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WEEKLY ECONOMIC AND MONETARY REPORT

3 April 2009

The big news this week is clearly the G-20 Summit – though, as discussed below (and despite considerable enthusiasm on both sides of the Atlantic), the progress announced is more cosmetic than real. As far as the actual economy is concerned, there is some genuinely good news this week. However, today's announcement that US non-farm payrolls fells 663,000 last month – bringing the total jobs lost since the start of the recession to 5.1 million – shows just how far there is to go before anyone can seriously say the global economy has bottomed out.

I G-20 SUMMIT

What did this week's two-day meeting achieve? And how important was it? On the latter question at least, opinions are all over the place. Some reputable commentators (and academics) are claiming it was the most important Summit since 1944. A few others (including equally reputable academics) argue it was a missed opportunity; the IMF's former chief economist, Ken Rogoff, for instance, claims "rich countries are in denial", and that too little attention was paid to the real problem countries.

So, what happened?

Basically, the Summit covered nine areas:

- Fiscal stimulus: It was hoped by Obama and UK Prime Minister Brown that the Summit would agree on a coordinated round of new government spending – something that was anathema to France's Sarkozy and (especially) to German Chancellor Merkel. In the end, the communiqui claimed agreement on a massive US$5 trillion spending package – but that was nonsense. This figure is the cumulative increase in government borrowing planned by G-20 countries in 2008-10. No new money is involved. In that sense, Merkel and Sarkozy won; Obama and Brown (and Japanese PM Aso) lost. Indeed, German FM Steinbrück was reported as saying that "we were very happy that there has been no obligation for fiscal stimulus by any country".

- The IMF: Most commentators see the Summit as a triumph for the Fund – and for its MD, Dominique Strauss-Kahn. It is certainly back at centre-stage of the global economy – though, even here, there has been considerable exaggeration of what has been achieved (or, rather, promised). The key element in the Summit communiquı is an expansion of the Fund's "usable resources" from around US$250 billion to US$750 billion – twice what DSK had originally asked for. This should give it adequate funds to handle the progressive implosion of Central and Eastern Europe (it is already bailing out Iceland, Latvia, Hungary, Ukraine, Belarus, Serbia, Bosnia and Romania), as well as perennial basket-cases like Pakistan, Turkey and most recently, Mexico (which is asking for US$47 billion). The problem is how this is to be funded. Included in the US$500 billion new money is (apparently) US$100 billion that has already been given by Japan, as well as US$75 billion pledged by the EU and US$40 billion from China. It seems to be assumed that the US will contribute US$100 billion, but the *FT* denies that Washington has agreed. There is apparently a possibility that the Fund will (for the first time) issue its own bonds. There was also talk of new gold sales (beyond the current program to sell 403 MT), intended to raise US$50 billion; however, that was subsequently dismissed by DSK – and it would, in any case, be very difficult given hostility in the US Congress. Whatever, this money will give a huge boost to the Fund's new (low-conditionality) Flexible Credit Line.

  There is also a call for the IMF to reform its governance (ie to adjust its voting system to give poorer countries a larger share) by 2011.

- World Bank: There is a reference in the communiquı to US$100 billion of new financing for the World Bank and other multilaterals. This is apparently separate from IFC's role in the new trade facility (see below), but it is uncertain how it is to be financed.

- SDR allocation: Responding to the pressure applied by Russia and China for some new "super-sovereign" currency that might eventually replace the US dollar as a reserve asset, the Summit agreed that there should be a new, general allocation by the IMF of Special Drawing Rights, up to a total of US$250 billion – approximately eight times the existing allocation. This is being interpreted (rightly) as a global form of 'quantitative easing", and it is obviously extremely significant. It is important to appreciate that this would be a 'general' allocation – which means that the SDRs will be distributed in line with country quotas in the Fund. Thus, the biggest beneficiary will be the US; countries that are underpresented in the IMF voting will get much less – though DSK has said that richer countries will be free to give (or lend) their new SDR allocation to other countries.

- Trade facility: The communiquı refers to a US$250 billion trade facility. As far as anyone can judge, what this means is that IFC and private banks will put up no more than US$3-4 billion in real money to establish a short-term, guaranteed, revolving trade facility that will finance up to US$250 billion in trade over a two-year period. It is not a new US$250 billion facility.

  There is also a repeat of last November's G-20 commitment not to impose any new trade restrictions for a 12-month period – a commitment that was widely (and almost immediately) breached. This time, the WTO is to 'name and shame' offenders. Unfortunately, there is no new deadline for completion of the Doha round, which is barely mentioned in the communiquı .

- Tax havens: One of several victories that Sarkozy seems to have achieved at the Summit is a commitment to crack down on off-shore financial centers – though, again, the agreement is long on rhetoric and short on action. The most egregious offenders appear to be rather puny – Costa Rica, Malaysia, the Philippines and Uruguay are the 'non-compliant' jurisdictions currently cited by the OECD. However, the Organisation has been tasked by the G-20 with coming up with a new list by November. Given China's sensibilities, this blacklist is most unlikely to include Hong Kong or Macau;

given US sensibilities, it is even more unlikely to include Delaware, Nevada or Wyoming (all of which have tougher secrecy requirements than most offshore centers).

- Financial regulation: This is where the French and Germans think they have made a real breakthrough. They may be right. Essentially, the Summit agreed to extend tough financial regulation to all systemically-important "institutions, instruments and markets" – including the credit rating agencies and the 'shadow' banking system. It also agreed that new, tougher capital rules will be imposed on banks once the crisis is over. In the meantime, the existing Financial Stability Forum (based in Basel) is to be expanded and reinforced. It will now be called the Financial Stability Board, and will include China, Brazil, India and the European Commission. Its staff (currently 25, under Banca d'Italia Governor Mario Draghi) will be beefed up, and it will be given a new role as an international financial watchdog and early warning system. It will also be expected to "coordinate" the regulation of systemically-important institutions, though it is important to appreciate that it will not have any cross-border authority.

  It is not hard to predict fights between the US and UK, on the one hand, and the EU, on the other, about the FSB's role. Is it, or is it not, a proto-global regulator?

- Bankers' remuneration: To some surprise, the Summit did make an attempt to tackle this politically tricky (though economically irrelevant) issue. It did not agree to any formal 'cap' on bankers' pay, but it did lay down several principles. In particular:

  - bank boards must be involved in all discussions on compensation/remuneration policy;
  - bonuses must be tied to longer-term performance, and should be paid in stock that vests over a longer period; and
  - better information on pay must be provided to shareholders.

- UN: The UN was also mandated by the Summit to set up a mechanism to monitor the impact of the crisis on the least-developed countries.

What was not covered? According to the *FT*, the biggest gap was the failure to produce a binding commitment to clean up 'toxic' assets from banks' books. However, one could argue that the absence of any new public sector spending commitments is a bigger problem – at least for those latter-day Keynesians who believe that the answer to the present crisis is to fill the 'output gap' left by collapsing private sector activity with government spending.

Whatever, it is worth emphasizing that (contrary to most informed expectations) the Summit was a huge PR success – for Obama, for European leaders, and, especially, for Gordon Brown, who may well be tempted to use the inevitable bounce in his popularity to call an early election. It may be "spin" (at which the British are very good), but it seems to have worked.

II FINANCIAL CRISIS

A THE US: The backlash over Geithner's latest bail-out plan (indeed, over Geithner himself) continues to grow.

At an academic level, the plan to subsidize private bidders to buy toxic assets off the banks is being attacked from both the right and left. Amongst liberals, Paul Krugman, Jeff Sachs and Robert Reich are all highly critical; Joe Stiglitz has called it "ersatz capitalism" – a partnership in which one partner (the private sector) robs the other (the taxpayer). The problem is the enormous subsidy given to the private bidders – who stand to gain 50% of any upside while risking only about 7% of the downside. There is also the possibility of 'gaming' the system, given that the banks who currently hold the debt (who are themselves heavily subsidized) can choose what debt to offer – and can also participate in the auctions as buyers.

Nevertheless, it is assumed that the plan will still go ahead.

The other big development in the US this week was yesterday's decision by FASB to relax the rules on marking-to-market assets held by American banks. It will now be easier for US banks to hold assets on their books at their purchase price. It may also be easier for them to avoid having to mark-down remaining assets on their books if they have sold comparable assets in the market, eg through the TARP programme.

Finally, it will be worth watching an important legal case, which looks like coming to court.

As we have noted before, KPMG is being sued for over US$1 billion in connection with its audit of New Century Financial, a sub-prime mortgage provider which collapsed at the beginning of 2007. New Century was the first major financial institution to go under as a result of the downturn in the US housing market, and KPMG is being accused of gross negligence in not having spotted that something was amiss. Other Big 4 auditors will be watching this case very carefully.

B **EUROPE**: In the UK, it was reported this week that the Dunfermline Building Society – a mid-sized mutual – was in danger of collapse as a result of its STG 650 million commercial property portfolio. This was the first opportunity for the government to use the new powers of early intervention given to it by the 2009 Banking Act. As a result, the Treasury moved swiftly to break up the bank – taking over the toxic assets and folding its deposit base into a bigger mutual, the Nationwide. However, the cost to the UK taxpayer may still be as high as STG 600 million.

In Spain, the first cracks have appeared in what was considered to be strongest banking sector in Western Europe.

Over the weekend, it was reported that Caja Castilla la Mancha was being bailed out through a €9 billion equity infusion by the government. Its problem was residential construction on the Spanish coast, and other smaller banks are likely to follow.

III RECENT ECONOMIC AND MONETARY DEVELOPMENTS

As reflected below, there are one or two 'green shoots' suggesting the possibility of economic recovery. However, the OECD, in particular, doesn't seem very impressed. Its latest forecast for GDP growth in the 30-member area this year is -4.2%, down from a projected fall of just 0.4% last November:

OECD: GDP forecasts (2009)

US	-4.0%	Turkey	-3.3%
UK	-3.7%	Mexico	-2.8%
Germany	-5.3%	Japan	-6.6%
France	-3.3%	Russia	-5.6%
Italy	-4.3%		
(eurozone	-4.1%)		
(EU	-2.4%)		

The OECD also warns that global trade flows collapsed in the fourth quarter of 2008, and it projects that unemployment within the OECD will be close to 10% by the end of this year.

The Asian Development Bank is not quite as pessimistic, but it has cut its GDP growth forecast for 'developing Asia' this year from 6.5% to 3.4%. East Asian growth is put at just 3.6%:

- China 7%;
- India 5%;
- Hong Kong -2%;
- South Korea -3%; and
- Taiwan -4%.

A **THE US**: As noted, non-farm payrolls fell 663,000 last month, a shade more than expected, while the unemployment rate jumped from 8.1% to a 26-year high of 8.5%. Moreover, although the 661,000 fall in February payrolls was left unchanged, 86,000 more jobs were cut from January's figure. The drop in payrolls was across-the-board – though government payrolls fell only 5,000. Although the market is likely to get some relief this month from the hiring of temporary workers for the decennial census, the US has now lost 5.1 million jobs since the recession began – with many more at risk if, indeed, GM and Chrysler are let go.