $84.41, its highest level since May. However, since then, prices have levelled off. After release of today's US jobless data, November WTI is trading around US $80.51, down 1.3% for the week, while November Brent is at US $84.33, up 0.7%.

<u>The main factors in the market</u> this week (aside from the economic growth data) have been:

- an unexpectedly sharp 3.1 million barrel increase in US weekly crude stockpiles;
- the continuing increase in commodity prices, with the RJ/CRB index rising this week from 285.9 to 294.2;
- a report from Goldman Sachs claiming that world oil demand in the first eight months of this year was up 2.7% year-on-year; and
- a French dockworkers strike that is hitting French refineries.

The general expectation is that crude prices will ease again next week – though that probably depends on what comes out of OPEC's Vienna meeting.

## V BANKING

There are several developments worth noting this week:

- TARP: The US Administration has sharply cut its estimate of the likely cost of the TARP bailout programme (which was originally expected to cost US $350 billion). Thanks in large measure to the profit it made by selling back its stake in AIG, the program is likely to cost the US taxpayer no more than US $29 billion – though the Treasury also expects to lose US $17 billion from its bailout of GM and Chrysler. It appears that 80% of the banks that got TARP money have since paid it back.
- EU: Yesterday, the European Commission proposed a series of tough regulatory measures, including a *de minimis* (ie 0.1%) financial activities tax that (it is estimated) should bring in €25 billion a year. In addition, CEBS (the new banking supervisory agency, soon to become the EBA) announced proposals for tough-new restrictions on bankers' pay – including worldwide limits for all institutions headquartered in the EU.
- SocGen: On Tuesday, Jerome Kerviel – the rogue trader, who cost SocGen €4.9 billion as a result of unauthorised trading – was found guilty, and was sentenced to three years in jail (two years suspended). He was also fined the full amount of the bank's losses – which he, clearly, will never be able to repay. The important element in this is that (to some surprise) the French court piled all the blame on to Kerviel – and not on the bank that failed to supervise him. (SocGen had already been fined €4 million for its negligence.)

## VI NEXT WEEK

In the US, the key economic releases next week are:

- retail sales for September (expected to be up 0.3%);
- the CPI for September (expected to be up 0.2%); and

- the preliminary Michigan confidence index for October (expected to be down).

The minutes of the latest FOMC meeting will also be published on Monday.

Elsewhere, key releases include:

- industrial production data for the eurozone and most member countries;
- UK unemployment; and
- Japanese consumer confidence.

Monday is a market holiday in both the US and Japan. The US quarterly earnings season will also be in full swing, with Google reporting on Thursday.

Regards,
GISE