WEEKLY ECONOMIC AND MONETARY REPORT

26 November 2010

While global markets did respond to this week's sabre-rattling by North Korea, the consensus seems to have been that this was just a reminder to the West (and perhaps to China) that the Pyongyang government – which survives almost entirely on aid of one sort or another – cannot be ignored. The problem is that the rest of the world is getting blasé about these incidents – which may tempt North Korea to do something even more inflammatory.

In the meantime, however, the markets have been focussed almost entirely on the accelerating problems of the eurozone.

I EUROZONE CRISIS

As noted, the crisis seems to be accelerating. Three weeks ago, the main problem was still Greece. Then Ireland – and now Spain (the markets seem to have written off Portugal). The problem is that the Spanish economy is twice the size of Greece, Ireland and Portugal put together. The European Financial Stability Facility (which has borrowing authority for up to €440 billion, though the *WSJ* claims that only €310 billion of this is really available when account is taken of the collateral that will have to be posted) can – probably – cope with Ireland and Portugal; but there is no way it could bail out Spain, which needs to roll over €300 billion in sovereign debt in the next three years and whose banks are heavily exposed both to Portugal and to the domestic construction industry. (Spain had a housing bubble comparable to that of Ireland, though mostly apartments on the Mediterranean coast.)

Recognising this, the European Commission apparently floated a proposal on Wednesday that the EFSF should be doubled in size. Initially, Germany seemed to agree, but the Bundesbank's "super-hawk", Axel Weber, has now insisted that there

should be no more funding for the EFSF. His insists (against all the evidence) that its present resources are enough.

In the meantime, the situation in Ireland has gone from bad to worse.

After insisting for two weeks that Ireland did not need a bail-out from the EFSF or the IMF, PM Cowan finally gave in over the weekend. As he put it, the threat of financial chaos was "too big a problem for such a small country". Accordingly, a joint EU/IMF team is currently auditing the government's books, and is expected to recommend a loan of €80-90 billion (mostly from the EFSF), plus parallel loans of GBP 7 billion from the UK (whose banks are probably the most heavily exposed to Ireland) and Skr 10 billion from Sweden. In return for this, the Irish government has agreed to a further €5 billion in tax increases and €10 billion in spending cuts, to be phased in over four years. This is on top of the €15 billion deficit reduction package already agreed, and it was described by the *FT* as "without parallel". The only concession that the Irish government appears to have got from the Germans (who were effectively dictating terms) was that it will be permitted to retain its (very low) 12.5% corporate tax rate – a rate that has attracted many multinationals to set up in Ireland.

The problem is that <u>the Irish government may not be able to deliver on its promise</u>. It will try to pass these measures in its (already scheduled) December 7 budget – and it may well succeed, (although, following a by-election loss today, its Parliamentary majority is down to two). But there will be a general election in early 2011, and Cowan's Fianna Fail-led coalition will almost certainly lose. All the major Opposition parties have said they will be free to reopen negotiations.

Under these circumstances, it is not surprising that the markets are still sceptical. At the beginning of the week, Irish 10-year government debt was yielding 7.99% (compared with 2.70% for the 10-year German *bund*), while CDS cover was costing 530 basis points. In comparison, Portuguese debt was yielding 6.68% and Spanish debt was at 4.73%. By yesterday, the Irish 10-year yield was over 9%, with comparable yields in

Portugal and Spain over 7% and 5% respectively. The cost of CDS cover for Spain has increased from 281 bp to 303 bp this week, and there was a major sell-off in Spanish bank shares yesterday.

The outlook seems grim – and Germany is not helping.

Earlier today, the Bundesrat (the upper house of the German Parliament) was expected to approve a banking reform bill that would require even senior bond-holders to take a "haircut" as part of any future restructuring of German bank debt. This 'bail-in' proposal is strongly supported by Chancellor Merkel, who has convinced the French to agree that it should also be imposed at a European level as a condition for the extension of the EFSF (which is set to expire in 2013). The problem is that, to date, sovereign bondholders have always considered themselves legally exempt from future reschedulings (even if, as in Latin America, the practice has been rather different). If it is explicitly recognised that bondholders will be hit, then yields on the bonds of 'peripheral' eurozone countries will rise sharply – which is what seems to be happening already.

A final point: There is some controversy about the total exposure of European banks to debtor countries – Ireland, in particular.

According to the BIS, Ireland owed US $139 billion to German banks at end-June, US $132 billion to UK banks, US $69 billion to US banks and US $54 billion to Belgian banks (who are the most exposed as a percentage of GDP). However, these enormous figures have been called into question; the German banks, for instance, claim that their total net exposure is only €400 million. Despite that, the markets are sceptical and have hit European bank stocks hard this week.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

At the end of last week, Fed Chairman Bernanke gave an important speech in Frankfurt in which he attacked China and others for deliberately undervaluing their currencies, while warning of a "two-speed recovery". In his view, those emerging markets with flexible exchange rates (eg Brazil, Turkey and South Africa) carry a "double burden"; they, more than anyone else, need China to free up its exchange rate.

A THE US: Markets were closed yesterday for Thanksgiving. Nevertheless, it has been a busy week for economic releases – which have generally come in stronger than expected. In particular, it was reported:

- that commercial property prices rose 4.3% in September – a record one-month jump;
- that consumer spending rose 0.4% in October, while personal income (in nominal terms) was up 0.5%;
- that the Michigan consumer confidence index jumped this month from 67.7 to 71.6 – its highest level since June; and
- that, in the latest week, first-time jobless claims fell 34,000 to a two-year low that is consistent with a net monthly gain in non-farm payrolls of around 200,000.

Not everything is rosy, however. In particular, it was also reported:

- that both new and previously-owned home sales slumped last month (by 8.1% and 2.8% respectively), largely because of the impact of foreclosures on the property market; and
- that durable goods orders fell 3.3% in October, with capital goods orders off 4.5%.

Nevertheless, the second estimate of the third quarter GDP growth rate was revised up from 2.0% to 2.5%. Despite that, the Fed has also released new – and slightly lower – economic forecasts for next year. It now estimates that GDP growth in 2011 will be 3-3.6% (down from 3.5-4.2% in June). At the same time, it expects unemployment (currently 9.6%) to ease to 8.9-9.1%, while core inflation will stay well below the 2% level targeted by the Fed.

That last point probably explains why Bernanke continues to push his Quantitative Easing program – despite increasingly public opposition from within the Fed (most recently from Fed Governor Kevin Warsh) and from the markets.

B **EUROPE**: While the markets have focussed on the eurozone's debt problems, the economic numbers released this week have been pretty good. At the eurozone level, for instance, it was reported:

- that the consumer confidence index improved in November (albeit not by very much), from -10.9 to -9.5; and
- that the composite PMI jumped sharply, from 53.8 to 55.4.

On the other hand, new industrial goods orders fell 3.8% in September (though they were up 13.5% year-on-year).

The outlook is particularly positive in Germany – where it was confirmed this week that the GDP growth rate in the third quarter was a strong 3.9%. In addition:

- the GfK consumer confidence index rose this month from 5.1 to 5.5; and
- the IFO business survey hit its highest level since reunification, rising from 107.6 to 109.3.

No wonder that German politicians are referring to this as a "golden autumn" – particularly with exports driving the economy. One cannot help but conclude that, while

membership of the eurozone has been little short of a disaster for 'peripheral' countries, it has given German industry a growing competitive advantage.

As for the UK, the big issue this week has been an increasingly obvious split on the BofE's MPC between Governor King (who has publicly backed the Coalition government's fiscal austerity programme, while showing some reluctance to expand the Bank's own programme of QE) and a neo-Keynesian minority (represented by the American, Adam Posen) who want more public spending and more QE. One has to assume that there will be resignations from the MPC – probably led by Posen.

In the meantime, the British keep spending. According to the CBI's distributive trades survey, retail sales were up for the fifth month in a row in November, with the net positive balance improving from +36 to +43. In addition, the ONS confirmed this week that the third quarter GDP growth rate was 2.8%, with net trade contributing half of this.

On the other hand, however, it was also reported that UK mortgage approvals fell 0.9% last month, and are now at a 19-month low. In addition – and despite the CBI data – Markit's household finance survey identified what it believes is a significant weakening of retail sentiment. With VAT being increased in January, Britons' propensity to spend seems likely to be tested.

C JAPAN: Despite concerns about Korea, the Nikkei-225 has just closed up 3.2% for the week – which is something of a surprise given:

- that Justice Minister Yanagida was forced to resign at the beginning of the week following unguarded comments about how "easy" his job was; and
- that consumer prices fell 0.8% year-on-year (0.6% for 'core' prices) in October – the 20th drop in a row.

There is no sign yet that Japan is exiting deflation – or that the government has the political clout to tackle it.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

At the end of last week, the euro had a minor bounce, recovering from a six-week low against the dollar on hopes of an Irish deal, to close the week at US $1.365/€. This week, however, it has been hit hard as the eurozone crisis has worsened. There was also a modest run into the dollar as a result of the tense military situation in Korea. As a consequence, the euro is currently trading at US $1.324/€ - down 3.0% for the week.

The euro has also fallen against the yen. At the close last Friday, it was trading at Y114.02/€. Despite concerns about Korea (which hit the yen/US $ dollar rate), the euro is currently worth Y111.36 – down 2.3% for the week. As for yen/US $ dollar, the dollar has strengthened from Y83.52/US $ to Y84.10. The dollar has also risen against sterling, by 2.1% - from US $1.596/GBP to US $1.5625 – and against the Swiss franc, from SF0.998/US $ to SF1.002.

Practically the only major currency against which the US dollar has not risen significantly this week is the Canadian dollar. At the close last Friday, it was trading at Can $1.021/US $; currently, it is Can $1.020. On a trade-weighted basis, the Canadian dollar is now at a seven-month high.

There has been talk that an agreement between Russia and China to invoice bilateral trade in their own currencies, rather than in US dollars, might undermine the dollar in the longer term. In the even longer term, there have also been suggestions that Putin's "offer" of a free trade agreement between Russia and the EU (despite Russia's failure to meet WTO entry conditions) could hit the dollar. However, in the short-term, the consensus seems to be that (on "technical" grounds alone) the dollar probably has another 5% to gain. Reflecting that, gold has eased this week from almost US $1,400/oz to US $1,362.

IV OIL

Week-on-week, oil prices have risen sharply – and unexpectedly – this week. The main reasons appear to be:

- a cold snap in Western Europe; and
- fears that an escalation of the Korean conflict could hit seaborne oil trade in Asia.

As a result, front-month marker crudes have risen strongly:

- WTI for January delivery closed last week at US $81.98 a barrel (the December contract, which was the previous marker, closed at US $81.51) and hit a high of US $84.24 on Thursday. It is currently trading at US $83.10 – up 1.4% for the week.
- January Brent closed last Friday at US $84.34 a barrel, and hit a high of US $86.50 yesterday. It is currently trading at US $85.04 – up 0.8% for the week.

It is worth noting that prices have risen despite an increase in US oil inventories. According to the EIA, US crude inventories rose 1.03 million barrels (to 358.6 million) in the latest week, while gasoline inventories rose 1.91 million (to 209.6 million). In contrast, distillate inventories fell 541,000 barrels.

According to a Bloomberg survey of oil traders, the market expects no change in oil prices next week.

V BANKING

There have been two significant developments this week – both of them in Germany:

- As noted, the Bundesrat was expected to pass a bank restructuring bill today. This will do several things. First, it will set up a bank rescue fund, to be financed by an annual levy on German banks. Second, it will set up a new reorganisation regime similar to Chapter 11 in the US. Among other things, this will permit the providers of new capital to outrank existing debt holders (including bondholders) in the event of liquidation. It will also permit the authorities to impose debt/equity swaps, and it will clarify the rules under which BaFin can split a troubled institution's assets into a "bad bank" and a "good bank".
- Yesterday, the Bundesbank published its latest (annual) *Financial Stability Review*. According to this, German banks are safer than they were this time last year. However, there are still grounds for concern. In particular:
    - German banks are still too dependent on short-term financing (30% of bank debt has a maturity of less than one year, compared with 22% before the crisis);
    - German banks need at least €50 billion in new capital by 2018 to meet the requirements of Basel 3;
    - there are still heavy losses to be recognised on toxic loan books (perhaps as much as €23 billion this year, though that is less than last year's €37 billion); and
    - the *landesbank* network is still vulnerable, and needs to see substantial consolidation.

VI NEXT WEEK

As far as US economic releases are concerned, the most important next week are likely to be:

- the Case-Shiller house price index for September (expected to be up 1%);

- the consumer confidence index for November, expected to be up sharply;
- the ISM index for November, expected to be flat; and, of course,
- non-farm payrolls for November, expected to be up around 150,000.

The Fed's Beige Book survey of business conditions will also be released.

In Europe, the key releases are:

- the eurozone business climate index for November;
- eurozone unemployment for October;
- eurozone PMIs for November; and
- preliminary eurozone GDP growth for the third quarter.

The ECB's policy committee also meets.

In Japan, retail sales and household spending for October are due to be released.

Regards,
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