WEEKLY ECONOMIC AND MONETARY REPORT

5 November 2010

Today's better than expected US payroll data came as a pleasant surprise after a week that seemed to be turning nasty. But it may only be a brief respite.

The real concern is the global backlash against the Fed's announcement of a bigger-than-expected second round of Quantitative Easing in the US – which seems likely to poison next week's G20 Summit in Seoul. Equity markets roared ahead on the Fed's move – but that is not necessarily good news. It appears to suggest that the US plans to try to devalue its way out of its problems; if so, Brazil's predictions of a "currency war" could prove prescient.

I G20 SUMMIT

APEC members are meeting in Kyoto, Japan today to coordinate their position ahead of next week's Summit in Seoul; both meetings are likely to be acrimonious – with hostility increasingly directed at the US.

The problem stems from the FOMC's decision on Wednesday to launch a new round of QE, totalling US$600 billion by the end of June. This comes on top of the existing US$1.75 trillion programme – which is being recycled as bond purchases mature – and it has infuriated America's trading partners, in particular China, Brazil and Germany. All three have complained that the US is now following a policy of competitive devaluation – and Brazil has said that it is "ready to retaliate".

Actually, Brazil seems to be taking the lead on this. Outgoing President Lula has said that he intends to attack the US in Seoul on both QE and the dollar, and his successor, Djilma Rousseff, has warned that the last time competitive devaluation was tried, "it led to World War II". Finance Minister Mantegna was a bit more circumspect, but even he insisted that "it does no good at all to just throw dollars from a helicopter".

Today's issue of the *Economist* wonders whether we are coming to the end of the global "dollar standard", and it seems clear that Obama will be hard put to defend the Fed's action at the Summit.

What else is on the agenda for Seoul?

First will be the macroeconomic outlook, and the appropriate policy response. On Wednesday, the OECD published revised GDP forecasts for 2011 which were substantially lower than those issued six months ago. For the US, for instance, growth next year has been cut from 3.2% to 1.75-2.25%; for the OECD-33, it has been cut from 2.8% to 2.0-2.5%. As a result, the Organisation urges central banks not to start increasing interest rates until the beginning of 2012 at the earliest.

Second will be the intractable problem of imbalances.

We are much less optimistic than we were last week that the US Treasury's proposal for a symmetrical commitment by surplus and deficit countries to hold their current account balance to less than 4% of GDP will get serious consideration. US Treasury undersecretary Lael Brainard has been downplaying the chances of a deal – in part because the Fed's decision on QE makes America's trading partners less willing to compromise. The EU has also been arguing against strict quantitative targets, which it believes are unworkable.

Other than that, the G20 will almost certainly endorse the new Basel 3 rules on bank capital and liquidity, and there may also be agreement on broad principles for 'resolving' troubled banks. The IMF has recently surveyed 62 large banks, in terms of how easy they will find it to comply with Basel 3, and its conclusions will undoubtedly be discussed in Seoul.

There is also likely to be a discussion about soaring food prices, and their impact on poorer countries.

The FAO has just issued a report showing that food prices are back to their crisis levels of 2007/08, with the food price index up 5% in October alone. Recent restrictions by Russia and Ukraine on grain exports will not help matters.

Aside from that, the focus on the dollar may help the Chinese avoid the usual criticism for their failure to revalue the renminbi. And the Koreans apparently want a broader-brush discussion of development, with the aim of winning agreement that a bigger share of the global aid budget should go to "traditional" infrastructure and investment projects.

II EUROZONE CRISIS

The other big issue of the week has been yet another flare-up of concern in the eurozone following last Friday's EU Summit. These mini-crises are becoming disconcertingly frequent. Even though they tend to be resolved, the fact that they reappear so often suggests strongly that there is something fundamentally rotten in how the eurozone works. Today's edition of the *Financial Times* carries a column by its respected (if ancient) commentator, Sam Brittan, in which he comes to the reluctant conclusion that the eurozone will eventually collapse; his view is increasingly the conventional one outside the ECB.

The problem this time is German Chancellor Merkel's insistence that the current, *ad hoc*, European Financial Stability Facility – set up with €440 billion from the ECB (plus IMF money) – must be replaced by a permanent body which will be able to handle any future crisis similar to that which almost engulfed Greece. That sounds fine; the current EFSF expires in 2013, and it would seem to make sense to put something permanent in place. It would also seem to make sense to use that opportunity:

- to tighten up the existing rules on debt and deficits that are in the Lisbon Treaty;
- to toughen the penalties on countries who break the rules; and
- to force holders of sovereign bonds to share the pain in the event that any eurozone member is forced to restructure its debt.

Unfortunately, all these proposals – which sound so reasonable – are in fact highly controversial.

First, any attempt to tighten up, or even clarify, the rules in the Lisbon Treaty risks reopening the Treaty as a whole – which would mean that all 27 member states would have to re-ratify it. That would be a huge undertaking, and it would almost certainly lead to disaster. EU President van Rompuy is apparently examining whether there is a way round the problem by involving Article 48(6) of the Lisbon Treaty, which permits marginal changes to be made without formally revising the Treaty. He may well say Yes – but the German Constitutional Court in Karlsrühe (which takes a conservative line on issues involving German sovereignty) may try to overrule him.

Second, it was always clear that weaker eurozone countries would resist the Franco-German proposal that the punishment for infringing the debt/deficit limits should be loss of Council voting rights. That is now off the table.

Third, the proposal to make bondholders "share the pain" risks destablizing bond markets since bondholders have traditionally been able to claim exemption from any rescheduling. As discussed below, there is evidence that merely raising the possibility that "haircuts" might be imposed on bondholders has already caused spreads to widen significantly for sovereign borrowers in peripheral eurozone members. ECB President Trichet has urged Merkel to drop this idea; unfortunately, it has wide popular support in Germany, and is strongly backed by Finance Minister Schauble (who argues that the current treatment of bonds gives a license to speculators).

One possible compromise, put forward by the Finns, is for all eurozone members to agree that any future sovereign bond issues will contain what is called "collective action clauses". These would make it clear that the bonds in question would not be exempt from any future rescheduling – but the provision would not be retroactive (ie. existing bond issues would not be caught).

As noted, <u>all of this has been very disruptive for the markets</u>.

This week, there has been a sharp increase in the cost of CDS cover for Greece (now 850 basis points), Ireland (now 525 bp), Portugal (now 403 bp) and even Spain (227 bp). Greek 10-year yields are now 11%, and Irish yields are over 7.4% despite new and painful austerity measures. Plus, Portugal is now paying 3.30% for 12-month money, up from just 2.88% a month ago. With the domestic political situation in Greece deteriorating ahead of crucial local elections this weekend, and with the ECB having refused to release documents relating to Greece's use of derivatives to hide its true exposure, the short-term outlook seems pretty dire.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: As noted, the October employment data was a pleasant surprise for the Obama Administration, which had endured a torrid week.

The first problem was political. The mid-term Congressional elections were almost as bad for the Democrats as the Republicans had hoped. As expected, Democrats lost 60 seats in the House of Representatives (the biggest swing since 1948) and ceded control. Although they managed to retain control of the Senate, they also lost eight state governorships and look a very battered party indeed. The key figures in Congress now are probably:

- Rep John Boehner, a colourless moderate conservative, who will become Speaker (assuming he doesn't face a challenge from a "tea party" radical);
- Rep Spencer Bachus, who will take over the House Financial Services Committee from Barney Frank (and will, therefore, have control over banking regulation); and
- Rep Eric Cantor, who will probably be House majority leader (and who has already produced a 22-page blueprint of potential cuts).

In the Senate, Jim DeMint is probably the rising star, given that he is the most senior Republican member who threw in his lot with the right-wing "tea party".

It is going to be very hard for the Administration to work with the new Congress. A bipartisan meeting is scheduled for November 18, but there is little room for compromise (though Obama has indicated that he is willing to extend the so-called Bush tax cuts – even for those earning over US$200,000). It seems quite likely that Obama will also be forced to shake up his economic team; the first casualty is likely to be Treasury Secretary Geithner.

The second problem is the very mixed reaction to the Fed's decision on Wednesday to pump an additional US$600 billion into the US economy by monthly purchases of Treasury securities with a maturity of up to 10 years. The FOMC's rationale for this "QE2" was "to promote a stronger pace of recovery" – and it is true that the initial reaction was a surge in equities. On Thursday, for instance, the DJIA had its best day since September 2008, and it is up approximately 2.8% for the week through mid-day Friday.

However, the Fed seems to be increasingly isolated in its view that more QE is what was needed. On Tuesday, for instance, Harvard's Martin Feldstein (a very orthodox, Keynesian economist) urged caution, calling more QE a "dangerous gamble with only a small potential upside and substantial risks of creating asset bubbles". Subsequently, he got support from across the ideological spectrum: Carnegie-Mellon's Alan Meltzer said "it won't do much", Stanford's John Taylor argued for lower taxes instead, and Columbia's Joe Stiglitz wanted direct public spending.

Nor is the stock market rally evidence that the market is happy. Equities rose primarily because the assumption is now that the Fed is trying to boost inflation and to depreciate the dollar.

That said, US economic data this week has been better than the Fed's rather panicky reaction might indicate. In particular, as noted, non-farm payrolls rose 151,000 last month – far better than the 60,000 that was expected. Plus, the September figure was revised from a drop of 95,000 to a drop of just 41,000. Although the unemployment rate was unchanged at 9.6% (almost certainly, an underestimate), this was good news – particularly in terms of private sector job creation.

In addition, it was reported this week:

- that the ISM manufacturing index rose in October from 54.4 to a five month high of 56.9;
- that the services ISM rose from 53.2 to 54.3;
- that personal spending in September was up 0.2%;
- that factory orders rose 2.1%; and
- that third quarter productivity grew at an annual rate of 1.9%.
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On the other hand, personal income fell in September by 0.1% - the first drop in over a year. And it was reported that the number of Americans claiming food stamps was up 17% year-on-year in August. On the whole, though, the economic numbers do not – yet – support the idea that the US faces Japan-type deflation. However, the Fed's move – which was more aggressive than expected – has got the "bond market vigilantes" worried; they fear (with some justification) that "Helicopter Ben" has gone soft on inflation.

B **EUROPE**: In general, eurozone PMIs were better than expected last month. Germany continues to be the zone's economic driver – though it was reported today (to some astonishment) that manufacturing orders fell a seasonally-adjusted 4% in September, with export orders down 6.6%. That indicates the vulnerability of even Germany to a stronger euro, and it is bound to increase tensions at next week's Seoul Summit.

For the rest, Italy's PMI was up, while France's was down – though the economy is still expanding. Surprisingly, perhaps, Spain and Ireland are also growing – though Spain's unemployment rate hit 19.8% in October, with 4.09 million out of work. Not surprisingly, Greece is still stuck in recession. Under these circumstances, it was no surprise that the ECB held interest rates unchanged at a record low of 1%. No surprise either that Trichet has also expressed his unhappiness with the Fed's latest move.

As noted, there are important local elections in Greece this weekend, which are being seen as a referendum on Pasok's reform agenda. There is also political unrest in France – where PM Fillon (whose popularity far exceeds that of the President) is trying to defeat Sarkozy's effort to force him out in favour of the perpetually dishevelled Ecology Minister, Jean-Louis Borloo.

As for the UK, the BofE followed the Fed and the ECB is keeping its interest rates unchanged this week. However, it did not follow the Fed on the question of QE – though Chancellor Osborne hinted that there may be more to come later.

In the meantime, most of the UK's economic indicators have been positive. In particular:

- the overall PMI rose from 53.5 to 54.9 last month;
- the services PMI rose from 52.8 to 53.2; and
- house prices rose slightly, after a fall in September.

However, the impact of the coalition government's spending cuts has not been felt yet – nor has the increase in VAT that will come in next January. In the meantime, the UK has shared in the global equity bull market, with the FTSE-100 up almost 4% for the week.

C **JAPAN**: This is the example no one wants to follow... This week, it was reported that Japanese industrial production was down 1.9% month-on-month in September, and that the core CPI was off 1.1% year-on-year in October. No one seems to have much faith in the BoJ's latest plan, which is to use part of its Y5 trillion stimulus package to purchase Japanese REITs. The Nikkei-225 gained 4.6% for the week – but, again, that reflects nothing more than the abundance of cheap money in the market.

D **CHINA**: As noted, China is likely to get an easier ride than it could have expected at next week's Seoul Summit – simply because the US has managed to alienate almost all its trading partners with its own policy of (apparently) deliberate depreciation of the dollar. In the meantime, the World Bank has upgraded its 2010 GDP growth forecast for China from 9.5% to 10%, while it also cut its inflation forecast from 3.7% to 3.0% (though it increased it to 3.3% in 2011). There is no doubt that the Chinese economy is humming; indeed the HSBC PMI for October rose from 53.8 to 54.7 – confounding those who expected it to fall.

The danger, according to the Bank, is overheating. It has also urged Beijing to raise interest rates further and faster, and to move to a flexible exchange rate.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, sterling was the biggest winner in the FX markets, largely because of stronger than expected third quarter GDP growth. It rose 1.8% against the dollar, whereas the euro fell 0.4%, the Swiss franc fell 1.1%, and the Australian dollar fell 0.7%.

This week, the big winner is the Australian dollar. Helped by an unexpected hike in interest rates by the Reserve Bank, it has strengthened from A$1.0202/US$ to A$0.986 – a rise of 3.3%. In contrast:

- the euro has strengthened just 0.9%, from US$1.391/€ to US$1.4035;
- sterling has risen 1.1%, from US$1.602/GBP to US$1.6202; and
- the Swiss franc, which fell sharply on Monday, bounced back to trade around SF0.986 – up 2.5% for the week.

In contrast, the yen is weaker, falling from Y80.46/US$ to Y81.32 – or by 1.1%.

The main factor in the market has clearly been the Fed's decision on QE. As Brazilian FM Mantegna pointed out, "the only result is to devalue the dollar". On a trade-weighted basis, the dollar is now at its lowest level of the year – and the assumption in the markets is that the Obama Administration would be happy if it weakened further. That is reflected in the price of precious metals; gold, for instance, has risen this week from US$1,344/oz to US$1,390 – or 3.4%. Given a growing belief that the Fed has started to target US inflation directly and the insistence of several new 'tea party' Congressmen that gold ought to play a bigger role in the global monetary system, the price could go higher still.

V OIL

Perhaps surprisingly, both marker crude prices fell slightly following announcement of the stronger than expected US jobless data today. Nevertheless, week-on-week, prices are up very sharply. Indeed, they are near a two-year high:

- WTI: WTI for December delivery closed last week at US$81.43 a barrel. It hit a high of US$86.92 earlier today, and is currently trading at US$86.25 – up almost 6% for the week.
- Brent: December Brent closed last Friday at US$83.15, and hit a high of US$88.21 earlier today. It is currently trading at US$87.52 – up 5.3% week-on-week.

What has caused this spike?

One factor is clearly the weakness of the dollar. As the dollar goes down, the price of oil tends to go up. Another reason (particularly for the sharper rise in WTI) is the threat posed to the Gulf by Hurricane Tomas. In addition, the rise in commodity prices over the last few weeks has been broad-based, with the R/J CRB index up this week from 299.8 to 311.8. Another factor is the latest *World Oil Outlook* from OPEC, which concludes that the recovery in oil demand is turning out to be substantially stronger than expected.

Most important, however, were comments by Saudi Arabia's Oil Minister in Singapore on Tuesday. He suggested that the Kingdom is "comfortable" with a price range of US$70-90 a barrel – which was interpreted as a policy shift, given that the market has assumed for some time that Saudi Arabia's preferred range is US$70-80.

That appears to have offset the continued high level of global stocks. According to the EIA, US crude stocks, for instance, rose 2 million barrels in the latest week – largely offsetting a 3.6 million barrel drop in distillate stocks and a 2.7 million barrel drop in gasoline stocks. It now appears that the market considers US$80 to be its target price.

VI BANKING

As noted, Spencer Bachus is likely to take over Chairmanship of the US House Financial Services Committee. What is particularly important about that is that he is on record as having opposed the so-called "Volcker rule" – which he has said would "impose substantial costs on the US economy". Under him, there is a strong possibility that the Dodd-Frank Act will be substantially gutted during the protracted rule-making process.

VII NEXT WEEK

As noted, there are important local elections in Greece this weekend, which are being seen as a referendum on fiscal reform. Next week, France takes over as Chairman of G20 – and has paved the way with a state visit by Chinese President Hu Jintao to Paris.

As far as US economic releases are concerned, the key next week are:

- the trade deficit for September, likely to be unchanged at around US$46 billion; and
- the preliminary Michigan sentiment index for November.

As for Europe, the key releases are:

- eurozone GDP data for the third quarter;
- the BofE's quarterly *Inflation Report*; and
- industrial production for the UK and Germany.

In Japan, the economy watchers' survey for October is due.

Regards,
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1. Γκερέκου Άντζελα, βουλευτής
2. Καρχιμάκης Μιχάλης, Βουλευτής
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