WEEKLY ECONOMIC AND MONETARY REPORT

20 March 2009

There is a lot going on. In particular, this week has seen a step-level change in the attention being focused on Quantitative Easing, with the announcement that the Fed will buy an extra US$1 trillion of long-term securities – mostly Fannie and Freddie mortgage-backed paper, but also US$300 billion in long-dated Treasuries. That has caused a plunge in US bond yields and a sell-off in the dollar, which had its biggest one-day loss in over 20 years on Wednesday. Fears of tit-for-tat devaluations are now very real.

I G-20 MEETING

There were no great surprises as a result of the G-20 Finance Ministers meeting near London over the weekend. Apparently, the BRIC states demanded a substantial increase in IMF resources at the April 2 Summit, and they are likely to get it. There is also agreement on bashing off-shore tax havens. There is, however, less agreement on fiscal stimulus – with splits opening up within the EU, as well as between the US and Europe.

Russia has also thrown a spanner into the works, by proposing that the Summit should discuss either a new supranational currency or a new issue of SDRs. A UN Commission of Experts on currency reform will report next week, and will apparently also recommend a new international currency modeled on the old European ECU.

According to a blueprint prepared by a G-20 Working Group, co-chaired by the Deputy Governor of the Reserve Bank of India and Canada's Deputy Finance Minister, the April 2 Summit will aim for agreement on:

- regulating hedge funds;
- an early warning system for credit and asset market bubbles;
- tougher capital and liquidity ratios for banks;
- more "intrusive" financial regulation; and

- more effective convergence of international accounting standards.

What is signally missing from this list is what the US wants – agreement on massive new fiscal stimulus. The Europeans – who also met at Summit level this week – are said to have quashed hopes of a coordinated stimulus package. According to German Chancellor Merkel, this is "not the time to look at more growth measures". She argues that the EU stimulus measures that have already been agreed must be given time – and that they have actually been under-estimated. They are, she says, more like 4% of EU GDP than 1.5%.

If the Europeans persist in their position, the G-20 meeting will probably be dominated by "second-tier" issues – notably the attack on off-shore financial centers and tax evasion. Reflecting this, Switzerland, Austria and Luxembourg have (pre-emptively) agreed to share account data with other jurisdictions, and even Monaco (which has long refused to cooperate with FATF) has said that it will strike a deal with France. That said, as noted, it does seem likely that there will be agreement to double IMF resourses (and perhaps even to triple them).

II **FINANCIAL CRISIS**

There is a certain amount of brave talk suggesting that – as far as the financial system is concerned at least - the end of the crisis is now in sight. On Monday, for instance, Fed Chairman Bernanke gave a television interview in which he said that the crisis "will begin to moderate and that we will see a leveling off" before the end of the year.

Unfortunately, the evidence for that is extremely thin. Indeed, the fear in the US is that the entire financial rescue operation is descending into chaos, with more and more of the Administration's time and effort being diverted into what is essentially political "theatre". There is (justifiable) outrage in the US over the US$165 million in bonuses that AIG paid out to senior executives, many in its Financial Products division, *after* it had been rescued by the Treasury – just as there is (equally justifiable) outrage in the UK over the STG 25-30 million pension "pot" that RBS's former chief executive, Fred Goodwin, had mysteriously accumulated, in large part

after his strategy for growing the bank had gone so wildly wrong. These are the sorts of issues that politicians love to get their teeth into – but they are essentially second-order problems, which are diverting attention away from the real problem of how to kickstart a global banking system that is still pretty much dead in the water.

Another (arguably) second-order issue which is taking up a lot of the Treasury's time in the US, and that threatens to sour relations between the US and Europe, is who really benefited from the US$85 billion government bailout of AIG?

Until this week, the gossip around the markets was that much of the money the US pumped into AIG was essentially passed straight on to Goldman Sachs, which had been a heavy buyer of CDS protection from AIG. Indeed, it was widely believed that Goldman would have collapsed if AIG had not been able to make good on credit protection contracts that it had entered into – and that this was a major consideration for senior Treasury officials with Goldman connections (Paulson, Geithner, Dudley *et al.*). Maybe; but now it appears that two big European banks, SocGen and Deutsche, got even more of the AIG bailout money than Goldman did – and that Deutsche, at least, would have failed if AIG had not been able to meet its commitments. Again, this has provided a field day for US politicians to attack the Obama Administration.

The UK government is also under attack – and not just for its incompetent handling of Goodwin's pension.

Yesterday, the (non-partisan) National Audit Office published a devastating report on its forensic examination of the collapse of Northern Rock. It seems clear that the FSA was grossly derelict in its supervision of Northern Rock, and that stress-testing was a joke. It is also clear that the bank's funding model was sufficiently anomalous that the regulators should have been all over it, and that rumours about its problems were rife in the markets long before the FSA acted.

Any good news? Well, the US has finally got its US$1 trillion Term Asset-backed Loan Facility (TALF) off the ground.

This is intended to restart the automobile and credit card securitisation markets. It provides a partial guarantee for hedge funds (and others) who borrow from it to buy asset-backed securities. The first tender appears to have gone a little bit better than expected, with applications for US$4.7 billion in loans; that is not great, but the word last week was that there might be no applications at all.

Where there has been progress this week is on the supervisory side.

On Wednesday, Adair Turner – the new(ish) chairman of the UK's Financial Services Authority – published a major report analyzing the FSA's failures, and laying out a vision for the future. This is an important paper – though there is a good chance that it will be sidetracked by EU-level regulatory initiatives based on the de Larosiθre report (published last month). Certainly, Europe seems to be moving towards a single pan-European financial regulator – a development that would relegate the FSA (currently, far and away the most important regulator in Europe) to being just one of 27 national bodies doing what Brussels or Frankfurt tells it. Nevertheless, the Turner report is significant - not least because it seems to represent a formal end to "light-touch" or "principles-based" regulation.

According to Turner, the UK "fell into a trap ... of trying to get a minor competitive advantage by making regulation a little lighter than elsewhere". Clearly, that will not happen again – at least, not under his Chairmanship. His report also acknowledges that there must be some sort of pan-European coordinating body (though not one that could *direct* national regulators, which is what de Larosiθre is proposing). More specifically, it calls for:

- banks to hold three times their present levels of capital against their trading books;
- a tighter definition of what constitutes higher-quality (ie Tier 1) capital;
- a one-month liquidity test (banks must be able to survive for at least one month if all access to liquidity dries up);
- a new 'gross leverage ratio', measuring total access against capital;
- closer regulation of hedge funds (if they 'evolve' into institutions that can pose a systemic risk, then they must be regulated like banks);

- so-called 'dynamic provisioning' (ie for banks to build up their capital in good times, as a buffer against bad times);
- international agreement on remuneration practices in the financial sector; and
- more power for host countries to impose capital and liquidity requirements on the branches of foreign institutions (a response to the problems of the Icelandic banks).

Assuming that the UK implements Turner's recommendations in full, the whole regulatory ethos in the UK will change. Not surprisingly, that has got the industry very worried.

Ironically, the most significant initiative launched by the banks themselves also involves Jacques de Larosiθre, who has just been appointed to co-chair (with the former Governor of the Bank of Canada, David Dodge) a Market Monitoring Group, created by the Institute of International Finance. This Group – which also includes George Soros and Malcolm Knight – will present a report on regulatory reform ahead of the IMF's Spring Meetings.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS.

As noted, one of the biggest issues this week has been where individual central banks stand on Quantitative Easing – or on "unorthodox" monetary policy more generally. The trend in favour of QE seems indisputable – though, at the moment, only the BofE is using the term for its purchases of long-term gilts and corporate debt. The Fed is clearly close behind, with its programme of purchasing agency debt and some Treasuries. And the BofJ announced on Wednesday that it would step up its bond purchases from Y1.4 trillion a month to Y1.8 trillion. Meanwhile, the ECB is offering only "enhanced credit support".

Initial evidence is that QE is having an effect. In particular, announcement of the Fed's long-dated Treasury programme caused US interest rates to tumble (the 10-year Treasury benchmark yield fell from 3.01% to 2.57%, while the two-year yield fell from 1.04% to 0.82%) and prompted a dollar sell-off. But it is uncertain how long this

will last – particularly given a resurgence of anxiety about US inflation in the last couple of days.

The problem is that policy-makers are groping in the dark. No one really knows what QE will do – or whether the real problem is weak demand now or hyperinflation a couple of years from now. That said, no surprise that politicians are focusing on the short term – and the IMF provided them with plenty of ammunition this Tuesday, when it released new (and even more pessimistic) GDP forecasts for 2009. For this year, the Fund now expects:

- global output to fall 0.6%;
- US GDP to fall 2.6%;
- eurozone GDP to fall 3.2%;
- UK GDP to fall 3.8%; and
- Japanese GDP to fall 5.0%.

As for China, it still insists it can do 8%. But both the World Bank and OECD are now predicting growth of only 6-6.5%.

A **THE US:** As noted, attention has been focused on the Fed's policy shift on QE – particularly on its decision to buy up to US$300 billion of long-term Treasury securities. However, that should not distract attention away from the continued economic deterioration. In particular, it was reported this week:

- that the Empire State (New York) manufacturing index fell to a new record low of -38.2 in March, from -34.7 in February;
- that industrial production fell 1.4% in February, with manufacturing output down 0.7%; and
- that leading indicators were down 0.4% in February, after a rise of 0.1% in January.

Fortunately, there were a few releases that were better than expected. For instance:

- the Philadelphia Fed's index recovered from -41.3 to -35 this month;

- new housing starts jumped an astonishing 22% in February; and
- first time jobless claims fell 12,000 in the latest week.

The Fed can also take some comfort from a pickup in US inflation, with the CPI up 0.4% in January. And the current account deficit fell sharply in the fourth quarter, from US$181.3 billion to US$ 132 billion – bringing the total deficit for the year to US$ 673 billion (down from US$731 billion in 2007). Unfortunately, that has more to do with plunging trade volumes than with stronger exports.

What really ought to have scared the markets (though it didn't) was the announcement of the so-called TIC data on Monday. This showed <u>a record outflow of foreign capital from the US</u> in January. Net foreign capital outflows were US$148.9 billion, compared with an inflow of US$86.2 billion in December.

This is truly awful, and it must call into question the ability of the US to go on funding the current account deficit – even at a lower level.

Bizarrely enough, none of this has affected US equities. Indeed, through Thursday, the DJIA was up 2.5%, the S&P500 was up 3.6%, and the Nasdaq Composite was up 3.6%. The reason seems to have been trader confidence that QE would have a positive impact. In early trading today, the indices are mixed (though the Dow is up).

B **<u>EUROPE</u>**: <u>At the eurozone level</u>, it was reported this week:

- that retail sales fell for the eighth straight month in January, down 2.2% year-on-year;
- that auto sales fell again in February, down 18.3% year-on-year (though sales in Germany were up 22% as a result of rebates); and
- that total employment fell 453,000 in the fourth quarter.

<u>Clearly, not an encouraging picture</u>. Nor is there much relief at the individual member state level. In Germany, for instance, the ZEW economic sentiment index (which looks six months ahead) did pick up a bit, recovering from -5.8 to

-3.5 in March – but the current conditions index fell from -86.2 to -89.4. Meanwhile, France is increasingly wracked by strikes, with 78% of voters (apparently) supportive of the strikes. As for Italy, it was reported yesterday that unemployment hit a two-year high of 6.9% in the fourth quarter.

But it is not really the 'core' eurozone countries that are causing concern. It is the peripheral countries – notably Ireland and Greece.

Apparently, there was a big fight at this week's EU Summit over how to handle a default by either of these countries. Merkel's party spokesman claimed yesterday that an emergency ECB fund has already been established to bail either country out; today, other German government spokesmen have denied that any such agreement was reached. Clearly, if there is such a fund, it may be better to keep it secret.

As for the UK, the BofE began the week by warning of a "1930s-style slump", in which the country cannot break out of a liquidity trap. In its *Quarterly Bulletin*, it also raised questions about the credit-worthiness of UK banks, and about the sustainability of personal indebtedness – which, at STG 1.46 trillion, is up 165% since 1997. That is probably the highest level in the world.

There certainly isn't much good news in Britain. Although there are some positive signs on the retail front (now that excessive inventories have been cut), it was also reported this week:

- that UK house prices (particularly in urban areas) are still falling;
- that unemployment hit 2.03 million in January, the first time it has gone over 2 million since 1987 (that is despite a continuing rise in public sector employment, fuelled in large part by higher public sector earnings); and
- that automobile production was down a massive 60% year-on-year in February.

It's a mess – and it is not certain whether the aggressive policies being followed by the Bank and Treasury are sustainable. As the IMF pointed out, the UK will have to borrow 11% of GDP next year – the highest borrowing requirement in the West.

C **JAPAN**: As noted, the BofJ is also stepping up its bond purchases. It also announced this week a new programme to lend Y1 trillion to the large banks, it hopes that they will on-lend this to Japanese corporates.

D **CHINA**: As noted, it has been reported that the OECD has cut its 2009 growth forecast for China from 8% to 6% - more or less in line with the World Bank. Even that may be optimistic, however: it was reported this week that foreign direct investment fell 15.8% year-on-year in February. It was also reported that SAFE – the government's foreign exchange agency - incurred very heavy losses in the equity market by moving a chunk of China's reserves into equities ahead of the crash. That will, no doubt, reinforce a natural conservatism, when it comes to investment policy, among China's leaders.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

The week began with concern that the Swiss National Bank's decision to intervene to drive down the SF would trigger a round of competitive devaluations. In particular, there was concern that Japan would follow.

In fact, the Swiss action could have been defended, not just as a counter-deflationary measure, but as offering some relief to Central and Eastern European countries where many (in some cases, most) mortgages are denominated in SF. As a result the 4.7% depreciation of the SF against the euro last week offered some relief to homeowners.

As for this week, however, attention has shifted to the US dollar.

The Fed's decision to expand its asset purchase programme into long-dated Treasuries triggered the biggest one-day loss that the dollar has suffered since 1985 – with the dollar falling 3.2% against the euro on Wednesday, 3.3% against the Swiss franc, and 2.3% against the yen.

Week-on-week, the dollar is also down across the board:

- against the euro, it has fallen from US$1.291/€ to US$1.358 – a drop of 5.2%; and
- against the yen, it has fallen from Y98.01/US$ to Y95.346 – a drop of 2.7%.

It has also fallen again against the Swiss franc and sterling. Despite the SNB's best efforts, the dollar has gone from SF1.186 to SF1.124 – a drop of 5.2%. As for the pound, it has risen 3.5%, from US$1.398/STG to US$1.447.

Given the very bad TIC data and the continuing programme of Fed purchases, it is easy to see the dollar continuing to weaken – and not easy to see what could turn it around.

V OIL

There has been a modest rally in almost all commodities this week – particularly after the Fed's move into QE. Gold, for instance, jumped 8% in two days, hitting US$960/oz yesterday, on fears of inflation. Broader commodity indices were up around 6%.

For the most part, this was more a reflection of the skidding dollar than a vote of confidence in US economic policy – but it has dragged oil prices up with other commodities. Despite OPEC's decision to leave quotas unchanged (for the moment), both marker crudes are up sharply for the week as a whole:

- Brent: April Brent closed last Friday at US$44.93 a barrel, up just 8 cents on the week. On Monday, the front month contract expired at US$43.98 – but the May contract firmed to US$46.45. It closed yesterday at US$50.67 (having set a high of US$51.64), and is currently trading at US$50.34 – up almost 12% week-on-week.
- WTI: April WTI closed last Friday at US$46.25 a barrel, up 1.6% for the week. By the close yesterday, it was US$51.61 (having hit US$52.25). It is currently trading around US$50.65 – up 9.5% for the week. The December 2009 contract is even firmer, closing yesterday at US$59.51.

It is worth noting that these increases have come about despite a sharper than expected 2 million barrel increase in US crude stocks in the latest week – which includes a 300,000 barrel increase in stocks at Cushing, OK. US gasoline stocks were also up 3.2 million barrels, which was a lot more than expected, and distillate stocks were up 100,000. There is some suggestion that the price of WTI has broken a key chart point, but the biggest factor in the firmer tone is almost certainly the weakness of the dollar.

VI NEXT WEEK

In the US, the key releases next week include:

- existing and new home sales for February, both expected to be down slightly;
- personal income and spending for February;
- durable goods orders for February, expected to be down 2%; and
- the Michigan sentiment index for March.

In Europe, the main releases due are:

- eurozone industrial orders for January;
- the IFO index for March in Germany;
- French consumer confidence for March; and
- UK inflation for February.

In Japan, the trade surplus for February is due, along with consumer price inflation.

Regards.
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