WEEKLY ECONOMIC AND MONETARY REPORT

3 December 2010

Today's release of US employment data for November – much weaker than expected – has refocused attention away from the crisis in the eurozone. Even before the jobs data, however, the mood in Europe was changing; the consensus now is that the immediate danger is over. The euro and, *a fortiori*, the eurozone are still in trouble. But the message of the markets seems to be that the next big push to break the currency will not come until early 2011, when several "peripheral" member states will have enormous refinancing programmes.

I EUROZONE CRISIS

In the past, it has proven very dangerous to display any optimism about the debt crisis in the eurozone; the markets have simply lined up each of the weaker peripheral member states in turn. Moreover, at the end of last week, it really looked as though Spain was next – which (since its economy is twice the size of Greece, Ireland and Portugal put together) might have been enough to break the eurozone. There were even rumours that Belgium was being targeted – which is plausible because (although the country's finances are not in bad shape) there is no effective government to impose fiscal austerity.

However, to some surprise, the sky has not fallen. Indeed, the integrity of the euro is less under threat than for some time. Why?

First, the Irish got the bailout that they had been promised (though the total package was a bit smaller than expected). Over the weekend, it was agreed that the eurozone's EFSF (its emergency financing facility, run by Klaus Regling – who is becoming increasingly important in the EU) would lend Ireland €22.5 billion over four years. This is to be matched by the same amount:

- from the IMF (though it should be noted that this commitment is subject to Board approval); and
- from the EU-27's financial stabilization mechanism (which will include contributions from the UK, Sweden and Denmark).

That amounts to €66.5 billion. In addition, the Irish themselves are to put up €17.5 billion, mostly from the NPRE – ie. the Sovereign Wealth Fund that is supposed to backstop the Irish pensions system. This brings the identified total to €84 billion (though €85 billion is the figure quoted in the newspapers). The average interest rate (presumably excluding the NPRE contribution) is said to be 5.8% - though it should be emphasised that the money will be drawn down over time, and may not all be needed.

Most of the money will go to recapitalise the Irish banks. The rest will be used directly by the government.

The consensus is that this is enough to get Ireland off the hook – for now. Plus, Greece used the Irish negotiations to get better terms on its own bail-out – particularly with regard to maturities. (It claims repayment has now been stretched to 2024.) This is important since Greece had not made the progress it had promised to the EU and IMF on debt reduction.

Second, German Chancellor Merkel *appears* to have made an important concession.

At the same time as the Irish package was being finalised, eurozone leaders also agreed the outline of a permanent crisis resolution mechanism, intended to cover any debt crisis within the eurozone after the beginning of 2013. Details of this are still very sketchy, but it seems that – while there has been a lot of talk about 'collective action clauses' and forcing private bondholders to "share the pain" – this will be done only on a case-by-case basis. In other words, there will be no automatic "bail-in" provision. Since the fear that they would be caught in any future debt restructuring was one of the big reasons that bondholders had been dumping bonds from the so-called PIGS, this was considered good news – or at least, better than expected. However, it is worth emphasising that there is very strong domestic political support for automatic "bail-in" in Germany, so Merkel may not get her way.

Third, the ECB's policy committee met yesterday and added to the sense that things in the eurozone are improving.

What it did not do was exercise what is being called its "nuclear option" – ie. expand its programme of buying the bonds of 'peripheral' eurozone members to €1-2 trillion. But Trichet did confirm that the ECB will extend the emergency bond-buying programme at its current level until next April. Moreover, his public pronouncements this week have been supportive of the ECB's role as buyer of last resort for eurozone government bonds. On top of that, rumours that the ECB's Board would push Trichet to unwind the help already given appear to have been unfounded.

In addition, in the last couple of days:

- the beleaguered Portuguese government managed to push through a tough budget for 2011, which is intended to shrink the deficit from 9.3% of GDP to 4.6%; and
- Spain announced a big privatisation programme to cut its deficit.

As a result, the immediate crisis has receded. Ten-year yields in Portugal, Ireland and Spain all fell by up to 50 basis points yesterday, and eurozone bond markets have had a three-day rally. In addition, today's issue of *The Economist* includes a strong plea to hold the eurozone together (though it also includes an attempt to map out what an exit from the euro for one or more countries would look like).

But the problem has not disappeared. As noted, Spain, Belgium and Italy all have big refinancing programmes in early 2011 – and that will pose a challenge. In addition:

- the proposed recapitalisation of the Irish banks may not be enough, given that (astonishingly enough) they are among the biggest lenders to Italy, Greece, Portugal and Spain;
- there is a strong fear that international banks will not want to show substantial holdings of 'peripheral' eurozone debt on their books at year-end – which could mean further selling; and
- the Irish deal could still unravel, given that the ruling Fianna Fail party will almost certainly lose the January election – and the big winner could be the left-wing/ultra-nationalist Sinn Fein party.

Plus, intellectual opinion (aside from *The Economist)* seems to be shifting against the euro. Over the weekend, for instance, Paul Krugman attacked the eurozone's

approach to Ireland, and suggested that Iceland had taken a better approach when it forced foreign banks and lenders to take a hit. As he put it, "punishing the populace for the bankers' sins is worse than a crime; it is a mistake".

Along the same lines, Willem Buiter (now Citi's chief economist) stirred up debate on Tuesday by insisting that Greece, Ireland and Portugal are all insolvent already – and that Spain is close behind. As he put it, "there is no such thing as an absolutely safe sovereign". And then, yesterday, two influential *Financial Times* columnists, Martin Wolf and John Plender, both suggested that the eurozone may be reaching the "end-game". We are a bit more optimistic in the short-term – but the problems of a "one-size-fits-all" currency in an economic union without a common fiscal policy has been deferred, not resolved.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

The most significant release of the week was clearly the US employment data for last month – though markets have also reacted to an apparent policy shift from China. What has not had any impact this week is the much-heralded Climate Change Summit in Cancun (which runs until December 10); rightly or wrongly, climate change has slipped way down the global agenda.

Two reports released this week also got rather less attention than they deserved:

- A report on investment from the OECD concluded that global cross-border investment will have fallen another 8% this year, following a fall of 19% in 2008 and of 43% in 2009. In the first half of this year, it also found that inflows of foreign investment within the OECD-33 itself were down 22% on the second half of last year. These are very significant declines.
- The WTO reported that total world trade in the third quarter of 2010 was up 18% year-on-year. Although that is a significant slowdown from previous quarters, it is a very strong figure – albeit, one that is hard to reconcile with the investment data.

A THE US: As noted, the November data for non-farm employment was a nasty shock. The headline figure was that non-farm payrolls rose just 39,000, following a

rise of 172,000 in October. That is nothing like enough to push the US jobless rate down – and, indeed, the unemployment rate rose from 9.6% to 9.8%. Perhaps equally significant, the "underemployment rate" is now 17%, and long-term unemployment is rising fast.

What will disappoint the markets is that the consensus was that payrolls would rise around 160,000. What will also be a worry is that private sector payrolls only increased 50,000, compared with an expected rise of 160,000. That is hard to reconcile with the ADP data for October, which claimed a net gain of 93,000 in private sector jobs.

The initial impact of the payrolls figure was a sell-off in equity markets and a rise in Treasuries. However, that seems to have corrected itself. US equities are now broadly flat for the day – and seem likely to end up for the week. Indeed, the DJIA is currently up 2.4% week-on-week, the S&P500 is up 2.6% and the Nasdaq Composite is up 1.8%. However, the yield on the 10-year US Treasury benchmark did fall from 3.00% to 2.98% on the employment data – though that is still up from 2.87% last Friday.

The problem is that the US economy is giving out mixed messages.

There are some signs of weakness. In addition to the jobs data, for instance, it was reported this week that (according to the Case-Shiller index) house prices are still falling, with its 20-city index off 0.8% in September. Plus, factory orders fell 0.9% in October. However, that was about the extent of the bad economic news this week.

On the positive side, it was reported:

- that retail sales are picking up – with two separate industry measures recording same-store increases of 5-6% year-on-year in November;
- that the composite Purchasing Managers' Index remained well above the 50 level, for the 16th straight month (though it eased from 56.9 to 56.6);
- that existing home sales rose an astonishing 10.4% in October;
- that the Fed's "Beige Book" survey showed the recovery continuing to pick up strength in all 12 Fed regions; and

- that all the major domestic automobile manufacturers reported sales up around 20% year-on-year last month.

That said, the Fed's Vice-chairman, Janet Yellen (who is close to Bernanke), gave a speech this week in which she urged more fiscal stimulus in the short-term – though it must be said that the FOMC itself is clearly split on this. There will be four new members of the Committee in January, and at least one (Dick Fisher, from Dallas) is an interest rate 'hawk'.

That same split also appears to have opened up within the (allegedly) bipartisan Commission on the Deficit, co-chaired by Erskine Bowles and Alan Simpson. The two chairmen had agreed on a mix of spending cuts and tax increases amounting to US$3.8 trillion by 2020, but the rest of the Commission was split. As a result, even though the plan passed by a narrow majority, Congress is not obliged to give it any time for debate. It is now dead.

B **<u>EUROPE</u>:** There is yet another ECOFIN Summit next week, to try to resolve the problem of the 2011 budget. In the meantime, most of the data released this week reinforces the picture of a two-speed European economy – with Germany surging ahead and the Southern tier falling behind.

Thus, for instance, the eurozone's Economic Sentiment Index rose last month from 103.8 to 105.3 – but most of that was due to a rise in Germany's ESI from 113.5 to 116.3. Portugal and Greece both fell. Same with employment: it was reported on Monday that the overall eurozone jobless rate jumped from 10.0% to 10.1% in October. But that picture is very misleading: it is 4.4% in the Netherlands, 7.5% in Germany – and 20.7% in Spain. Same with GDP growth: according to the Commission, third quarter growth was 0.7% in Germany, 0.4% in France, 0.2% in Italy and zero in Spain. In Greece, it fell 1.1%.

Essentially, Germany and, to a lesser extent, The Netherlands, Austria (and perhaps France) are detaching themselves from the rest of the eurozone economy. In Germany, in particular, confidence is high, inflation is low, retail sales are resilient – and the Bundesbank is now predicting 3.6% growth for this year, its best

performance since 1992. The only uncertainty is political: Merkel's (relatively) accommodative attitude towards the euro-crisis has earned her no political points at home, where she is attacked from the Left and Right – as well as by respected central bankers like Otmar Issing.

Still, her political problems are nothing compared with those of Sarkozy in France (where it is anticipated almost every day that the IMF's Dominique Strauss Kahn will announce he is running for President in 2012) or of Berlusconi in Italy (who may yet be the main victim of the WikiLeaks revelations, given that it is alleged Russia's PM Putin has some kind of hold – financial or otherwise – over him).

As for the UK, pressure on the BofE Governo, Mervyn King, continues to mount. He is being attacked on several fronts:

- He is accused of being too 'political', in that he has come down soundly in favour of the Coalition government's austerity programme (though there has never yet been a central banker who was not in favour of austerity).
- He is being accused of being (at best) indiscreet, in that he confessed his concerns about the inexperience of PM Cameron and Chancellor Osborne to the US Ambassador (who, naturally, passed them on to Washington). No surprise there, either.
- Far more significantly, he is facing an increasingly open revolt on the MPC for what is seen (by the neo-Keynesians) as his excessive caution on monetary policy. The main dissident is the American member, Adam Posen – assisted by David Blanchflower, who stepped down from the MPC earlier this year.

In the meantime, King's caution appears to be supported by recent UK economic data – which is mildly encouraging. In particular, it was reported this week that the manufacturing PMI jumped last month from 55.4 to a 16-year high of 58. True, the services PMI eased from 53.2 to 53.0, but the relative weakness of sterling is making UK exports more competitive. On the other hand, however, both Hometrack and the Nationwide reported a modest fall in house prices last month.

More significantly, the (newly-created) Office of Budgetary Responsibility released new UK economic forecasts on Monday. Although it has lowered its GDP forecast for 2011, it increased the 2010 growth forecast from 1.2% to 1.8%. It also predicted that the budget deficit would fall from GBP 149 billion to GBP 18 billion by 2015. Given the OBR's independence, that is important.

C **JAPAN:** There was *some* good news this week. In particular, it was reported that housing starts were up 6.6% year-on-year in October. However, that was lower than the 10% that had been expected. Moreover, it was also reported:

- that industrial output fell 1.8% in October – the biggest drop in 18 months;
- that the jobless rate hit 5.1% in October;
- that household spending was off 0.4%;
- that the core CPI was down 0.6% year-on-year; and
- that automobile production was off 10% for the month.

Not surprisingly, BofJ Board member Suda is warning of a prolonged slowdown. Confidence will not be helped by reports that FM Noda is contemplating raiding the country's pensions reserve to cover a Y2.5 trillion financing gap. Despite that, however, the Nikkei-225 has just closed up 2% for the week.

D **CHINA:** Yesterday – after considerable speculation – the PBoC announced that it is shifting its monetary policy stance from "moderately loose" to "prudent" – ie. it is tightening. The implications of this include tighter credit, higher interest rates and – perhaps – an acceleration of the revaluation of the renminbi.

What triggered it? The answer probably lies in the other two major economic releases of the week:

- On Tuesday, it was reported that inflation hit a two-year high of 4.4% in October.
- On Wednesday, both the official PMI and HSBC's own PMI came in stronger than expected for last month. The official PMI rose from 54.7 to 55.2; HSBC's rose from 54.8 to 55.3.

That said, not everyone is yet convinced by the Chinese 'miracle'.

Indeed, over the weekend, a big US hedge fund (Corriente) released a report warning of what it called "enormous tail risk" in China. In its view, inappropriate (ie low) interest rates and an undervalued currency have led to:

- a bubble in the production of cement and steel, both of which face massive overcapacity;
- a property boom which means there is at least 3.3 billion sq.ft. of unneeded office space in China;
- unsustainable expectations about the value of residential and commercial property; and
- massive over-exposure of the Chinese banking system to infrastructure lending, often hidden by lending through local investment companies.

Corriente also believes that the public debt/GDP ratio is, in fact, 107% - not 20% as claimed. It could be even higher.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Earlier today, the euro was heading for its fourth weekly fall against the dollar, but that now seems less likely.

At the close last Friday, the euro was trading at US$1.322, having been under pressure all week. At that time, the dollar looked like a safe haven (given tensions in the eurozone and Korea), Blackrock's Larry Fink was confidently predicting that it would go to US$1.25/€, and it had fallen 3.9% week-on-week.

This week, the euro initially continued to fall, hitting an 11-week low of US$1.297 on Tuesday. After that, however, a combination of factors has turned sentiment around:

- Trichet's commitment that the the ECB would "do something" with regard to eurozone government bond purchases gave the euro a boost – even though, as noted, he did not formally expand the bond purchase programme;

- the IMF's announcement that it would look to double the resources it can contribute to Europe provided extra comfort; and
- today's US jobs data has reawakened concerns about the strength of the US recovery.

As a result, the euro has bounced back to US$1.338/US$ - up 3.2% from its Tuesday low, and up 1.2% week-on-week.
The euro has also recovered against the yen. It is currently trading at Y110.67/€ - up 0.4% for the week.

That said, it is worth noting that the euro broke its 200-day moving average against the dollar on Monday – which is normally a strong sell signal. Technical traders also point to the Ichimoku and Fibonacci charts as predicting a further euro fall to US$1.25 in early 2011. Just at the moment, however, it is the dollar that is under modest pressure. As a result, the gold price (denominated in gold) has edged up further – rising this week from US$1,374.60/oz to US$1,388.30/oz. In euro terms, the price has barely moved – from €1,040/oz to €1,038.

IV <u>OIL</u>

Surprisingly perhaps, this US jobs data has not yet had a significant impact on the oil price. Indeed, both WTI and Brent are up slightly today. Week-on-week, that bullish tone is even more evident:

- WTI for January delivery closed last Friday at US$83.76/barrel – up 2.25% for the week; while
- January Brent closed at US$85.58 (up 1.24%).

Today, WTI is trading at US$88.48 a barrel (up 5.6% for the week), while Brent is at US$91.19 (up 6.6%). Brent is now at a two-year high.

<u>What has driven this</u>? It isn't the US stock situation. In the latest week, US crude stocks rose 1.07 million barrels, according to the IEA, and stocks at Cushing, OK are up 12% year-on-year. Much more important appears to be the cold weather in Europe, which has boosted demand for heating oil. In addition:

- OPEC meets this month in Quito, and there is some concern that a price rise may be on the table; and
- there are reports that Saudi Arabia may increase its official selling price for Arab light into the Asian market as of January.

That said, it is hard to believe that the latest price rise will stick.

V **BANKING**

The big issue this week has been release of data from the Fed on exactly which institutions (banks or otherwise, domestic or foreign) took advantage of the huge amounts of liquidity that it made available through various lending programmes at the height of the crisis. The Fed had resisted making this data available on the grounds of confidentiality, but its hand was forced by the Dodd-Frank Act.

First, the amount of the liquidity... Different reports have used different figures – US$2 trillion, US$3.3 trillion, even US$9 trillion. The problem is to define exactly which programmes were involved, and to decide whether the key is gross or net exposure. Anyway, it appears that the main programmes were:

- the Primary Dealers Credit Facility (which provided overnight money);
- the Term Auction Facility (1-3 months);
- the Commercial Paper Funding Facility;
- the Agency Mortgage-backed Security Purchase programme; and
- the Term Asset-backed Securities Loan Facility.

The Fed has identified over 21,000 transactions with the banks – and it turns out that the biggest beneficiaries for facilities (other than overnight money) were Barclays, BofA, Bank of Scotland, Wells Fargo, Wachovia, SocGen, Deutsche, RBS, BayerischeLB and Dexia – seven of which are foreign owned. Plus, UBS was the main beneficiary of the CP Funding Facility. That said, US institutions also dipped in: Goldman Sachs borrowed US$18 billion, Morgan Stanley borrowed US$60 billion – and even GE was a beneficiary. The Fed also lent US$71 billion to the hedge fund industry.

Although there are likely to be political recriminations, the real message of this is just how extraordinary were the steps that the Fed had to take to save the system.

VI NEXT WEEK

In the US, the main economic releases next week include:

- the trade deficit for October (expected to be unchanged at US$44 billion); and
- the Michigan sentiment index for November (expected to rise from 71.6 to 72.2).

Elsewhere, key releases are:

- UK industrial production for October;
- German factory orders for October; and
- the final third quarter GDP reading in Japan.

In addition, the UK's MPC meets on Wednesday and Thursday, and both the eurogroup and ECOFIN meet in Brussels on Monday.

Regards,

GISE