WEEKLY ECONOMIC AND MONETARY REPORT

22 October 2010

All of the main policy disputes that have pushed the global economy to the brink of another crisis will be on show at this weekend's meeting of G20 finance ministers and central bankers, in Gyeongju, Korea, this weekend. Prospects for substantive agreement are not good – though there have been (joking) references to a "Hyundai Accord", equivalent to the 1985 Plaza Accord which led to a sharp appreciation of the Japanese yen.

I G20

The run-up to November 11-12 Seoul Summit is now becoming crowded with preparatory meetings.

Earlier this week, the Financial Stability Board met in Seoul, under the chairmanship of the Banca d'Italia's Mario Draghi. According to him, the Board has endorsed a new set of principles to reduce reliance on credit rating agencies. Apparently, member states (and the Basel Committee) have agreed to remove or replace references to CRAs in banking regulations wherever possible. (It will be remembered that Basel 2 elevated CRA ratings to official status by insisting that certain securities would have to maintain an investment grade rating from the major CRAs.) Draghi also said that the FSB will submit recommendations to next month's G20 Summit on the vexed issue of "too big to fail" institutions.

This weekend, G20 finance ministers and central bankers are meeting – albeit without Brazil's Guido Mantegna and Henrique Mireilles, neither of whom has chosen to attend. This is a pity since it was Mantegna who first warned of a global 'currency war' – which will almost certainly be the No1 topic for discussion.

As noted, there has been talk of a Plaza-type accord on currencies, and BofE Governor King also suggested that there might be a 'grand bargain' to rebalance the global economy, in which China might agree to accelerate the renminbi's

appreciation, and the US might back down on its policy of aggressive Quantitative Easing.

Although rumours of a deal are rife, this still seems unlikely. Indeed, the trend is in the other direction. This week, for instance, it was reported:

- that Brazil had increased its tax on capital inflows to restrict foreign purchases of domestic bonds (and, therefore, to hold down the real);
- that (according to the Governor of the Bank of Israel, Stan Fischer) Israel has been intervening to hold down the value of the shekel since March 2008; and
- that (according to the US) China is still intervening to hold down the renminbi.

According to a leaked copy of the draft communiqué, finance ministers will agree "to move towards a more market determined exchange rate system", and will refrain from "competitive undervaluation" (which seems to be the new buzzword). But it seems most unlikely that this agreement will have any teeth. Indeed, India and South Africa have both warned this week that we are on the brink of all-out currency war.

That said, it is worth noting that the IMF's position is not so clear. Traditionally, it has opposed capital controls. But, on Monday, MD Strauss Kahn warned of massive economic destabilisation if capital continues to flood into emerging markets – particularly in Asia. In his view, these inflows lead to "exchange rate overshooting, credit booms, asset price bubbles and financial instability". As a result, the Fund is now supportive of capital controls (at least on a temporary basis) – which is a clear reversal of policy.

The World Bank is also moving into this camp. On Tuesday, it released a report on the potential risks of unconstrained capital flows. If they continue, it said, "the authorities will be faced with the challenge of... ensuring competitiveness, financial sector stability and low inflation". That said, the Bank also made it clear that it wants China to let the renmimbi appreciate.

The other issue that is floating around ahead of the finance ministers' meeting is an American proposal (put forward by Treasury Secretary Geithner) that the G20 might consider setting current account surplus and deficit targets directly – ie that surplus countries should agree to a specific timetable to work their surpluses down, as deficit countries try to eliminate their deficits. Although there is an intellectual argument in favour of this policy symmetry, it is hard to see how it would work in practice.

As for the G20 leaders' Summit itself, the omens are not good.

Earlier this week, Indian PM Manmohan Singh gave an interview in which he warned that the entire G20 process is now in "serious difficulties", and that it is losing credibility since it seems able to achieve nothing more than "lowest common denominator" agreements. In his view, the global situation is now very similar to that in the 1920s – and there is a real danger of a "disastrous collapse in activity". Unfortunately, the G20 seems unable to have any positive impact – or to stop countries going their own way.

That said, there have been a few more additions this week to the G20's Seoul agenda. In particular:

- the World Bank is pushing the issue of food price volatility;
- Korea is hoping that the US will put forward a compromise proposal on trade that could give the Doha round one final chance of life;
- the US, Canada and Korea (together with Spain, which will attend the G20 as an observer) are urging a refinancing of the World Bank's Global Trust Fund (which was set up in 2008, and is now desperately short of funds); and
- Germany has said it intends to raise the issue of Chinese restrictions on the export of so-called "rare earths" (those 17 elements at the bottom of the periodic table – germanium, europium etc – that are crucial in production of sophisticated electronics).

The irony is that, a year ago, the conventional wisdom was that the old G5/G7/G10 steering group for the global economy lacked legitimacy – and that the future lay with

the G20, where emerging markets were better represented. Now, the emerging consensus is that the G20 is too big and unwieldy to come to any useful (or enforceable) decisions.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

The major event of the week was probably announcement of the UK government's Comprehensive Spending Review – through which it intends to cut the budget deficit by around GBP 83 billion (from its current level of GDP 155 billion, or 11.5% of GDP) over four years. This is an unequivocal rejection of Keynesianism – and it lines the UK up with other EU members (and with the ECB) in putting deficit reduction at the top of the policy agenda.

There has already been some "revisionism" by analysts (some of whom claim the CSR is not quite as severe as it seemed at first), but – by any measure – the cuts are the deepest in at least 40 years. Indicative of this, local government expenditure will be cut 27% in real terms, spending on Interior Ministry items (police, prisons etc) will be cut 23%, and defence will be cut 8% - leaving the UK unable again to mount an operation of the size of its involvement in Iraq. Perhaps more pertinent, it would not be able to defend the Falkland Islands if Argentina chose to invade them again. All in all, it is expected that, as a result of the cuts, the UK public sector will shed over 490,000 jobs by 2014.

Those proposals (which also include a raising of the retirement age, a new pensions levy on public sector employees and a "bonfire of benefits") will be accompanied by a raft of tax increases, most of which had already been announced. The most controversial will be a new bank levy. Details of this are still sketchy, but there is little doubt that its impact could be enormous. It will (apparently) be assessed at a rate of 0.05-0.1% on the global balance sheet (except for 'stable funding sources', eg retail deposits) above GBP 20 billion of all UK-based banks, and on the UK operations of foreign-owned banks. This has led to immediate fears of double taxation, since (if other countries adopt similar legislation) banks could be hit with multiple levies in multiple jurisdictions. It has also led to threats that at least two big UK banks (HSBC

and Standard Chartered) may re-domicile in Asia to avoid the levy – which the government claims will bring in GBP 2.5 billion a year after 2012.

A **EUROPE**: It has been another good week as far as the eurozone is concerned.

On Monday, for instance, it was reported that Greece's EFG Eurobank group had been able to raise €300 million in the interbank market, using Greek bonds as collateral – the first time it had been able to do so this year. On Tuesday, both Greece and Spain launched surprisingly successful note auctions:

- Spain sold a total of €6.4 billion in 12 and 18-month notes at interest rates of 1.842% and 2.009% respectively, down 66 bp and 137 bp from last month; and
- Greece sold €1.17 billion of 3-month notes at an average yield of 3.75%, down 23 bp month-on-month.

So, for the moment, the crisis is over…

However, there are plenty of other grounds for concern. One concerns the ECB – where there is a growing suspicion that Axel Weber is trying to sabotage Trichet by demanding an end to the Bank's bond-buying programme. There are those who believe Weber has given up all hope of succeeding Trichet as ECB President; there are others who believe his extreme opposition to QE is a vote-winner back in Germany. Either way, divisions on the ECB Board are not a good thing.

There are also problems with both the European Commission and the Parliament.

On Tuesday, the Commission floated new proposals for a 'transparent' euro-tax, which would end the current procedure whereby EU member states retain a national veto on tax affairs. That was picked up on Wednesday, when the European Parliament approved a 6% rise in the EU's annual budget, to €130 billion – twice what member states had indicated that they might approve. This was described by the UK government as 'obscene', given the spending cuts that are taking place at the

national level – which seems reasonable given that most of the increase is for agricultural subsidies. In fact, however, the budget demand should be seen primarily as part of a longer-term strategy by the Parliament (with the Commission) to promote the idea of an autonomous, and transparent, euro-tax.

As far as the EU economy is concerned, the news this week has been mixed.

At the eurozone level, for instance, the overall PMI for October fell from 54.1 to 53.4 – largely because of a drop in the services sub-index. The manufacturing index, however, rose from 53.7 to 54.1. At the same time the eurozone consumer index was unchanged at -11, while the Confidence index for the EU-27 improved marginally, from -11.7 to -11.6.

Perhaps more worrying, the eurozone's current account deficit widened in August, from €4.1 billion to €7.5 billion – the biggest deficit in almost a year. The pressure on the ECB to "do something" about the stronger euro will inevitably increase.

Fortunately, perhaps, the German economy is still looking strong – though the ZEW expectations index fell to 7.2 in October, its lowest level since January 2009. Offsetting that, IFO's business confidence index jumped unexpectedly last month, from 106.8 to 107.6, and manufacturing still appears strong. As a result, the government is now forecasting 3.4% GDP growth this year – though it expects this to fall to 1.8% in 2011 as the strong euro starts to bite.

Elsewhere in the eurozone, the focus is on politics:

- In France, the CGT leader, Charles Foulard, has just announced two more days of general strikes – October 28 and November 6. In addition, wildcat strikes, often involving students, continue to paralyze transport and oil refineries. Labour unrest – which is notionally intended to force the government to drop its proposal to increase the minimum retirement age from 60 to 62 – is now becoming a referendum on Sarkozy. Having twice delayed a final vote on the proposed pensions reform, the Senate is

expected to approve the bill today – though, with demonstrations outside, it may decide to put a decision off again.

- In Spain, PM Zapatero's approval ratings are right down there with those of Sarkozy – 84% of voters have "little or no trust" in him. Given the need to pass tough spending cuts, he announced a Cabinet shake-up on Wednesday. The two key moves are that Foreign Minister Moratino has been replaced by the former Health Minister, Trinidad Jimenez, and that Alfredo Perez Rubalcaba – a potential successor to Zapatero – becomes Deputy PM.

Outside the eurozone, the UK is – as noted – deep into an orgy of tax increases and spending cuts. In the view of one influential former member of the BofE's MPC, this is "the greatest macroeconomic mistake in years" – one which guarantees a double-dip recession and a long period of anaemic growth.

Maybe; but, equally, the government probably had no choice. It was reported on Wednesday that the PSBR hit a record GBP 15.6 billion in September – up from GBP 14.8 billion a year ago, and much higher than the GBP 14.2 billion that was expected. For the first nine months of the year, the deficit was GBP 952 billion – or 64.6% of GDP. Had Chancellor Osborne not announced tough new measures, the markets may well have turned against Britain. As it is, the yield on the 10-year government gilt fell from 3.00% on Tuesday to 2.94%.

The problem is that spending cuts won't help an economy that is clearly slowing down again. True, there are some positive signs. In particular, UK automobile production was up 5.8% year-on-year in September (though, for the first nine months of the year, it was off 35%), and lending to businesses inched up in August by GBP 300 million – the first rise since February. But most of the news this week has been bad. For instance, it was reported that:

- factory orders hit a six-month low in October, with the CBI's index falling from -17 to -28;
- mortgage lending dropped 1% in September, to a 10-year low; and

- retail sales fell 0.2% in September, while August sales were also revised down.

No surprise, perhaps, that the minutes of the latest MPC meeting show the Committee to have been split. One member (the American, Adam Posen) pushed for another GBP 50 billion of QE on top of the existing programme, while the hawkish Andrew Sentence wanted a 25 bp increase in interest rates.

B **US:** For once, most of the economic news from the US this week has been positive. In particular, it was reported:

- that housing starts rose 0.3% in September, the third rise in a row (though new permits fell 5.6%);
- that the Philadelphia Fed's regional business index rose last month from -0.7 to +1.0, the first increase in three months;
- that leading indicators were up 0.3% in September;
- that the NAHB home builders confidence index rose in October from 13 to 16 – the first increase in five months; and
- that first-time jobless claims dropped a sharper than expected 23,000 in the latest week.

On the other hand, industrial production dropped 0.2% in September – the first fall in over a year. And the Fed's Beige Book survey showed sluggish growth almost everywhere, with employers still reluctant to take on new staff.

There is also the problem of funding the "twin deficits". It was reported on Monday that so-called TIC flows (not foreign purchases of US securities) fell from US$63.3 billion in July to US$38.9 billion in August. China was still a net buyer – pushing its holdings of US Treasuries up US$21.7 billion to US$868.4 billion. But, at some stage, this will become a major concern for the market.

However, that time is not yet near. Indeed, the yield on the Treasury's 10-year benchmark Note fell this week from 2.58% to a low of 2.48% (though it has backed up again today), while the 30-year yield eased from 4.00% to 3.94%. Plus, all the

main equity indices are up – despite rather disappointing earnings, particularly from some of the banks (Goldman's profits fell 40% in the third quarter, to US$1.9 billion, and Morgan Stanley actually recorded a surprise US$91 million loss).

C **CHINA:** As noted, China will find itself under pressure at both this weekend's meeting in Korea and at next month's Summit. The US will continue to push for a much sharper renminbi appreciation – though it is worth bearing in mind that it is still prevaricating on whether or not to list China as a "currency manipulator". If no progress is made this weekend, the Administration may have no choice but to act (possibly as early as Monday) – particularly with the November 2 mid-term elections so close.

In the meantime, China itself surprised the markets by raising interest rates by 25 basis points on Tuesday – pushing its lending and deposit rates up to 5.56% and 2.25% respectively.

This was almost certainly an attempt to bring the domestic property bubble under control – but, because it caught the markets by surprise (it was the first increase since 2007), it also hit all commodity currencies. The Australian, Canadian and New Zealand dollars all fell sharply, as did the South African rand. Gold also dropped US $36/oz on the day, and oil marker crudes were off over US$3/barrel. All of this indicates just how sensitive the global economy has become to China.

On that score, it is also worth noting:

- that the Chinese have just reported a small drop in the third quarter growth rate, from an astronomic 10.3% to a very strong 9.6%; but
- that inflation is also picking up – with the headline CPI rising from 3.5% to 3.6% last month.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

At the end of last week, the dollar was once again under pressure – trading at a nine month low against the euro (it closed at US$1.401/€, having hit US$1.41) and at a

15-year low against the yen (it closed at Y81.28). The expectation was that a further round of QE from the Fed was a near-certainty following the next FOMC meeting.

This week, however, the remorselessly negative sentiment against the dollar has abated somewhat – though its recovery is uneven, and sentiment remains fragile:

- US$/euro: As noted, the euro closed last week at US$1.401. This week, it has traded in a narrow range of US $1.391 -1.398, and it is currently around US$1.392 – down 0.6% for the week.
- US$/sterling: The pound closed last week at US$1.603. This week, it has fallen quite sharply – despite the generally favourable response to the Coalition government's programme of cuts and tax increases. It is currently trading at US$1.568 – down more than 2% for the week.
- Yen/US$: At the close last week, the dollar was trading at Y81.28. It actually fell further, and hit another 15-year low of Y79.5 before recovering to Y81.46 at the present time.
- SF/US$: The Swiss franc has continued to trade above parity with the dollar – though the dollar has recovered significantly. At the close last week, it was trading at SF0.956/US$. It is currently around SF0.977 – up 2.1% for the week.

What has contributed to the dollar's (modest) recovery? First, the US authorities (and Geithner in particular) have been vociferous in insisting that the US is not trying to weaken the dollar deliberately. The markets might have been sceptical about these protestations, except that (as noted) there have been rumours that a deal might be in the works for the Chinese to let the renminbi rise in return for less QE on the part of the US.

Second, the surprise decision by the Chinese to nudge their interest rates up a quarter-point prompted a sharp move out of riskier assets – and, therefore, into the dollar.

Third, there were domestic factors. In the UK, for instance, the prospect is now for sharply lower growth, with BofE Governor King predicting a "sober decade" of higher

savings and lower consumption. In Switzerland, the franc was hit by poor export data.

And, of course, the gold price fell – for the first time in six weeks. That said, it is worth emphasising that sentiment in the FX market has not changed fundamentally; if nothing positive emerges from the G20 meeting, the dollar could still be vulnerable.

IV OIL

Oil prices have been choppy this week, with no clear trend:

- WTI: WTI for November delivery closed down US$1.44 last Friday, at US$81.25/barrel. It then jumped sharply on Monday to US$83.08, as it became clear that the strike at French oil refineries might lead to the diversion of supplies from the US. However, China's unexpected interest rate increase on Tuesday rattled the oil markets, and the price of WTI slumped to US$79.49. There was a recovery on Wednesday, with the December contract taking over as the marker crude at US$82.54. However, that didn't last with the price falling US$1.98 a barrel on Thursday to US$80.56, largely because of a rise in US crude inventories. Today, there has been a modest increase, and December WTI is currently trading around US$80.78 – down 0.6% for the week.
- Brent: December Brent closed last week at US$82.75, and has followed much the same pattern as WTI. It is currently trading around US$82.12 – down 0.8% for the week.

Technical analysts suggest the price could go up to US$90 in the fourth quarter. In the short term, however, the market is negative – except for the potential impact of the French strike on imports into Europe and the danger (which is real) that Tropical Storm Richard will turn into a hurricane and affect Mexican output.

V BANKING

As noted, the UK is proposing a highly controversial levy on the balance sheets of UK banks and banks doing business in Britain. This has the potential to hit big banks hard – and even to drive one or two banks out of the UK.

Elsewhere in the EU, the big development was a compromise agreement on the regulation of hedge funds. Although this still needs the European Parliament's approval, it will almost certainly go through. It is not yet clear who won or lost. The key elements are:

- that hedge funds will be able to operate throughout the EU on the basis of a single regulatory "passport" (which is a victory for the UK); and
- that they will be subject to regulation by the new, Paris-based European Securities Markets Authority (a victory for France).

The European Commission has also published its proposal for a so-called "resolution regime" for banks. Under this, regulators would be allowed to suspend dividends, replace executives and force asset sales if, in their opinion, a bank is in danger of failing.

In the US, it is worth saying a word about what is becoming known as "Foreclosuregate".

It is unclear whether this will amount to anything, but it is increasingly obvious that many banks that were involved in the origination, packaging and trading of collateralized mortgage obligations failed to document those mortgages properly – either because of fraud or negligence, or because systems that were designed for a much lower volume were overwhelmed as the size of the market expanded. Now, lawyers are acting to stop the banks foreclosing on many of these properties, on the grounds that they don't have proper title to the houses in question.

VI NEXT WEEK

In the US, the main economic releases due next week are:

- the advance estimate of third quarter GDP growth, expected to be around 2.4%;
- the Michigan sentiment index for October, expected to be up 0.1;
- durable goods orders for September, expected to be up 0.8%;
- consumer confidence for October, expected to be up 1.0; and
- new home sales for September, expected to be up 2.8%.

Elsewhere, key releases next week are:

- eurozone new industrial orders for August;
- UK GDP growth for the third quarter;
- eurozone business climate and consumer confidence indexes; and
- Japanese industrial production for September.

The BoJ's Monetary Policy Committee also meets.

Regards,
GISE