Αρχείο Ζομωανάκη

WEEKLY ECONOMIC AND MONETARY REPORT

15 May 2009

There continues to be something of a mismatch between the growing conviction that (thanks to unprecedented amounts of public money) the banking crisis is more or less over and the continuing problems of the 'real' economy. The (unappetizing) prospect is that bankers will once again get richer, as the rest of the working population gets poorer.

I FINANCIAL CRISIS

A THE US: Princeton's Paul Krugman summed up the Administration's problems over the weekend. Obama's policy, he said, is "to muddle through the financial crisis, hoping that the banks can earn their way back to health". As he put it, "it might work" – given time. In the meantime, however, we have the unedifying prospect of "wasting a crisis" – of bankers (who caused the mess in the first place) producing huge profits, thanks to the public funds poured into the banks, and paying themselves huge bonuses, while, in the rest of the economy, unemployment rises inexorably.

Certainly, from the point of view of the banks, things do look much better.

LIBOR, for instance, has fallen from a high of 4.85% to just 0.85%, the LIBOR/OIS spread has dropped to a 10-month low of just 65 basis points, and the so-called TED Spread is at its lowest since the crisis began. Credit risk spreads are also now below pre-Lehman levels. In addition, it was reported this week that three more US banks (CapOne, US Bancorp and BB&T) have applied to repay their TARP funds, and at least seven banks (including Morgan Stanley and BofA) have announced plans to raise more capital. BofA has also raised an additional US$7.3 billion by selling its stake in China Construction Bank.

Of course, this could all be a chimera. After all, it was also announced this week that Fannie Mae lost a further US$23.2 billion in the first quarter, and that it is looking for another US$19 billion bail-out from the Treasury. There have also been a number of stories in the press warning that credit card losses will be the next scandal to hit US banks, and there are plenty of cynics who are now convinced that the Treasury's much-vaunted "stress tests" of US banks were a sham (as German FM Steinbröck bluntly said they were on Wednesday).

The idea that the US government is deliberately downplaying the seriousness of the crisis is growing. On Tuesday, a major US buyout boss publically condemned the TARP as a sham, and said that it would be better for the US to nationalize the banks outright. As he put it, "taxpayers ought to know that we (ie the bankers) are receiving a subsidy. They (ie taxpayers) put in 40% of the money, but get little of the equity upside". Now, the Fed and FDIC are said to have clashed over the extent to which the government should be an active shareholder in the banks in which it has a major interest; the Fed wants the government to keep its hands off, but the FDIC (run by the aggressive Sheila Bair) wants it to take a much more active policy role.

B **EUROPE**: Earlier this week, the *WSJ* carried an important article alleging that European banks are in much worse shape than their US competitors as far as capital is concerned. To reach a 5% Tier 1 capital ratio under stress conditions similar to those simulated for US banks, the *Journal* calculates that European banks would need substantial new capital:

To reach 5% Tier 1 capital, European banks' capital requirements (euro billion)

Commerzbank	7.41	Bank of Ireland	1.86
Credit Agricole	3.24	Danske Bank	1.77
Allied Irish	2.85	BNP Paribas	1.66
Swedbank	2.15	SocGen	1.59

Perhaps it is no surprise that, immediately after this, Germany unveiled its own (radical) "bad bank" proposal. This may well act as a model for elsewhere in Continental Europe, as well as for the Germany's *Landesbanks*.

The idea (which must still be approved by parliament) is that the big German banks will have the option of putting their worst structured products into off-balance sheet bank-owned SPVs at 90% of their present book value. In return, the banks will get an SPV note guaranteeing repayment within 20 years – a guarantee that will be backed up by the government, for a fee. The result of all this is that German banks will not have to take a major hit on their balance sheets at this stage – which may leave them at a considerable competitive advantage vis-ũ-vis US and other European competitors.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

Is the worst of the recession over? That certainly seems to be what G-7 governments want the markets to believe – and traders are keen to go along. After all, it is far easier to make money in a bull market. However, many economists (including those at the IMF) remain deeply sceptical that the global economy can bounce back given the massive debt load that has been accumulated, and there are plenty of equity analysts who argue that this is a "suckers' rally", such as occurred with some frequency between 1929 and 1933. The most recent data – particularly in Europe – would seem to support sceptics.

A THE US: Last week, the DJIA rose 4.4% - notwithstanding a shock on Friday, when Berkshire-Hathaway (the investment vehicle for the legendary Warren Buffett) announced a record US $1.5 billion annual loss. This week, there has been a backlash. Despite optimism about the economy, the Dow was down 242 points (or 2.8%) through Thursday, with GM stock hitting a 70-year low and Treasury debt auctions getting a poor reception. In early trading today, markets are mixed, but all the main indices seem certain to close down for the week.

What is going on? According to the press, the consensus still favours an early economic recovery. The *Wall Street Journal*'s latest survey of 52 economists, for instance, predicts that, although the US economy will contract at an annual rate of 1.4% in the second quarter, it should be growing again by August. There is some support for this – though it is far from unequivocal. Industrial production fell 0.5% in April, the smallest drop in six months - suggesting (to some) that the economy is stabilizing. And the Empire State (New York) activity index improved in May from -14.7 to -4.6. However, the mood is probably a bit less optimistic than last week, not least because:

- retail sales (which were expected to be flat) fell a further 0.4% last month, after a 1.5% fall in March – and would have been down 0.5% but for a modest recovery in auto sales;
- the number of mortgage defaults continues to rise, jumping 32% year-on-year in April; and
- first time jobless claims jumped unexpectedly by 32,000 in the latest week, while continuing claims hit a fifteenth straight record.

On top of that, GM management has acknowledged that – with losses running at US $113 million a day, and with bondholders still resisting a voluntary restructuring - bankruptcy looks increasingly inevitable. Whether Chrysler will be able to cobble together a deal with Fiat also still looks uncertain, but GM's collapse would be far more devastating.

And now Obama is getting pressure from academia... On Wednesday, Harvard's Martin Feldstein launched an astonishing attack on the Administration's economic policy, arguing that Obama's planned US $1.1 trillion in tax increases over the next decade repeats the mistake that Japan made in 1997, and risks killing off any recovery. Given Feldstein's reputation as a cautious economic conservative, this attack was unexpected; the Administration is now being squeezed between those (Krugman, Feldstein etc) who believe its programme will not work because it is not bold enough or because it is undermined by tax increases, and those (Barro, Lucas etc) who feel it cannot work because it will just displace private sector investment.

In the meantime, just about the only sign of economic life in the US was an unexpected *rise* in the trade deficit in March – from US $26.1 billion to US $27.6 billion. That this is down from US $58 billion last October indicates how sharply global trade has fallen, but the fact that imports fell less steeply than exports in the latest month could be interpreted as a very modest sign of recovery. Or not.

B **EUROPE**: It is very hard to get enthusiastic about Europe's short-term economic prospects. According to the IMF (which, admittedly, has taken on a new role as global economic Cassandra), the eurozone economy is expected to shrink 4.2% this year and by 0.4% in 2010. For 'emerging' Europe (ie the old Soviet bloc), the outlook is even worse – a fall of 4.9% this year and growth of just 0.7% in 2010. (The EBRD is actually even gloomier in the short term; it is forecasting a contraction of 5.2% this year for the region, although growth is 2010 may be as high as 1.4%.)

The *Financial Times* has recently published its own survey of European economies, and it is equally negative:

FT: Consensus economic forecasts for Europe (2009)

	GDP	Unemployment		GDP	Unemployment
Germany	-5.4%	8.6%	Greece	-3.5%	3.9%
France	-3.0%	9.6%	Russia	-3.8%	9.5%
UK	-3.8%	8.2%	Latvia	-13.1%	15.7%
Italy	-4.4%	8.8%	Iceland	-11.6%	5.6%
Spain	-3.2%	17.3%	Ireland	-9.0%	13.3%
Netherlands	-3.5%	3.9%			

Astonishingly enough, the FT's forecast for Latvia may be too optimistic. GDP fell at an 18% annual rate in the first quarter. All three Baltic States are in danger of economic implosion.

On top of that, it was reported today that eurozone GDP fell 2.5% quarter-on-quarter in January-March - a record, and substantially worse than the 1.6% fall in the fourth quarter of last year. In addition, it was reported that total European automobile demand was off 12% year-on-year in April.

Under these circumstances, one would expect the ECB to follow other central banks on quantitative easing – and, as noted, it has agreed to purchase €60 billion of covered bonds (mostly German *pfandbriefe*). That, however, has triggered a major row in Frankfurt, with Bundesbank President Weber continuing to argue strongly against direct bond purchases, and other ECB Council members (including Trichet) apparently willing to act more decisively. The main concern of Weber *et al* is the deterioration in the eurozone's fiscal balance.

As far as individual eurozone states are concerned, the picture is uniformly dispiriting:

- In Germany, it was reported today that GDP fell a massive 3.8% in the first quarter, much worse than the 3% that had been expected and the worst result in over 40 years. This being Germany, however, there is no consensus on whether the appropriate policy response should be more spending or higher taxes. An independent panel of experts has just released a new projection, forecasting that the German economy may shrink up to 6% this year – but even that has not swayed either the Bundesbank or more conservative elements in Merkel's coalition. For them, the priority remains the record budget deficit, which could go as high as €90 billion next year.
- In France, the situation is less acute. Indeed, the 1.2% drop in first quarter GDP was actually a bit better than expected. However, the French automobile industry has been particularly hard hit, and the second quarter is looking bad.
- In Italy, first quarter GDP fell 2.4% - the fourth straight quarterly fall, and a record.
- In Spain, GDP was down 1.8%, or 2.9% year-on-year. PM Zapatero has already responded, with a package of tax cuts for SMEs and a (controversial and probably non WTO-compliant) bonus for purchases of Spanish-made automobiles. He has also announced an end to mortgage tax breaks after 2011 in order to avoid future real estate bubbles.

As for the UK, the OECD suggested this week that the worst of its recession might already be over – and it pushed its index of leading indicators up from 96.3 to 96.6 in March.

There is some evidence in support of this. In particular, it was reported this week:

- that UK retail sales were up 6.3% year-on-year in April as a result of decent weather (though the like-for-like increase was only 4.6%); and
- that (according to the RICS) house sales picked up last month.

Even the 0.1% fall in manufacturing output in March was (much) better than expected – as well as being the smallest monthly drop in over a year. As a result, the suggestion is that the UK recession is bottoming out. On the other hand however:

- average worker wages fell 0.4% in the first quarter, the first fall in over 45 years – despite a 3.6% increase in public sector pay; and
- unemployment hit a 13-year high of 2.2 million in March, pushing the jobless rate up to 7.1%.

Moreover, in its quarterly *Inflation Report* (published on Wednesday), the BofE cut its own growth projection for this year from -3.5% to a range of -3.8-4.0% - worse, even, than the Treasury's own forecast. Governor King rubbed it in by saying "this is not like the typical business cycle…", and suggested that the economy could go on contracting through the second half of next year. With BT just announcing 15,000 new layoffs, following a STG 977 million first quarter loss, it is clear that there is still plenty of pain in store – even if most economists agree with the OECD that the greater openness of the UK economy means that it may bounce back before some eurozone members.

A political note: The drip, drip, drip of scandal, relating to the abuse of the Parliamentary expenses system by British MPs of all political parties, has reduced Parliament's credibility to an all-time low – just two weeks before very important European and local elections. If there were any UK political party that did not have its nose in the public trough, it would undoubtedly clean up at the polls. As it is, the fact that everyone – left, right and centre – has been cheating the system *probably* means that there will be no obvious winner or loser. However, never in living memory has the standing of democratic politics as a profession in Britain been lower.

C **JAPAN**: The electoral outlook has been thrown into disarray by the unexpected resignation of DPJ leader Ichiro Ozawa, as a result of a funding scandal involving a close aide. Elections have to be held by September 10, and – prior to Ozawa's departure – the ruling LDP had only 28.7% support in the polls. For the first time in many years, the DPJ leadership is really worth fighting for.

Certainly, the ruling LDP doesn't look as though it will get much help from the economy. This week for instance:

- Sony recorded its first annual loss in 14 years, Y99 billion;
- Toyota recorded a Y437 billion loss, and warned that it would lose a further Y550 billion in FY2009/10; and
- Nissan recorded a Y234 billion loss for FY2008/09

On top of that, it was reported that machine tool orders (which had bounced 0.6% in February) fell again in March, dropping 1.3%. No surprise that, week-on-week, the Nikkei-225 is down 1.8%, following its 5.1% rise last week.

D **CHINA**: There was a fascinating observation from PBoC Governor Zhou Xiaochuan yesterday: China, he said, is still grappling with the bigger role in the world order that is being thrust upon it. The implication is that Beijing doesn't yet have a clear position on the role it wants to play – or on the role the renminbi should play.

This is important because (in some eyes, at least) the Chinese economy is bouncing back quicker than many observers had expected. Indeed, Nobel prize-winning economist Joe Stiglitz predicted this week that China will be a "winner" from the crisis thanks to its high savings rate and prompt government action. We are a bit sceptical. True, according to government figures, retail sales were up 14.8% year-on-year in April – which suggests that there has been some shift to domestic consumption. And automobile production was apparently up 18%. But there are several less encouraging signs.

One is overall industrial production. That was up 7.3% year-on-year in April – OK, but down from 8.3% in March. In addition, the government acknowledges:

- that total exports were down 22.6% year-on-year in April, the sixth straight drop;
- that crude steel production was down 4%; and
- that new shipbuilding orders were off an astonishing 95% in the first four months of the year.

Under these circumstances, it may be premature to say that China is out of the woods – or that it will be a "winner" from the crisis.

B **SOUTH AFRICA**: Following installation of Jacob Zuma – an uneducated Zulu nationalist – as the new President, there is considerable unease about the direction of economic policy likely to be followed by his ANC government. This is important not only because South Africa is the dominant economy in sub-Saharan Africa, but because of the precedent it sets: can South Africa maintain the relatively investor-friendly environment cultivated, in particular, by the old Finance Minister, Trevor Manuel, and the Governor of the Reserve Bank, Tito Mboweni?

Signs so far are mixed. Mboweni apparently stays at the Bank, but Manuel has been moved to head a new National Planning Commission – the powers of which are at present uncertain. The new FM is Parvin Gordhan, 60, a pharmacist by trade who has latterly headed the customs agency. He is generally considered good news, though his background includes a period underground with the ANC. Of greater concern is the appointment of Ebrahim Patel as Minister of Economic Development and Rob Davies as Trade and Industry Minister; both are members of South Africa's hard-line Communist Party.

III FOREIGN EXCHANGE DEVELOPMENTS

Today's slightly stronger than expected US economic data has barely had any impact on the dollar, though the euro was hit in early trading by bad German data. Week-on-week, the dollar is down almost across the board. Indeed, earlier this week, its trade-weighted index hit a five-month low of just 81.87:

- Yen/US$: At the close last Friday, the dollar was trading at Y98.90/US$. On Monday, it fell to Y97.48, largely because of a growing 'safe haven' role for the yen in Asia. By the close on Thursday, the yen had strengthened further, to Y95.64/US$. In early trade today, it touched Y94.84. Even though the dollar has since recovered marginally to Y95.35, it is still down 3.6% for the week.
- US$/euro: At the close last Friday, the euro stood at a seven-week high of US$1.352 – though the consensus was that it was due for a correction. Despite that, it strengthened through the first half of the week, peaking at US$1.363 on Wednesday. Since then, it has eased to US$1.358 – still up 0.4% for the week.
- US$/STG: The pound ended last week at US$1.510. Since then, it has traded within a very narrow range, opening this morning at US$1.518. However, it is currently trading at US$1.525 – up 1% for the week, despite BofE warnings that the recovery in the UK will be slow and that Britain is "vulnerable to further shocks".

IV OIL

Last Friday, both benchmark crudes closed at a six-month high, above US$58 a barrel, with June WTI at US$58.63 (up 10.2% week-on-week) and June Brent at US$58.14.

The main driver behind this was greater optimism about the pace of global recovery, coupled with a belief that OPEC was exerting tougher control on output. Plus, there was better news out of China – with imports up 13.6% year-on-year in April, to 3.95 million b/d, the first rise since last October. The result was that the firming trend continued at the beginning of this week, with WTI peaking at US$50.08 on Tuesday and Brent hitting US$58.91. That meant prices were up 85% since the five-year low that had been reached in February.

Since then, however, prices have eased. June WTI, for instance, closed yesterday at US$58.62 a barrel, and is now trading at US$57.76 – down 1.5% for the week. The June Brent contract expired yesterday at US$56.69 (down 2.5%), but the July contract is also currently trading at US$57.73 – down 0.7%.

What has caused this (modest) turnaround, after such a strong run-up? It certainly wasn't US inventory data. Indeed, in the latest week, US crude inventories fell 4.7 million barrels, compared with an expected increase of 1.4 million. Even though US stocks are still close to a 19 year high, this was a surprise – as was the 4.1 million barrel drop in gasoline stocks. True, distillate stocks rose 1 million barrels, but even that was a smaller rise than expected.

One factor is probably refinery utilization, which dropped from 85.3% to 83.7% last week. More important, however, was an IEA report suggesting that OPEC's ability to police the 4.2 million b/d cut in output that it had promised is fraying. According to the IEA, OPEC raised its overall output by 270,000 b/d in April – the first rise in seven months. Even though Saudi Arabia is said to have cut production by more than expected, both Iran and Angola have been pumping considerably more than anticipated. Plus, demand is still falling. According to the IEA, demand this year will be down 2.56 million b/d from last year – which is 160,000 b/d more than it was projecting only. Last month. Eight out of the 10 top oil-consuming nations will have lower consumption this year.

V NEXT WEEK

It is a fairly quiet week for economic releases in the US. The main ones due are:

- leading indicators for April, expected to be up 0.6%;
- the Philadelphia Fed index for May; and
- housing starts for April, expected to be up (albeit from a low base).

More attention will probably be focused on release of the FOMC minutes.

In Europe, the main releases due are probably:

- the ZEW economic sentiment index for May in Germany;
- May purchasing managers data, also in Germany; and
- the BofE minutes for the May 6-7 meeting of the MPC.

In Japan, the May *tankan* survey is due, along with first quarter GDP. The BoJ's MPC also meets on Thursday-Friday.

Regards.
GISE