WEEKLY ECONOMIC AND MONETARY REPORT

25 September 2009

Politics takes over...The UN General Assembly convened this week, in part to prepare the way for the Copenhagen Summit on climate change. G20 leaders are convening today in Pittsburgh. There are important Federal elections in Germany this weekend, followed by an almost equally important vote on the Lisbon treaty in Ireland next Thursday. Then there are elections in Greece (which the incumbent centre-right right party will almost certainly lose), followed by the Bank/Fund meetings in Istanbul – on which we have already submitted a briefing note.

In the meantime, the consensus continues to be that the Western economies are crawling out of recession. However, it may be significant that the most recent economic data has tended to be less good than markets expected: expectations are now running ahead of reality.

I UN/G20 SUMMIT

The general feeling was that the UN talks on climate change were an anti-climax, and that China's new initiative on pollution was fairly meaningless. This probably reflects a feeling in the US that it is hard to take climate change seriously at a time when global temperatures appear – temporarily, at least – to have stabilized, and when there are other pressing problems that have to be addressed. As a result, expectations for Copenhagen are being downgraded.

That said, there was considerable interest in the four "pillars" of US policy that Obama identified in his speech. In addition to environmental restoration, these were:

- nuclear disarmament;
- Middle East peace (specifically, he spoke of an "end to the occupation that began in 1967" – an encouragingly blunt use of words); and
- economic growth.

Re-establishing economic growth is also high on the Pittsburgh agenda.

Ahead of the G20 meeting, the ADB raised its growth forecasts for most Asian economies – emphasising how quickly they are bouncing back. This year, it now expects China to grow 8.2% (up from the previous forecast of 7.0%), India to grow 6.0% (up from 5.0%), and developing Asia as a whole 3.9% (up from 3.4%). However, there remains concern for Europe and North America. Indeed, a pre-release of the forthcoming *World Economic Outlook* shows that the IMF does not expect normal growth to resume until 2015. As a result of this, the US and UK in particular are pushing for a commitment that the major economies will not "exit" prematurely from fiscal and monetary stimulus – and that, when they do, they will do so in a coordinated way (with the G20 being the preferred agent of coordination).

That raises another issue – Washington's concern with balancing the global economy.

This is an old chestnut. The US wants recognition that chronic *surplus* countries (like China, Japan and Germany) have just as much responsibility for correcting global imbalances as do chronic *deficit* countries (the US, the UK). The threat that Obama holds over the surplus countries is the possibility of a precipitous fall in the dollar. However, since the Chinese still peg the renminbi to the dollar, that threat probably carries more weight with Europe than with Beijing.

The other big issues to be dealt with in Pittsburgh are:

- financial regulation; and
- IMF reform.

On financial regulation, it would be wrong to expect anything very specific; the details of any regulatory measures will be worked out in the Basel Committee and on the Financial Stability Board. That said, the Europeans in particular will push hard for broad (political) commitments:

- to tie bankers' remuneration to long-term performance (perhaps through a voluntary code of conduct);
- to boost bank capital (perhaps with a pro-cyclical element to the capital requirements);
- to introduce a new liquidity test; and (as a sop to the British)
- to explore the possibility that all big banks should maintain a so-called "living will" that would help regulators liquidate them in a crisis.

Slightly surprisingly, the Fund's *Global Financial Stability Report*, published on Monday, included a defence of securitization – warning that, once the crisis is over, it will still be needed to distribute risk more optimally around the system.

More specific commitments are likely on IMF reform – and there is a feeling that (as at the last G20 Summit) the Fund will emerge as the big winner in Pittsburgh.

It appears that the IMF will be given a new, enhanced surveillance role over the global economy. There will also be agreement in principle to boost emerging market representation on the Fund's board. The US has accepted a cut in its quota to 17% (still enough for a veto), and it is pushing hard for the EU to restructure its representation so that it frees up quota for the BRICs in particular. As for the IMF resources, it is worth noting that the board approved the sale of 403.3 MT of gold (one-eighth of its stockpile) last Friday. The US Congress has also approved this, so it should produce approximately US$14 billion in new resources.

Surprisingly, one idea that we had dismissed may get a hearing in Pittsburgh – the so-called Tobin tax.

The idea of a very small tax on financial transactions – either (as Tobin originally envisaged) to put "sand in the wheels" of finance, or to fund North-South development finance – has received influential support over the last week or so from former Fed Chairman Volcker, German FM Steinbrück and FSA Chairman Turner. It still seems a (very) long shot, but it cannot be ignored altogether.

Other issues to come up will include a further crackdown on alleged tax evasion (including sanctions against offending jurisdictions), and China's proposal to use part of its current account surplus to back a new "super-sovereign" fund to invest in poor countries.

II BANKING

A EU PROPOSALS: Probably the main development of the week was the release of the Commission detailed proposals for implementing the regulatory reforms advocated by the de Larosiθre committee.

These include a new European Systemic Risk Board (chaired by the ECB), plus three new Authorities – dealing with banking, insurance and securities. The ESRB has only limited legal powers, but the Authorities (which will be governed by a majority vote) will be given the power to overrule national supervisors in "emergency situations" and to impose a settlement when there is a dispute between national supervisors. The Authorities will also have substantial budgets and permanent staffs.

B US DEVELOPMENTS: Over the weekend, Chris Dodd, Chairman of the Senate Finance Committee, proposed that the four US financial regulators (the Fed, the OCC, the FDIC and the OTS) be combined into a single agency – rather than (as the Obama Administration wants) make the Fed into a "super-regulator". There are now two proposals in the table – and this one may have political traction because it does not appear to reward the Fed for its alleged incompetence.

The SEC is also starting to talk tough. It has proposed a ban on so-called "flash" trading – algorithmic trading, in which thousands of bids and offers can be made in a second to feel out the market. The SEC said it felt such trades give short-term traders an unfair advantage over long-term investors. However, the exchanges can be expected to oppose the ban, since flash trading has been responsible for pushing up daily trading volume by 164% since 2005.

C UK DEVELOPMENTS: The FSA's Chairman, Adair Turner, has become increasingly vociferous in his criticisms of the pre-crisis investment banking model.

Far from retracting his earlier comments that a lot of derivative products (and the bankers who manufacture them) are "socially useless", he has expanded on the theme – and has warned that it will not worry him one bit if the City of London shrinks substantially.

One early result of this may have been seen today. HSBC – Britain's' biggest bank - announced that its CEO will relocate to Hong Kong from London.

D **OECD:** On Wednesday, the OECD published guidelines aimed at governments who are considering selling back their stakes in rescued banks to the public sector. In particular, it urged:

- that governments should tap new pools of capital, rather than sell to existing competitors;
- that selling to pension funds, university endowments, and SWFs would be better than selling to banks;
- that governments should not sell to highly indebted institutions or individuals; and
- that toxic assets should generally be taken off the banks' books before sale, using the "bad bank" model.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US:** On Tuesday, US census data for 2008 was released – illustrating some of the real damage that the recession has done. Particularly significant was the drop in the home ownership rate from 67.1% to 66.6% - with the rate for black families falling from 46.6% to 45.6%. As far as incomes are concerned, real median household earnings rose in only five (of 50) states last year, compared with 33 in 2007. The lowest was US$37,790, in Mississippi; the highest was US$70,545, in Maryland.

As noted, economic data has generally surprised on the downside this week. On Monday, for instance, it was reported that the Conference Board's index of leading

indicators rose 0.6% in August, which was the fifth consecutive rise – albeit less than expected, and down from 0.9% in July. More significantly, it was reported:

- that existing house sales fell 2.7% in August, after four consecutive rises, with the median price down 12.5% year-on-year; and
- that durable goods orders (admittedly, always volatile) were off 2.4% last month, the worst reading since January, and sharply lower than the rise of 0.4% that had been expected.

Ex-transportation, durable goods orders were flat – compared with the expected rise of 1.0%.

There are, however, still plenty of encouraging signs. First-time jobless claims, for instance, were down 21,000 in the latest week. And the inventory of unsold houses is now down 16.4% year-on-year. But this week's data gave the markets a nasty turn – as did the FOMC. No surprise that the Fed funds rate was left unchanged at 0-0.25% - but there was some surprise at the hint in the accompanying policy statement that the Fed will start scaling back its support early in 2010.

<u>That appears to have pricked (at least temporarily) what has been an unprecedented rally in US equities</u>. Though last Friday, for instance, the DJIA had risen 46% in just six months – the biggest rise in over 100 years. This week, through Thursday, the Dow is down 1.2%, the S&P500 is off 1.6%, and the Nasdaq is off 1.2%. In early trade today, the Dow is down 13 points, or just over 0.1%. At the same time, US Treasuries have also sold off, with the yield on the 10-year benchmark bond rising from 3.30% to 3.38% - despite strong demand at this week's auctions.

B **<u>EUROPE</u>:** As noted Germany and Greece face elections, and Ireland has to vote on Lisbon. There is also speculation that the Czech Republic's eurosceptic President, Vaclav Klaus, may use the country's Supreme Court to force a referendum. These are, therefore, potentially tricky political waters for the EU – and there are more problems ahead. This week, for instance:

- the ECB released details of its inaugural survey of credit conditions for SMEs, showing that the overwhelming majority faces tighter access to credit in the first half year; and
- a political row broke out over Magna's deal to buy GM's Opel and Vauxhall brands in Europe, when it was revealed that Magna will cut 100% of GM's Belgian workforce, 31% in the UK – but only 17% in Germany (which just happens to be bankrolling the deal).

While the terms of the Magna deal may prompt the European Commission to act on competition grounds, Chancellor Merkel must be fairly satisfied. She has a least neutralized an issue that threatened to undermine the CDU/CSU in this Sunday's elections. Even so, the elections could still be a tight-run thing. The latest polls show the CDI/CSU with 35% of the vote and the FDP with 14%. In contrast, the SPD has 26%, the Greens have 10% and the Left 11%.

Theoretically, the economy ought to help Merkel. In particular, it was reported this week:

- that the IFO index of business confidence rose in September from 90.5 to 91.3 – the sixth straight increase; and
- that the GfK consumer confidence index rose from 3.8 to 4.3.

True, consumer prices fell 0.1% year-on-year in August, but (as the latest Bundesbank survey claims) there is no solid evidence yet of the credit crunch hurting German business. The catch, however, is that the Federal election is increasingly being fought on "social" issues (fairness etc.), and not on economics. That does give the SPD an outside chance of prevailing.

As for France, it was reported this week that the consumer confidence index rose this month, albeit only from -37 to -36, while unemployment rose 18,000 in August to 2.55 million. More worrying, perhaps, is Spain – where the economy is (in some eyes, at least) sliding into depression. PM Zapatero continues to insist that the country will escape the worst of the recession, but it is estimated that the unsold property overhang now amounts to 1.62 million units – compared with an annual demand of

218,000. Independent economists also predict that unemployment will hit 25% later this year.

As for the UK, there is real concern about the direction of monetary policy – with a strong suspicion that BofE Governor King is trying to engineer a controlled depreciation of sterling so as to generate an export-led economic recovery. If he is, history should tell him this is a very dangerous policy.

There also seems to be a widening split within the MPC itself. The minutes of the September meeting were published this week, and show a 7:3 split over whether to increase the Quantitative Easing programme from STG175 billion to STG 200 billion. King is in the minority that wants to increase, but his own chief economist, Spencer Dale, has warned that QE is already pumping up another asset bubble.

In the meantime, the CBI has updated its short-term UK economic forecasts. It now sees growth of 0.3% in the third quarter, and 0.4% in the fourth – both upward revisions. However, it has revised its first half 2010 forecast down – to 0.1% for the first quarter and 0.3% for the second. The primary reason is the re-imposition of a 17.5% VAT rate next year. Longer term, however, the UK economy must be vulnerable as a result of the deterioration in government finances.

It was reported over the weekend that government borrowing hit a record STG16.1 billion in August, thanks primarily to a 13% fall in tax receipts. For the 12 months to end-August, government borrowing hit STG127 billion, up threefold year-on-year.

C **JAPAN:** Post-election reality is starting to bite in Japan – and it is probably no coincidence that the Nikkei-225 has just closed down 1% for the week. Hatoyama *et al* have been hinting strongly this week:

- that they will reverse LDP plans to privatise the post office (which is really the biggest deposit-taking institution in the world); and
- that they may "forgive" SME loans for up to three years.