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WEEKLY ECONOMIC AND MONETARY REPORT

19 June 2009

The consensus continues to say that the global economy is coming out of recession – led by the US. As noted before, we are a bit sceptical, and it is worth pointing out that most mainstream Keynesian economists (notably Paul Krugman) believe the so-called 'output gap' (ie the hole in aggregate demand) is still increasing, and that the Bush Administration's attempt to fill it with a US $1 trillion fiscal stimulus is inadequate. The implication of their analysis is that we could be heading for a 'double dip' recession, while many Chicago-school monetarists are predicting a very sharp rise in inflation. Both sides have plausible arguments, but it is clear that they cannot both be right.

I G-8 MEETING

Last weekend's meeting of G-8 Finance Ministers in Italy reflects the same split of opinion on what is the appropriate macroeconomic response to the crisis. The communiquı emphasised that "there are signs of stabilisation… including a recovery of stock markets, a decline in interest rate spreads (and) improved business and consumer confidence" – but it could offer no clear 'exit strategy'. Instead, the IMF has been asked to look at alternatives ahead of the next G-8 Summit (to be held in the earthquake-hit town of L'Aquila on July 8-10).

The other thing that came out of the Finance Ministers' meeting was the so-called 'Lecce framework' – a set of principles for financial reform, which are (to some extent) reflected in the regulatory initiatives launched on both sides of the Atlantic this week.

II FINANCIAL REGULATION

This has been a big week for regulation – on both sides of the Atlantic.

A THE US: On Wednesday, Obama revealed details of the reform proposal that Geithner and the White House's economic adviser, Larry Summers, had been working on with a small Treasury team. This now has to go to Congress – where Sen. Dodd and Rep. Frank have both expressed serious reservations. Despite that, something will be passed – and it will probably look a lot like what the Administration is proposing, since Geithner has already made a number of political compromises.

The key proposals contained in the 90-page White Paper are:

- a new Financial Services Oversight Council, made up of the heads of all the regulatory agencies, which will monitor systemic risk and identify gaps in the regulatory architecture;
- a new role for the Fed as the regulator of systemically important financial institutions (not just banks);
- elimination of the OTS, which will be merged into the OCC (to be renamed the National Bank Supervisor) – thereby ending the special regulatory status of the US thrift industry;
- creation of a new Resolution Authority, which will be able to seize non-bank firms with systemic importance;
- a new Consumer Financial Protection Agency, to cover complaints against banks, credit card companies and bank holding companies;
- tighter rules on derivatives, including a central counterparty for exchange-traded derivatives and a common clearinghouse for OTC trades;
- a new National Monitor for insurance;
- "more high-quality capital" (undefined) for banks; and
- a pledge to work with international regulators on common standards.

This is probably the biggest regulatory shake-up in the US since 1933. However, it is actually *less* radical than some observers had expected. According to *The Washington Post*, many of the Treasury's original ides got negotiated away. In particular:

- the only regulatory agency that will actually disappear is the OTS;
- the CFTC and CBOT (who had been expected to merge, since they overlap, will remain separate and independent of the SEC);
- there will continue to be 50 individual state regulators for the insurance industry (though, as noted, there will be a National Monitor); and
- there will remain separate state and national bank charters.

Plus (and perhaps most important), institutions that are "too big to fail" will be regulated hard (in terms of capital and liquidity) by the Fed. But their right to become too big (or too complex, or too interconnected) will not be challenged. There will be no reimposition of Glass-Steagall, no restrictions on mixing commercial and investment banking, and no geographical restrictions. As a result, today's issue of "*The Economist*" calls the Administration's proposals a "curious mix of audacity and timidity", and concludes that it is "not bold enough".

There is one other problem that Dodd, in particular, has already jumped on. By giving the Fed a much bigger regulatory role, there is a danger that it will lose its independence, and that it will become just another department of the Treasury. Given the importance that is generally attached to the independence of the Fed, this could well undermine political support for this aspect of the plan – though no one doubts that some sort of reform package will be approved.

B **EUROPE**: EU leaders met in Brussels yesterday and today, and are reported to have broadly endorsed the Commission's May 27 blueprint for regulatory reform – which was itself based on the de Larosiere report, published earlier this year. This means the Commission will now prepare a draft Directive (or Regulation) creating a two-tier pan-European regulatory structure, including a European Systemic Risk Council (with central banks and national regulators) and three new European 'Authorities' covering banking, securities and insurance. There will also be provision for the pan-European regulation of credit rating agencies.

Apparently, the British have succeeded in restricting the extent to which the three Authorities (which will be governed by Qualified Majority Voting) will be able to 'direct' national regulators. But this is bound to re-emerge as a big issue in the Autumn.

At the same time, there is a debate going on in the UK (far and away the most important financial centre in Europe) on the shape of its own national regulation. On Wednesday, both the Chancellor of the Exchequer and the Governor of the BofE made speeches on the subject – and it is very clear that they are miles apart. The Chancellor emphasised that no fundamental structural changes are necessary; the Governor made it clear that he wants the Bank to play a much bigger (and more hands-on) role in day to day supervision.

One other point: It was reported today that the Swiss National Bank is considering whether to force the break up of UBS and Credit Suisse as a way of reducing risk. The problem is the same as in Iceland, and even the UK: the disproportionate size of the banks' exposure relative to national GDP. The collective assets of UBS and Credit Suisse are six times Swiss GDP – which means it is really not practicable for the government to stand behind them in an emergency.

III FINANCIAL CRISIS

The shift of focus from the immediate situation of the banks to the future shape of financial regulation should not lead one to conclude that the crisis is over.

Indeed, this week, it was reported:

- that Moody's has downgraded 25 Spanish banks and five *cajas*, put UBS on negative credit watch, and warned that it might downgrade 21 Italian institutions; and

- that the ECB is predicting new European bank write-downs of US $283 billion by the end of next year, mostly on loans, because (in its view) the "credit cycle has not yet reached a trough".

The IMF seems to share the ECB's concerns. Indeed, on Monday, Strauss-Kahn was quoted as saying "the worst of the crisis is still to come".

That said, the big US banks are falling over one another to repay the money they received from the TARP so that they can 'get the government off their backs' (ie start paying themselves mega-bonuses again). On Wednesday, it was reported that JPMC is to pay back US $25 billion, Goldman and Morgan Stanley US $10 billion each, Amex US $3.4 billion, US Bancorp US $6.6 billion and BB&T US $3.1 billion. In addition, JPMC and Morgan Stanley both announced that they will no longer issue FDIC-guaranteed bonds; Goldman is expected to follow.

The danger is that these banks will soon forget that the only reason they survived is because they were bailed out by the US taxpayer. And the only reason they are making money (and they are, indeed, extremely profitable at the moment) is because of Treasury manipulation of the yield curve and because they are earning interest on deposits with the central bank. The temptation is for bank managements to take credit for the turnaround – and to get back to 'business as usual' (at least until the next leg of the crisis hits them).

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US**: The IMF released its annual (Article 4) report on the US economy this week. Its forecasts are slightly up from the Spring, but they are still quite negative. It is now projecting that GDP will fall 2.5% this year (compared with an earlier forecast of -2.8%) and that it will grow just 0.75% in 2010 (compared with no growth at all). Perhaps as significant, the Fund warns that the current fiscal stimulus will mean that the US need

to tighten fiscal policy (ie cut spending or increase taxes) by 3.5% of GDP over the next 10 years.

In the meantime, the economy still seems to be bouncing along the bottom. In particular, it was reported this week:

- that the Empire State (NY) activity index weakened again in June, from -4.55 to -9.41;
- that the NAHB homebuilders confidence index fell in June, after two straight increases;
- that industrial production fell 1.1% in May (largely because of automobiles), with capacity utilisation hitting a record low of just 68.3%; and
- that wholesale prices were down 5% year-on-year in May, while the CPI was down 1.3% (though it was up 0.1% month-on-month).

On the other hand, it was also reported:

- that the Philadelphia Fed index improved sharply this month, from -22.6 to -2.2;
- that continuing unemployment claims fell sharply in the latest week;
- that the Conference Board's index of leading economic indicators rose 1.2% last month; and
- that new home construction jumped 17.2% in May.

What might give the authorities pause was news that net foreign purchases of US stocks, notes and bonds fell sharply in April, from US $55.4 billion to just US $11.2 billion. Both China and Japan cut their holdings of Treasuries over the month – adding substance to suggestions that they are looking for an alternative to the dollar.

None of this has been great for the markets. At the close last week, the DJIA was finally in positive territory for the year (even though it was still down 38% from its 2007 record).

However, weaker than expected economic data this week seems to have undermined the so-called 'reflation trade'. As a result, even though markets bounced yesterday, the DJIA is down almost 200 points (2.2%) through early trade on Friday, with the S&P500 down 2.2% and the Nasdaq Composite off 1.3%. At the same time, the yield on the benchmark 10-year Treasury has risen from 3.80% to 3.88%, despite the fact that the two-year yield has actually fallen from 1.27% to 1.25%.

B **EUROPE**: The EU Summit meeting being held today has apparently concluded that "further budget stimulus would not be warranted" – and that priority should now shift to "consolidation" (ie getting public finances back in order).

That is despite the fact that the EU shed 1.9 million jobs in the first quarter, leaving the unemployment rate at 8.6% (up from 6.8% a year ago). However, it does reflect a modest improvement in the major eurozone members:

- In Germany, for instance, the ZEW monthly sentiment index rose in June from 33.1 to 44.8, with the current conditions index also improving, albeit from -92.8 to -89.7.
- In France, it was reported today that Insee is now forecasting that the recession will have ended by the fourth quarter, following falls of 0.6% in the second quarter and 0.2% in the third. For the year as a whole, GDP is expected to contract 3%, but 2010 should be positive. (That said, it was also reported this week that the CPI fell 0.3% year-on-year in May, the first such fall since 1957.)
- In Italy, it was reported that the OECD has raised its GDP growth forecast for 2010 from -0.4% to +0.4%. (However, it also cut its forecast for 2009 from -4.3% to -5.3%.)

The outlier is probably Spain. For a long time, it appeared that (thanks in part to – allegedly – tougher bank supervision) Spain would escape the worst of both the banking crisis and the recession. Now, the government is predicting growth of -3.6% this year,

and house sales were down 48% year-on-year in April – a record. With unemployment approaching 20%, and the banks heavily exposed to the property sector, prospects are grim.

They are also pretty grim in the UK though (as we have said before, and as Paul Krugman pointed out over the weekend) the relative openness of the British economy means that recovery will probably come earlier than in Continental Europe.

This week, it was reported:

- that UK automobile production was down 43% year-on-year last month;
- that retail sales fell unexpectedly in May – down 0.6% month-on-month and 1.6% year-on-year;
- that factory orders had their sharpest fall in a decade this month;
- that unemployment rose to 2.26 million in May, pushing the jobless rate to a 12-year high of 4.8%; and
- that gross mortgage lending fell last month from STG 10.5 billion to STG 10.3 billion.

On the other hand, all the major supermarket chains are doing exceptionally well, with like-for-like sales up 4-8% year-on-year.

However, the looming problem is government finances. Public sector borrowing hit a record STG 19.9 billion last month, pushing gilt yields up. Not surprisingly, the FTSE-100 is now down around 2% for the week.

And then, of course, there is the political situation... Although (to considerable surprise) PM Brown has managed to hang on, his support is dwindling. Latest minister to quit is Kitty Ussher, Economic Secretary to the Treasury (who is in charge of City affairs). Brown's credibility is shattered – unfortunately, at a time when, as noted, the Europeans are bent on undermining the UK's primacy in financial services.

C **JAPAN**: PM Aso also has a similar problem with his cabinet. Latest to quit is the Interior Minister, Kunio Hatoyama – who attacked the PM over plans for the post office. The result is that the opposition DPJ is expected to do very well in the elections that must be held by September at the latest.

D **BRIC ECONOMIES**: At the beginning of this week, Brazil, Russia, India and China organised the first BRIC Summit at Yekaterinburg, near Moscow. Together, they account for around 15% of the global economy. More important, they hold around 40% of total official reserves.

The meeting itself may have been more symbolic than substantive, but it has been agreed to meet again next year in Brazil. As far as common interests are concerned, the communiqui repeated the four countries' demand for a greater voice in running the IFIs and for a more diversified global monetary system. There was apparently talk about buying each other's bonds and swapping currencies.

It is also worth noting that, before the BRICs met, the Shanghai Cooperation Organisation also met in Yekaterinburg – including Kazakhstan and Iran. It was reported that China pledged US $10 billion in aid to Central Asia.

Domestically, the Chinese recovery still seems to be on track. Yesterday, the World Bank upgraded its economic forecasts. It now projects Chinese GDP growth of 7.2% this year (up from 6.5%), and 7.7% in 2010. Most of this is apparently set to come from investment, and there is still a sense that domestic consumption is lagging.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

The longer term future of the dollar is undoubtedly being undermined by the talk (particularly among the BRICs) about reserve asset diversification. However, this isn't an immediate issue. Indeed, on Monday, Russian FM Kudrin conceded (yet again) that

there is “no alternative” to the dollar – and that, for the moment at least, the dollar is in “good shape”.

The dollar has also benefited a bit this week from the perception (right or wrong) that the US is coming out of recession faster than Europe. That said, the yen has (rather unexpectedly) strengthened:

- US $/euro: At the close last Friday, the euro was trading at US $1.402 – and the expectation was that it would weaken on fears about the condition of European banks. That expectation proved broadly correct. By the close on Monday, it had fallen to US $1.377. Even though it has since recovered to US $1.391, it is still down 0.8% for the week.
- US $/sterling: The pound closed last week at US $1.65, up strongly against both the euro and the dollar on a belief in British ‘green shoots’. However, the dollar recovered strongly on Monday, closing at US $1.626. Even though sterling has recovered to US $1.639, it is still down 0.7% for the week.
- Yen/US $: At the close last week, the dollar was trading at Y98.20. It fell to Y95.68 on Wednesday. Even though it is trading at Y96.72 today, the dollar is still down 1.5% for the week.
- SF/US $: The SF came under some pressure yesterday, when the SNB warned that it would intervene if necessary to stop the franc’s appreciation against the dollar. As a result, week-on-week, the franc has eased from SF 1.076/US $ to SF 1.085 – or by 0.8%.

VI OIL

Last week, both WTI and Brent strengthened sharply, and closed at or near eight-month highs – July WTI at US $72.04 a barrel (up 5%) and August Brent at US $70.92 (up 3.5%).

This week, the price of front month WTI has eased slightly, while that of Brent has firmed. In early trading today, July WTI is trading at US $71.93 (down 2%), while Brent is at US $71.86 (up 1.3%). Among the factors in the market this week have been:

- China: Despite the general optimism about 'decoupling', PM Wen Jiabao was downbeat when he spoke on Monday about the pace of recovery – and that hit the price of commodities across the board.
- Capacity: On Tuesday, the US DofE reported that global spare production capacity is now at a seven year high of 5 million b/d.
- US stocks: On Wednesday, regular EIA data showed US crude stocks down 3.9 million barrels in the latest week, while gasoline stocks were up 3.4 million. Despite this, crude stocks are still unusually high.
- US demand: It was reported yesterday that demand for both gasoline and diesel is rising strongly.

So far, the problems in Iran seem to have had little impact on the oil market, even though it is the fifth largest exporter in the world (it produces about 3.65 million b/d, and exports 2.2 million). The reason is that commercial stocks are high. If stocks were lower, the global system would be far more vulnerable. However, there is a possibility of a chain shutdown of refineries in the UK, following a labour dispute at the Total facility in Lincolnshire. If that spread, the impact on European product markets would be considerable.

VII NEXT WEEK

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

- the final revision for first quarter GDP growth (expected to be unchanged at -5.7%);
- existing home sales for May, expected to be up about 5%;
- durable goods orders for May (expected to be down 0.9%); and

- personal income for May (expected to be up 0.2%).

The FOMC also meets, but is unlikely to change the funds rate.

The OECD's *Economic Outlook* is also published next week, and the UN has organised a Global Summit on development issues.

Regards,
GISE