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WEEKLY ECONOMIC AND MONETARY REPORT

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The consensus is firming that the global economy is past the worst, and that recovery is on the way. Even the IMF (which had become an economic Cassandra) has changed its tune; yesterday, it released a new forecast, predicting global growth of 2.4% next year (up from 1.9% last April). Today's edition of *The Economist* reinforces this, arguing that "the worst economic storm since the 1930s" is beginning to clear. The OECD also believes that a "possible trough" may have been reached in April; its composite index of leading indicators for the OECD-30 rose 0.5 points in April (the second rise in a row), after 21 consecutive falls.

This reinforced mood of optimism will undoubtedly be high on the agenda for the G-8 Finance Ministers meeting which begins in Lecce, Italy today. However, a couple of cautionary notes are in order.

First, while the Fund has become more optimistic, the World Bank has (rather surprisingly) become more negative. Yesterday, Zoellick predicted that the global economy will contract 3% this year – almost double the Bank's forecast of two months ago. Moreover, he predicted "aftershocks" from the crisis that would hold back recovery for several years.

Second, while 'green shoots' of recovery are now fairly evident in the US and the UK (the two economies that were hit earliest and hardest by the financial crisis that started in 2007), the situation may actually be deteriorating in the rest of Europe. The apparent success of Continental Europe in insulating itself from the immediate effects of the crisis may now be rebounding; all that may have happened is that the worst economic effects were postponed – not eliminated.

Third, there is considerable scepticism about China.

So far, this is primarily confined to academia – but it will probably hit the mainstream soon. The conventional wisdom is that China has 'decoupled', and that its stronger than expected growth performance (industrial output up 8.9% year-on-year last month, with the government projecting 8% GDP growth this year) is helping to pull the rest of the global economy out of recession. However, China is actually running an increased trade surplus (US$13.4 billion in May, up from US$13.1 billion in April). How (economists are asking) can a country that is running such an enormous trade surplus lead a surge in global demand? The implication is that the global recovery may be a bit less convincing that governments would have us believe.

I THE FINANCIAL CRISIS

Earlier today, the European Commission published a fascinating breakdown of the assistance that it believes governments have given to their financial sectors since the crisis began. In the US, for instance, it reckons that the government has "spent, lent or committed" US$12.8 trillion. In the EU, the total cost of the bailout to date is US$5.3 trillion (or €3.8 trillion), with the main contributors being:

- the UK (€781 billion);
- Denmark (€594 billion);
- Germany (€554 billion)
- Ireland (€385 billion);
- France (€350 billion);
- Belgium (€265 billion);
- Netherlands (€246 billion);
- Austria (€165 billion);
- Sweden (142 billion); and
- Spain (€130 billion).

The figure for Denmark is unexpectedly high; that for Spain is low – though it could well go sharply higher as a result of the worsening real estate crisis. The Commission estimates that 18 EU member states have new bank liquidity measures in place, 15 have recapitalization facilities and 11 have provided liquidity support. It is worth noting that the total assistance provided to European banks to date is greater than the GDP of Germany.

Despite that, the IMF's MD, Dominique Strauss-Kahn, argued this week that European banks are still in trouble, and that they need to raise US$375 billion in new capital. In contrast, he said, US banks need to raise 'only' US$250 billion.

Banks on both sides of the Atlantic are making considerable progress in this regard. In addition to the US$65 billion raised in May by the top 19 US banks, Citi pledged on Monday to raise US$33 billion. In addition, in the UK, LloydsTSB raised STG 4 billion this week – and promptly used STG 2.3 billion to repay some of the STG 17 billion it had borrowed from the government. Equally significant, Barclays – which had raised capital from Middle East investors as an alternative to a government bailout – has just announced that it has sold its BGI fund management operation (the biggest in the world, with US$1.6 trillion under management) to BlackRock. The deal is worth around US$13.3 billion; Barclays will also end up with 18% of the expanded BlackRock. (It is, nevertheless, a surprise, since BGI was considered the 'gem' in the Barclays 'crown'.)

The other big issue this week was the decision by the US Treasury on Tuesday to let 10 banks off the TARP "leash" – ie to let them repay the money the government had given them. This is important since the banks will no longer be obliged to defer to the Treasury on issues such as compensation. It is also significant in that it shows just how powerful the big US banks still are politically – and in that it suggests that they have learned nothing from their recent "near-death" experiences.

The banks that are off the hook are: JP Morgan Chase (which got US$25 billion from the TARP); Goldman Sachs (US$10 billion); Morgan Stanley (US$10 billion); US Bancorp (US$6.6 billion); CapitalOne (US$3.6 billion); Amex (US$3.4 billion); BB&T (US$3.1 billion); BoNYMellon (US$3 billion); State St (US$2 billion); and Northern Trust (US$1.6 billion.

On the other hand, the banks that the Treasury still considers too undercapitalized to repay their TARP money include: BofA (US$45 billion); Citi (US$45 billion); Wells Fargo

(US$25 billion); PNC (US$7.6 billion); GMAC (US$6 billion); SunTrust (US$5.9 billion); and RegionsBank (US$3.5 billion).

Of this latter group, the FDIC is still trying to impose a management shake-up on Citi, and Congress has been holding hearings into BofA's takeover of Merrill Lynch. It has become abundantly clear that BofA's CEO, Ken Lewis, was not exaggerating when he complained that the Fed and the Treasury had forced him to complete the Merrill takeover. He apparently invoked the so-called "MAC" clauses in the deal and wanted to walk away - but was told by Paulson and Bernanke that he would be fired if he tried.

A number of other items are worth noting this week:

- On Tuesday, S&P issued a new warning over Asian debt ratings, essentially putting sovereigns on credit watch.
- On Wednesday, Sweden received a €3 billion emergency loan from the ECB to underpin its banking system in the face of the Baltics' continued problems. In addition, Latvia (the worst affected) has managed to raise US$10.4 billion from the IMF and Europe. As a result, the crisis in the Baltic States has abated somewhat.
- Germany announced plans for a new public sector "bad bank" to take on the toxic assets of the state-owned Landesbanks. The individual states would, apparently, underwrite the value of those assets, which would be worked down over time.
- Yesterday, George Soros, the legendary currency trader, told a conference in Beijing that, in his opinion, credit default swaps are a "weapon of mass destruction', and should be outlawed because of the asymmetric structure of risk and reward.

That last suggestion is unlikely to be taken up – at least, in the present (relatively optimistic) climate. However, there will be a number of controversial recommendations

next week, when Treasury Secretary Geithner unveils his proposals for regulatory reform in the US. According to the *FT*, the Treasury will propose:

- a new Council of Regulators, which will include representatives of the main US regulatory agencies, and which will oversee an expanded role for the Fed as the regulator of all systemically-important financial institutions; and
- a new stand-alone regulator for consumer protection.

The *FT* claims that this represents a rather unsatisfactory compromise, with no agency willing to give up its regulatory authority – and all of them appealing to their friends in Congress for support.

II **RECENT ECONOMIC AND MARKET DEVELOPMENTS**

As noted, there is a general feeling that the "Anglo-Saxon" economies are coming out of recession – but that Continental Europe is still stuck in the mud. As for the rest of the world, the assumption seems to be that it has 'decoupled' – but that may be challenged. If decoupling turns out to be a myth, the poorer countries may be in serious trouble. On Monday, it was reported that the very ambitious promises that the G-20 had made at its last meeting about enhanced IMF funding are looking empty. Of the US$500 billion in extra funding that was promised, Japan has apparently lent US$100 billion. None of the rest has been forthcoming, and the White House is finding it harder and harder to get Congress to approve the US$108 billion that the US is supposed to come up with.

A **THE US**: The good (or, at least, better) news this week is:

- that retail sales rose 0.5% in May, the third straight increase;
- that first-time jobless claims fell 24,000 in the latest week;
- that business inventories dropped 1.1% in April, to a more normal level that should permit some restocking; and

- that the preliminary reading for the Michigan confidence index in June rose to a nine-month high of 69, from 68.7.

On the other hand, the Fed's Beige Book was unexpectedly negative, showing that business conditions remained weak or got worse in all the Fed regions last month. In addition, much of the increase in retail sales came from higher gasoline prices – hardly an unmixed blessing. Plus, it was reported:

- that mortgage foreclosures were up 18% year-on-year in May; and
- that household wealth fell US$1.3 trillion in the first quarter, and is now at a five-year low.

In addition, Paul Volcker told a conference in Tokyo that, in his view, recovery is still a long way off, and that it will be "a long slog". That probably isn't what the White House wants to hear from one of its top advisers, but it may explain why all the main US equity indices are flat for the week (through early Friday). It may also explain the weak response to the Treasury's US$19 billion auction of 10-year Notes on Wednesday – though (to some surprise) the 30-year issue went much better yesterday.

B **EUROPE**: Politically and economically, the gap between the UK and the eurozone has widened again this week.

Politically, the focus was on the European elections. Generally, the centre-right did better than expected, and the Socialists did worse – though extreme left parties picked up support, particularly in Central Europe. In the UK, the big story was the overwhelming defeat of the ruling Labour Party and the success of the (anti-EU) UKIP and the (far-right) BNP. In the new Parliament, the dominant grouping will be the centre-right EPP/ED with 264 (out of 736) seats. In contrast, the PES (Socialists) will have 161 seats and the ALDE (Liberals) will have 80. Unfortunately, the UK Conservatives (who are mildly eurosceptic) have dropped out of the EPP to join a fringe group of "non-affiliated" parties; as a result, they will be largely excluded from the key parliamentary committees that

handle financial services – the most important issue for Britain. There are bound to be repercussions from this.

Economically, there is a belief (right or wrong) that the UK is coming out of recession. For instance, the (semi-official) National Institute reported yesterday that GDP grew 0.2% in April and 0.1% in May, and predicted that there would be a significant recovery in the second half of the year. In its opinion, this means that (for Britain) the recession will turn out to have been less severe than the downturn in the early 1980s.

Support for this view is not too hard to find. For instance, the *FT* reported that, in its latest survey of City economists, 11/20 said the recession is over. Plus, the RICS reported that the London housing market has finally started to recover, after dropping for two years. And manufacturing output jumped 0.4% in May, its first increase in 14 months.

All of that supports the consensus. On the other hand, however, it was also reported:

- that like-for-like retail sales were down 0.8% in May, year-on-year; and
- that (according to the BofE) house prices have fallen 19% in the last 18 months, leaving 1.1 million Britons with negative equity.

In addition, the BofE itself seems sceptical about the recovery. Deputy Governor Tucker warned on Tuesday that British banks are still not lending, and the MPC announced that it would expand its quantitative easing programme to the purchase of asset-backed commercial paper to fund working capital – hardly a vote of confidence in British industry. As a result, it is probably no great surprise that the recovery in the Stock Market has faltered a bit – though the mood is still more bullish than elsewhere in Europe.
As for the eurozone, the mood is markedly less optimistic – though Bundesbank President Weber warned (as he tends to do) that the ECB must now consider *raising* interest rates as a protection against future inflation.

Maybe; but it was reported earlier today that eurozone industrial production was down a record 21.6% year-on-year in April, considerably worse than expected, with consumer durables down 22.4% and capital goods off 26.7%. The picture is not much better in individual eurozone member states:

- Germany: It was reported on Wednesday that industrial production fell 1.9% in April, much worse than the 0.3% drop that had been expected. It was also reported that German exports were down 28.7% year-on-year, the steepest ever fall. As a result, manufacturing revenues were off 23%. Not surprisingly, inflation is now at a 22-year low; indeed, the CPI was flat in May, having risen 0.7% in April. The Bundesbank is now projecting that the German economy will shrink 6.2% this year, and that growth will be zero in 2010. Despite this (and reflecting the conservatism of economic management in Germany), the Bundesrat has just voted to cap new borrowing by the Federal government and to force individual states to balance their budgets when this particular recession is over.

- France: Here, too, factory output fell 1.4% in April – which was a good deal worse than expected. Also, consumer prices were down 0.3% year-on-year in May – the first ever drop.

The situation was a little bit different in Italy, where industrial production was up 1.1% in April (though it was still down 24.2% year-on-year). And, in Spain, the main concern this week has been Moody's downgrade of mortgage-backed bonds, which suggests that Spanish banks are far from being out of the woods.

There is also Latvia – though, as noted, optimism is up following an infusion of international aid. In the end, however, there seems no way of avoiding a devaluation of the lat – which could be politically devastating, since 90% of Latvian mortgages are euro-denominated.

C **JAPAN**: The comment today by Finance Minister Yosano, that Japan has "unshakeable faith" in the creditworthiness of the US has helped the dollar – and that in turn will help Japanese exporters. Already, as in the US and UK, there are signs of recovery. In particular:

- bankruptcies fell sharply in May, and were down 6.7% year-on-year – the first fall in over a year; and
- the household confidence index jumped to a 14-month high of 35.7 in May, up from 32.4.

On the other hand, it was also reported that core private sector machinery orders fell 5.4% in April, which was a nasty surprise. Despite that, the Nikkei-225 (already up sharply this year) has just closed up a further 3.8% this week, and is now at an eight-month high.

D **CHINA**: As noted, there is now concern among some leading academics about the global impact of China's continuing trade surplus, and whether it is inconsistent with China's apparent role as the new global economic 'locomotive'.

Leaving that aside, however, it does seem that (if one believes Beijing's own data, and clearly not everyone does) the economy is bouncing back quite strongly. Reflecting this, it was reported this week:

- that automobile sales were up 34% year-on-year in May (and 14% for the first five months of the year);
- that industrial production jumped a stronger-than-expected 8.9% year-on-year in May;
- that property prices in 70 major cities rose 0.6% in April month-on-month;
- that new bank lending doubled in May from 2008, to US$97 billion; and
- that total retail sales were up 15.2% year-on-year in May.

That certainly looks like recovery – if the numbers are correct.

E **RUSSIA**: It was reported this week, that Moscow has decided to suspend its bid to join the WTO, in order to coordinate its terms of access with Kazakhstan and Belarus. The intention is that the three countries should then join as a customs union.

At the moment, it is unclear if Russia is serious. It has been negotiating WTO entry for 16 years, and withdrawal at this stage would mean hundreds of agreements would have to be redone. The assumption is that Putin is bluffing – or that he does not understand how complicated the process of WTO entry is.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

It has been a very volatile week, in part because of the political uncertainties caused by the European elections. In addition:

- It was reported on Monday that the Fed's own balance sheet has risen to over US$2 trillion as a result of its policy of quantitative easing. One consequence of this is that dealers are starting to price in an increase in the Fed funds rate at some stage this year.
- There has also been renewed speculation about the dollar's role as a reserve currency. Although the Japanese Finance Minister insisted he was totally comfortable with the dollar, Russia let it be known that it intends, over time, to reduce its holdings of US Treasuries – albeit, gradually as they mature.
- Brazil also indicated that it may "rebalance" its reserves – in this case, by shifting from US Treasuries to the new bonds that the IMF plans to issue. This is a threat to the dollar that the US Treasury might not have anticipated.
- Towards the end of the week, the so-called 'carry trade' came back into fashion, as concerns about risk started to fade.

For whatever reason, week-on-week, the dollar is broadly flat against the euro, down quite sharply against sterling, flat against the yen and down against the SF:

- US$/euro: At the close last Friday, the euro was trading at US$1.401, the dollar having recovered from hitting a new low on Wednesday. On Monday, the dollar recovered to US$1.389/€ on talk of a higher Fed funds rate. However, it fell back on Tuesday, and has since traded in a very narrow range. In early trade today, it is at US$1.403/€ - virtually unchanged for the week.
- US$/sterling: Last Friday, the pound closed at US$1.601, having fallen 1.2% against the dollar over the week. On Monday, the political crisis in the UK – which appeared (and still appears) likely to cost PM Brown his job – pushed sterling down to US$1.58. Since then, however, it has bought back strong across the board. In early trading today, the pound is at US$1.6494 (up 3% for the week); it is also trading at 85.08p/€, up 2.8%.
- Yen/US$: At the close last week, the dollar was trading at Y98.23 – having firmed sharply on Friday. It eased to Y97.5 on Wednesday, but has since recovered, and is currently trading at Y98.20
- SF/US$: Last week, the dollar closed at SF1.084. It is currently trading at SF1.076 – down 0.7% for the week.

The possibility of significant reserve asset diversification is starting to weigh on the dollar. However, confidence in economic recovery will tend to provide some support.

IV OIL

The oil price has continued to rise sharply this week. Even though there has been a modest sell-off in early trade today, both key reference crudes are up sharply:

- Brent for July delivery closed last Friday at US$68.34 a barrel, and is currently trading at US$70.85 – up 3.7%; while
- July WTI closed last week at US $68.44, and is currently trading at US $71.87 – up 5%.

It is worth noting that WTI was just US $33.98 on February 12; the price has more than doubled since then – and, indeed, it now close to an eight-month high.

The main factor in this recovery is clearly the economic outlook. Yesterday, the IEA published its latest projection for oil demand this year. Even though, at 83.3 million b/d, it is still down 2.5% year-on-year, this latest estimate is 120,000 b/d higher than last month's forecast. In addition:

- the US EIA cut its forecast for OPEC production this year from an average of 28.65 million b/d to 28.49 million;
- BP's CEO was quoted as saying that US $60-90 a barrel is the "right sort of level" for oil prices; and
- China reported that net crude oil imports hit a 14-month high in May.

Beyond that, prices have been supported by the latest US inventory data. In the latest week, it was reported that crude stocks fell 4.4 million barrels to a two-month low of 361.6 million, that gasoline stocks fell 1.6 million barrels, and that distillate stocks (which had been expected to rise 1.4 million barrels) fell 300,000.

Under these circumstances, a firm tone was to be expected – and it is likely to continue.

A final point: It looks very much as though the next head of the IEA, in succession to Mohammed el-Baradei, will be Yukiya Amano, a veteran Japanese diplomat. The formal vote is July 2.

V NEXT WEEK

G8 Finance Ministers are meeting today and tomorrow in Italy; since Geithner will be there, the financial and economic crisis will be top of the agenda.

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

- the Philadelphia Fed index for June, expected to be up around four points;
- industrial production for May, expected (surprisingly) to be down 0.8%;
- housing starts for May, expected to be up 2%; and
- leading indicators for May, expected to be up 0.9%.

Elsewhere, Japan's MPC meets on Monday and Tuesday. The EU also holds a Summit meeting in Brussels on Thursday.

Regards,
GISE