WEEKLY ECONOMIC AND MONETARY REPORT

15 October 2010

Last weekend's IMF/World Bank Annual Meetings (on which we will submit a more detailed report next week) were generally a disappointment; the difficult decisions have now been passed on to the G20 leaders Summit in Seoul next month. In the meantime, the main area of international concern is the danger of a so-called "currency war" – with the major economic blocs seeking to use currency depreciation as a way to boost exports, and hence growth. This fear has been around for some time, but it is now firmly in the mainstream of economic analysis (indeed, it is the cover story in today's issue of *The Economist*).

I ANNUAL MEETINGS

As noted, the Meetings were a disappointment. Fear of competitive currency depreciation seems to have dominated discussions, with Bank President Zoellick warning that "we run the risk of repeating the mistakes of the 1930s". But that was about as tough as it got. The IMFC's communiqué, for instance, was pretty bland. It urged that member countries "work towards a more balanced pattern of global growth, recognising the responsibilities of surplus and deficit countries" – but didn't put any real pressure on China to revalue or to boost its domestic consumption. (Or, indeed, on the US to reform its finances.)

As a result, all the difficult decisions have been deferred to the G20.

That said, Managing Director Strauss-Kahn did announce that the Fund will issue "spillover" reports, assessing how the economic problems and policies in one country will affect others. This will be an expansion of existing Article 4 examinations of members' economies. There also appears to have been a limited agreement on structural reform of the IMF's voting system, with Europe ceding two of its seats to

faster-growing emerging economies. However, once again, details have been deferred to the G20.

What may be more interesting are the concerns that were raised in the margins of the Meetings.

At the regulator meeting of the IIF, for instance, bankers insisted that the assumption of the BIS that the economic impact of higher capital ratios will be minimal (or even, in the longer term, beneficial) was misguided. Deutsche Bank's Josef Ackermann, the IIF's chairman, claimed that higher capital charges would cut global GDP by 3.1% over five years. The IIF also warned that a capital surcharge on systemically-important institutions (so-called SIFIs) would force the big banks to cut their lending sharply.

Perhaps less obviously self-serving, the US Department of Agriculture also took the opportunity of the Annual Meetings to warn of a looming global food crisis. It noted that the prices of corn, rice and wheat have all risen sharply recently, and that shortages are developing.

Now, the focus shifts to Korea.

Next week, the Financial Stability Board meets in Seoul to tackle some of the issues that were not really addressed in Washington. These include the vexed issue of a capital surcharge on SIFIs – a proposal that is supported by the US, UK and Switzerland, but which is (vehemently) opposed by France, Germany and Japan. There will also be discussion on resolution regimes and on the use of hybrid forms of capital (including so-called "co-cos") on bank balance sheets. The aim (which may be too ambitious) is to have a recommendation ready for the G20 Summit on November 11-12.

The run-up to the G20 Summit will also see a continuation of the so-called "currency war". Indeed Japanese PM Kan demanded on Wednesday that the G20 should

examine what Japan believes to be irresponsible activity by China and Korea in the FX markets to keep their currencies down.

II EUROCRISIS

Although there continue to be strikes throughout Europe against austerity – with the focus this week on Greece (where unemployment in July hit 12%, up from 9.6% a year ago) and France (where unions claimed 3 million demonstrators on the streets to protest pension reform) - the news has mostly been rather encouraging. In particular, it was reported that Spanish, Greek and Portuguese banks all cut their borrowing from the ECB last month – which *may* suggest that their access to the interbank market is improving.

Coupled with reports that the IMF is recommending that Greece should be given more time to repay its emergency borrowings, this has given the Greek bond market a big boost. It also enabled Athens to sell €1.17 billion of six-month bills this week at a lower interest rate than last month. Plus, it has again been reported that China has agreed to buy Greek government paper.

There is, however, one big cloud on the horizon. 'Hawks' in Germany and at the ECB are pushing hard for a tough new crisis resolution mechanism which would set clear rules for access to EU funding (through the EFSF or otherwise) in the event of another eurozone insolvency. This has now been backed by the heads of the six German economics institutes – though it is likely to be opposed by several member states (not least, on the grounds that it might require changes to the Lisbon treaty, which would risk opening up other issues as well).

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

The big issue is clearly currencies. While the major concerns are the weakness of the US dollar and the unwillingness of the Chinese to let the renminbi appreciate

significantly, the problem is broader. True, the Singapore authorities have tightened interest rates and permitted the S$ to appreciate; but, elsewhere in Asia, the Thai, Malaysian and Korean authorities have all intervened in one way or another this week to hold their currencies down. As the *Financial Times* put it, rather neatly, the world seems to be in a currency race which "everyone is trying to lose".

The other big concern is Quantitative Easing. It is now taken for granted that the FOMC will opt for another round of QE when it meets on November 2 – and that appears to have been confirmed by Fed Chairman Bernanke's much anticipated speech to the Boston Fed today. The question is whether it will work – or whether it will just cause the decline of the dollar to turn into a rout.

There appears to have been a shift of opinion on this. There are still two camps. In the words of a right-wing American commentator, Irwin Stelzer, they are:

- the "red-ink corner" – which supports more QE and further fiscal stimulus (and which includes Paul Krugman, Larry Summers, Joe Stiglitz, Bernanke himself and, in the UK, Labour party policy makers such as Ed Balls); and
- the "black ink corner" – which opposes more QE and demands tighter fiscal policies (and which includes Trichet, UK Chancellor George Osborne and most eurozone government leaders).

What is new is that the intellectual tide seems to be turning from "red" to "black" – leaving Krugman *et al* somewhat isolated. The reason is the poor jobless figures in the US – which are being used as evidence that QE does not work. It is also pointed out that QE may be addressing a problem that does not exist. After all, there is no shortage of liquidity; indeed, banks on both sides of the Atlantic currently have excess reserves. This does not mean that the Fed will abandon QE; indeed, the markets are right to assume that there will be one more push. But it will almost certainly be the last – and it will probably not be as big as Krugman *et al* would have liked.

In the meantime, it was reported this week that the OECD's index of leading indicators fell for a second straight month in August, from 103 to 102.9. Although the Organisation insists that market psychology is more negative than warranted by the data, there is a real chance that the advanced economies could yet experience a 'double dip'.

A THE US: As noted, Fed Chairman Bernanke told an audience in Boston today that additional monetary stimulus may be warranted because US inflation is too low and unemployment too high. This was what the market expected – and it makes another round of QE virtually certain.

However, is he right to be so concerned?

On the price front, it is true that the CPI rose just 0.1% last month, and that core CPI was flat. On the other hand, it was reported yesterday that producer prices rose 0.4% in September, and were up 4% year-on-year. True, ex-food and energy, the PPI was up just 0.1% - but the US is still some way from Japanese-style deflation. (And, it should be added, a recent opinion poll in Japan found that – contrary to received economic wisdom – most people quite like modestly falling prices.)

As for employment, that continues to be the key political concern.

Last week's non-farm payrolls data was very disappointing. This week, it was reported that first-time jobless claims jumped 13,000 in the latest period, to 462,000. There is a growing conviction that what we are seeing in the US is an essentially jobless recovery – which is a huge political concern, not least because the limited US social safety net means that a prolonged period of unemployment is more terrifying in the US than it would be in, say, Europe. Not surprisingly, therefore, a Gallup poll showed this week that discretionary spending for low and middle income groups is now at an all-time low, while even for upper income groups it is flat at best.

That said, there are a few positive signs. Despite the drop in discretionary spending, for instance, it was also reported today that total retail sales jumped 0.6% last month (and were revised up for August). In addition:

- mortgage applications rose almost 15% in September, albeit from a very low base; and
- the NY Fed's 'Empire State' business conditions index jumped this month from 4.1 to 15.7.

There is, however, no good news on the trade front – despite the weakness of the dollar (though it has to be emphasised that a weak currency only helps the trade account with a lag – and there are good reasons to expect the lag to be considerable in the case of the US).

Yesterday, it was reported that the US trade deficit widened in August from US $42.6 billion to US $46.3 billion – with imports up 2.1% and exports up only 0.22%. More worrying than the global figure was the bilateral deficit with China – which jumped from US $25.9 billion to a record US $28 billion. The US Treasury is scheduled to decide whether to designate China as a deliberate currency manipulator later today; most observers expect it to fudge the issue (once again). But it is very hard for the Obama Administration to overlook a deficit of this size.

That said, a weaker dollar does seem to have given the US stock market a boost – though equities have also been helped by strong corporate earnings, driven by fierce cost-cutting (another reason that job growth is so slow).

Whatever, the result is that US stocks are currently at or near a two-year high. Through Thursday, for instance, the DJIA was up 90 points (0.8%), the S&P500 was up 0.8% and the Nasdaq Composite was up 1.4%. In early trade today the markets are mixed – but they seem likely to close up week-on-week. What is perhaps more worrying is that the bond market has started to sell off. Through early trade today, the yield on the

benchmark 10-year US Treasury has risen from 2.38% to 2.49%, while the 30-year yield has risen from 3.74% to 3.96%. Coupled with the huge rise in the gold price (now US $1,369/oz), that suggests the market is losing faith in central banks – and that it is starting to focus on the longer-term threat of inflation.

B **EUROPE**: Next week, the European Parliament will almost certainly approve a 5.9% increase in the EU's budget – bringing annual spending on EU programmes and administration to €142.6 billion. This will be enormously controversial. Individual member states are hacking back their own spending under pressure from the ECB – and they are most unlikely to agree to a budget increase for the EU itself that is more than twice what the Council had originally proposed. However, the Parliament may well be looking to provoke a row so that it can press two other demands:

- an increase in its "own resources" (eg some sort of 'European tax' that would enable it to avoid annual budgetary scrutiny from member country governments); and
- a medium-term budget framework for 2014-20, that would commit member states to higher EU spending.

In the meantime, it was also reported this week:

- that eurozone industrial production rose 1% in September, which was more than expected – despite a 13.6% year-on-year drop in Irish output; and
- that inflation rose from 1.6% to 1.8% last month – its highest level since November 2008.

On the trade side, the eurozone ran a deficit in August of €1.4 billion – compared with just €200 million in July. Exports were up 1%, but imports were up 1.8% thanks to the strength of the euro.

At the member state level, the main focus of concern within the eurozone this week has been France. Although the unions may have been exaggerating the size of demonstrations, there is no doubt that public sector opposition to Sarkozy's (modest) pensions reform is intense – and it has now spread to universities and high schools. The government sent police in to break blockades at eight out of France's 12 oil refineries today – and that may have averted an immediate crisis. But the unions (and students) have shown that they are serious about intending to shut the country down.

As for the UK, everyone is waiting for the "other shoe to fall" – in the form of the government's Comprehensive Spending Review.

This will produce a detailed guide to the spending cuts to be imposed by the Coalition government, and it is expected to be published next week. It will be tough – and it comes on top of a major programme (announced yesterday) to cull the proliferation of non-governmental agencies that occurred under the previous government. It will also undoubtedly add to the unhappiness of Britain's middle-class voters, who have been buffeted over the last two weeks by:

- reform of the system of universal child benefit payments;
- very sharp proposed increases in university fees; and
- restrictions on tax-advantaged pensions contributions.

There is a feeling that the mood among the natural supporters of both the Conservative and LibDem parties (who make up the Coalition) is getting mutinous. It will not be helped by what the British Chambers of Commerce believes is a steep downturn in the services sector and by another increase in those applying for unemployment benefits last month.

There have been suggestions that the government's nerve may be failing on the speed of fiscal tightening, but there is no real sign of that yet. In addition, a key member of the BofE's Monetary Policy Committee warned on Wednesday that there is no margin for

error. In his view, "the risk of a loss of confidence and credibility appears to be increasing" – which may mean higher interest rates.

C **CHINA**: As noted, Beijing is under pressure on a number of fronts:

- On trade, its own figures suggest that the global trade surplus was US $16.9 billion in September, with exports up 25% year-on-year. Although the surplus actually fell from US $20 billion in August, it is the rise in exports that will concern China's trading partners.
- On the economy, it was reported this week that property prices are still rising, with the 70-city index up 0.5% in September, despite curbs on bank lending.
- On the renminbi, China now faces public pressure from Japan and Germany, as well as from the US. On Wednesday, German Economics Minister, Brüderle warned of a "trade war" if Beijing didn't let the renminbi rise. Japanese PM Kan seems equally willing to escalate the bilateral row over the renminbi, even though Japan actually runs a trade surplus with China.

As far as its policy response is concerned, Beijing did ask the six biggest Chinese banks temporarily to increase their reserves by 0.5% - not enough to head off criticism at the Seoul Summit.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Not a good week for the US dollar, which seems to have been under pressure across the board. Last week, it lost 1% of its value against the euro, 0.8% against sterling, and 2% against the Japanese yen. Given the lack of any significant agreement at the Annual Meetings, the expectation was that – absent unexpected central bank intervention – the dollar would come under pressure again this week.

This has indeed proved to be the case:

- US $/euro: At the close last week, the euro was trading at US $1.391/€. Although it weakened to US $1.387 on Tuesday, the euro picked up again from Wednesday – largely because of increasingly confident predictions of another round of QE by the Fed. By Thursday, it had broken US $1.40, and it is currently trading at US $1.4011. That means the dollar is off another 1.2% for the week.
- US $/sterling: The pound closed last week at US $1.595. It eased to US $1.579 on Tuesday – but then picked up again. It is currently trading at US $1.6022 – up 0.4% for the week.
- Yen/US $: The yen has hit a series of 15-year highs against the dollar this week – much to the chagrin of the Japanese authorities (who note, for example, that the yen is up 12.8% against the dollar for the year-to-date, compared with "only" 4.8% for the Korean won). It closed last Friday at Y81.92/US $, and is currently trading at Y81.35. On several occasions, it has flirted with its post-war high of Y79.75/US $ - and many assume that it will break this level.

Meanwhile, the Swiss franc has consolidated below "parity", and is now trading comfortably around SF0.957/US $. There is also talk of both the Australian and Canadian dollars also breaking "parity". The former is currently trading at A$1.011/US $ (having closed yesterday at A$1.004), and the latter is at Can $1.010 (having been as strong as Can $1.003).

The danger is that dollar weakness could get out of hand – hence the strength of gold, with some hedge fund managers now confidently predicting that it could go to US $3,000/oz or higher. On the other hand, if there were any sign that China was willing to revalue the renminbi, or if the Fed changed its mind on QE (and it is worth remembering that the FOMC is split on this issue), the dollar could bounce sharply.

V OIL

Marker crude prices rose modestly last week, with WTI for November delivery gaining 1.3% to close at US $82.66 a barrel last Friday and Brent closing at US $84.03. This was part of a broader increase across all commodity classes, with the R/J CRB commodity price index up 3.1%.

This week, prices have eased – but only slightly. In early trade today:

- WTI is at US $82.17 a barrel – down 0.6% for the week; while
- Brent is at US $83.38 – down 1.2%.

The main factor behind the lower prices was probably OPEC's Ministerial Meeting in Vienna. It was no surprise that the Organisation left production quotas unchanged. But the markets took comfort from the generally relaxed comments from major producers. Saudi Arabia, for instance, expressed itself as "happy" with the way the market is now – even though it appears clear that several producers are selling well above their quota entitlement. True, the Libyan and Algerian representatives said they wanted a price of around US $100 to offset the weakness of the US dollar, but that was seen as nothing more than a rhetorical flourish.

In addition, the EIA reported this week that US product demand is now at its lowest level in over a year, with gasoline demand running at 8.812 million b/d (down from 9.256 million a year ago). Distillate demand is also down. That more than offset the impact of a 400,000 barrel fall in US crude inventories in the latest week, coupled with a 2.1 million barrel drop in product inventories.

On balance, bearish forces seem to be regaining the upper hand – though it is important to appreciate the impact of a falling dollar on oil producers' buying power.

VI **BANKING**

Three points worth noting:

- Capital-raising: The general feeling is that most big European banks will have to raise money in the markets to meet the tougher capital requirements of Basel 3. Indeed, it has been suggested that the total required for the EU may be up to €160 billion. Under these circumstances, it probably makes sense to go first – which is what Standard Chartered is doing. It has announced a GBP 3.3 billion rights issue – with the possibility of another similar tranche to follow.
- Wall St. pay: According to a survey by the *WSJ*, total remuneration on Wall St. this year will be up 4%, to the second straight record. In contrast, revenues will be up just 3.5% - which means that total remuneration will be around 32.1% of revenues.
- Accounting: It was reported on Tuesday that the Dutch financial regulator, Hans Hoogevorst, 54, a former finance minister, will take over from David Tweedie as head of the IASB from next year. Although he is not an accountant, he may be better placed to negotiate with the US FASB on international financial reporting standards. In recent years, the trans-Atlantic harmonisation initiative has come under a great deal of strain.

VII **NEXT WEEK**

As noted, the Financial Stability Board meets next weekend in Seoul.

As far as key US economic releases are concerned, markets will focus on:

- long-term capital flows for August;
- industrial production for September (expected to be up 0.3%);
- housing starts for September (expected to be down);
- leading indicators for September (expected to be up 0.3%); and

- the Philadelphia Fed index (expected to be up).

The Fed also releases its Beige Book survey next week.

Elsewhere, the key releases are:

- the ZEW survey for October in Germany;
- the minutes of the last MPC meeting in the UK; and
- the eurozone's PMI for September.

Regards,
GISE