

The travelling economist

Digging deeper into the G3 – US, UK and Europe

April 2011



Contents

Executive summary	1
The economy	3
Central banks	9
Fiscal policy	20
Politics	28
Anecdotal stories	31
Stephen Halmarick – biography	36
Further information	37

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision.

Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of Colonial First State Asset Management (Australia) Limited ABN 89 114 194 311 (CFSAMAL). This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy, none of CFS or CFSAMAL offers any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS and CFSAMAL. You should not rely on the contents. To the fullest extent allowed by law, CFS and CFSAMAL exclude all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by any of CFS or CFSAMAL. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.

Executive summary

Taking in six cities and 28 meetings over nine days in February and early March 2011, I was able to delve deep into the economic, policy and political outlook for three of the key developed markets which will hereafter referred to as the G3: the US, the UK and Europe ('EU'). While these economic regions are in various stages of recovery from the financial crisis recession, the surprise was how different the recovery path is likely to be over the years ahead and how very different policy responses look set to play out. In addition, especially in the US and EU, the politics of monetary and fiscal policy and financial sector reform could well be a significant, ongoing factor that markets will need to digest.

My sense was that the different path for policy in the year ahead is based on different policy objectives, especially in the US relative to the EU. In the US there is one number that will count above all others in determining the strength, or otherwise, of the economy – and the likely outcome of the 2012 Presidential election – and that is the unemployment rate. Policy is likely to be directed by the goal of substantially reducing the unemployment rate in the years ahead. So, despite some signs of progress in the economic recovery, my expectation is that the US Federal Reserve ('the Fed') will likely keep both arms of monetary policy (ie interest rates and the US balance sheet) at their extremely easy settings for a significant period yet.

In the EU, the priority of controlling headline inflation is clear. With this single focus in mind, the European Central Bank ('ECB') looks set to tighten monetary policy in the near term; beginning the path of returning policy to a more normal setting. This official increase in interest rates will come at the same time as EU authorities are continuing to pump liquidity into a number of countries (with Portugal joining Ireland and Greece in needing access to debt funding) and some parts of the banking system.

For asset markets, these differences in policy path could be meaningful. In the US, there is an economic recovery that is continuing at a modest pace, with different parts of the economy performing in different ways, ie housing vs manufacturing. But it seems clear that the pace of recovery has not been strong enough as yet, and is unlikely to be in the year ahead, to push the unemployment rate significantly lower. As a result, the ongoing recovery in the US is likely to be accompanied by continued easy monetary conditions, including quantitative easing ('QE2') and very low interest rates. In addition, despite a heightened political will to tighten fiscal policy, the highly combative nature of the political cycle also implies little probability of significant fiscal policy tightening in the near term.

As a result, asset markets in the US could perform strongly, as demonstrated by equity markets and credit spreads, as the policy levers remain very supportive. This should also imply further increases in government bond yields as the year progresses, while none of this would suggest that the USD is about to appreciate strongly.



Stephen Halmarick
Head of Investment
Markets Research

In the EU, the situation seems very different. The 'northern' parts of the EU are growing strongly, driven by a resurgent Germany that is benefiting from its export performance to emerging markets. Germany has also seen significant productivity gains in the labour market, following hard decisions that have been made in the 20 years since re-unification. This strong growth is, however, likely to see the ECB begin to tighten monetary policy in the very near term. In addition, fiscal policy will be tightened aggressively across the EU over many years ahead.

In 'peripheral' Europe, made up of countries such as Portugal and Ireland, too much government debt and unstable financial institutions remain problematic. The most likely scenario for this part of the EU is, however, a continuation of the 'muddle through' policy, with indebted sovereigns and banks provided with the necessary liquidity to keep them alive.

This provision of liquidity for the 'insolvent' jurisdictions will occur at the same time as monetary policy and fiscal policy is tightened, likely providing a headwind for financial markets. Opportunities within the EU could, however, be more focused on companies that are globally integrated and where governments are selling assets.

In the UK, the economy is recovering slowly but is about to face a significant tightening of fiscal policy, which will make strong economic growth very difficult to achieve in the near term. Inflation has, however, been persistently above target and this is likely to see the Bank of England ('BoE') follow the ECB in tightening monetary policy in the coming months. This will likely make it difficult for UK assets to perform strongly in the months ahead.

This detailed report is an accompaniment to the daily blog I wrote while on a trip, visiting New York, Washington, London, Edinburgh, Frankfurt and Zurich. In this report I have detailed the outlook for the G3 economies; the opinions of, and likely policy path of their central banks (the Fed, BoE and ECB) and the outlook for fiscal policy. The ongoing debt concerns in the EU 'peripheral' economies and parts of the banking system are also detailed, along with the views from the Swiss National Bank ('SNB'). I have also included some information on the political factors that could impact on financial markets, especially in the US and the EU. Finally, I have included some of the more interesting anecdotal stories from my travels; to provide a little further insight into what is happening on the ground.

I trust that you find both this report and the blogs interesting and informative, that they provide a clearer picture of what is happening in three of the most important economies of the world and how these developments are likely to impact financial markets.

Note: *Since the body of this text was written in late March, the ECB has lifted interest rates by 25 basis points to 1.25% and Portugal has formally requested assistance/bailout by the EU and International Monetary Fund ('IMF'). Both of these events were anticipated and are discussed in this research report.*



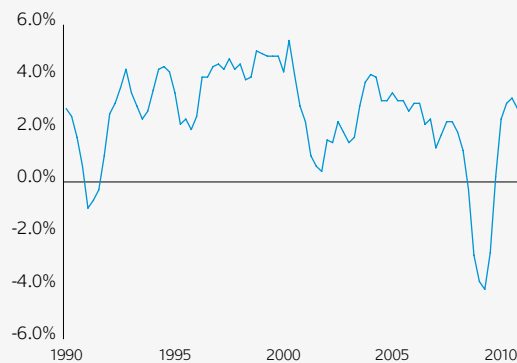
The economy

	295 700	-2 240	-36 0
		-805	
	-298 745		-27
09/12/31		-36 827	3
Pro-forma			

United States

The first thing that surprised me in my meetings in New York was how bullish the economists I met were. Most were expecting real GDP growth in 2011 and 2012 of around 3.5% per year – 4% per year, up from 2.8% at the end of 2010. It is worth noting at this point however, that since mid-February, some economists have downgraded their growth expectations. Support for this optimistic outlook came from signs of some improvement in the labour market, the very strong balance sheet position of most corporates, the need to catch up on private sector investment, some signs of a better supply of credit to parts of the economy and the strength in economic indicators in the manufacturing sector. In general, there was a sense that the consumer was becoming more willing to spend and that, as a result, the household savings ratio would stabilise around 6%, from a peak just above 8% post-financial crisis.

Chart 1: US GDP annual % growth



Source: Bloomberg. Data to 31 December 2010.

These positives were offset, however, by recognition that the housing market remains very weak, with little sign of any improvement. Non-residential construction is also soft and the outlook for State and local finances implies further contraction from this sector.

It also didn't take much to have various economists admit that the expected strength in the economy was relatively narrowly based among the 'international' cities of the US (such as New York or Boston) and that growth could slip back to around 2.5%-3% if things didn't continue to progress well. This, it seems to me, is now a more likely prospect; we should expect continued recovery in the US economy, but not at a pace that is likely to lead to a significant reduction in the unemployment rate (see below for what this implies for the Fed) and that the recovery process has yet to broaden out substantially.

One economist who, it seemed to me, was looking for 'silver linings' also noted that to some extent the money that was formerly spent on housing (ie mortgage repayments) was now going to consumption and that with housing expected to remain weak, this would leave more room for consumer spending.

Another view from a Wall Street veteran economist was that it is important to look at the recovery in the US economy with an historical perspective. As he put it, the US authorities were able to halt the greatest financial shock and the worst recession since the Great Depression in under a year and that this was an incredible achievement. As he also put it, while it could be argued that the recovery is sub-par, at least we are in recovery!

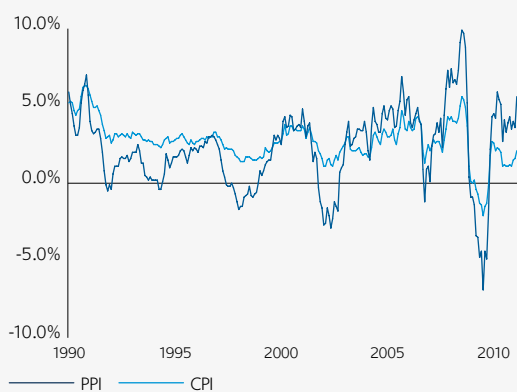
He continued that in having stabilised the financial system and started on the road to recovery, the economy is now at the start of a long-term adjustment process that would depend a lot on a growing population and entrepreneurial skills of individuals and companies. He also made the point that the threats to the financial system and the economy were no longer likely large enough to really throw the recovery off track (though, it must be said, this was prior to the escalation of events in the Middle East and North Africa and the tragedy in Japan).

On inflation, there was a general view among the financial market economists that although the risks of deflation had been reduced, the risk of a serious increase in inflation remained low. Without a recovery in employment growth, wages growth was likely to remain subdued and this would keep inflation pressures in check. Higher food and energy prices were perceived to be more likely to reduce consumption in other parts of the economy, rather than contributing to overall inflationary conditions.

Having said that, I definitely encountered some economists (although they were in the minority and not representing the central bank) who were worried about a spill-over of inflation pressures from the emerging markets world to the US – driven by food and energy. The worry for these economists was the build-up of the spread between Producer Price Inflation ('PPI') and Consumer Price Inflation ('CPI') – where producer (or input) prices were rising but consumer prices could not keep pace (ie the consumer was still too weak to pay the higher prices). This was obviously seen as a negative factor for companies in sectors where input prices were rising sharply (such as foodstuffs and apparel).

“... we should expect continued recovery in the US economy, but not at a pace that is likely to lead to a significant reduction in the unemployment rate.”

Chart 2: The US PPI:CPI spread



Source: Bloomberg, CFGAM. Data to 28 February 2011.

In some sense, those who actually invest in financial markets for a living were very bullish on US asset markets. This was mainly because of the belief that the US authorities would continue to do all they can to keep the US economy firmly in recovery mode, exerting upward pressure on asset prices. The expectation was that this support for the economy from authorities could lead to a positive feedback loop: supporting job creation, the consumer and the economy more generally.

Some good ‘lines in the sand’ for further economic growth and a better performance from asset markets were monthly non-farm payroll job increases of 200,000-250,000, with nominal GDP growth of around 5% per year. These outcomes are expected to help asset markets do well, with a rising floor in asset prices.

Looking at the US commercial property sector more closely, the feeling on the outlook is best described as ‘pretty optimistic’, but only when put in the context of a bad few years. So things were improving from the lows of 2008-2009, but were still a long way from the buoyant conditions that were evident around 2006. Demand for commercial properties was being seen in the manufacturing sector, but also with some gains in the retail sector. Most of the increased demand appears to be from larger firms, with small business still soft as a result of both general economic conditions and reduced access to credit.

The key to the outlook was, not surprisingly, seen as employment growth, with monthly payrolls of 200,000-250,000 needed to provide further support to the market. As such, the 216,000 increase in employment in March was seen as a positive development.

There were also some signs of life in the Commercial Mortgage Backed Securities (CMBS) market, with 2011 issuance expected to be around US\$70 billion compared with US\$25 billion in 2010. This had to be put in the context, however, of a peak in issuance of around US\$500 billion in 2006.

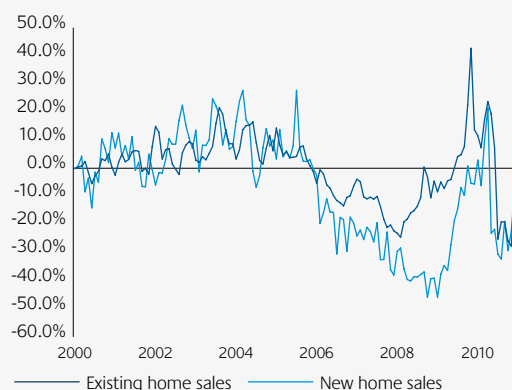
On the negative side there was the general recognition that the signs of improvement were mainly in the larger cities, or the ‘international’ cities; New York, Washington, Boston, Chicago and San Francisco. Away from these cities, the market remained quite subdued. This can also be seen in rents, which are rising in the big cities (especially New York, Washington and San Francisco), but are still trending down almost everywhere else.

There was also discussion of the ‘distress in the pipeline’, with very little price discovery via transactions; banks still had a lot of property on their balance sheets which they hadn’t yet taken to market. This was referred to as the ‘extend and pretend’ strategy! Nonetheless, there was a general feeling that valuations in the commercial property space were improving.

There was also very limited new construction taking place and very little in the pipeline. This was seen as being positive for rents, but also an indicator of the cautious attitude still in markets and access to credit.

The commercial property sector is also generally worried about the residential property market. Another downturn in house prices (which is now underway) was seen as a negative for US banks, which could impact the commercial property sector as well. The expectation of further budget cuts at the State and local government level was also seen as a negative for office space demand.

Chart 3: US existing and new home sales (%/yr)



Source: Bloomberg. Data to 28 February 2011.

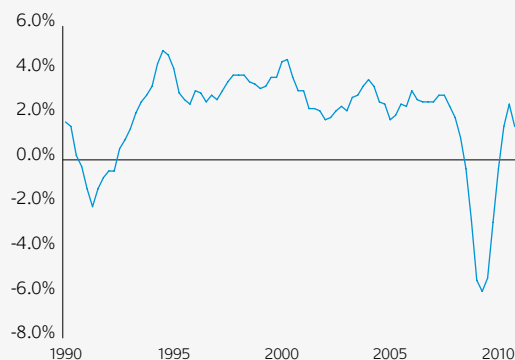
“... it is clear that the UK is recovering from the depths of the recession caused by the financial crisis, but the path back to sustainable recovery remains very difficult.”

United Kingdom

Three years on from my most recent visit to London, I expected to find the economy in a weak state in 2011. As shown in Chart 4, it is clear that the UK is recovering from the depths of the recession caused by the financial crisis, but the path back to sustainable recovery remains very difficult. While GDP growth had increased to 2.5% per year in Q3 2010, the GDP reading for the end of 2010 showed a surprising decline to just 1.5% per year – although some of this slowdown was weather related.

I was surprised, therefore, on my visit to Canary Wharf to see this centre of the financial district in very robust shape; I had expected a much more downbeat atmosphere. But it was clear that the Canary Wharf area was very strong, with plenty of signs of recovery in the financial district.

Chart 4: UK GDP growth (%/yr)



Source: Bloomberg. Data to 31 December 2010.

General expectations for the UK economy were, however, subdued and more than one economist told me that the city of London was now pretty much an economy unto itself and that the rest of the UK was in much worse shape – this was confirmed for me when I visited Edinburgh.

Economic growth forecasts for the UK are around 1.7%-2.0% per year for 2011, still a somewhat subdued pace of recovery given the depth of the recession (ie -5.0% per year in 2009). However, some of this modest growth path can be explained by the significant fiscal policy tightening that is set to get underway in the UK, equal to around 2.5% of GDP. The significant cuts to government employment will be in parts of the UK outside of London, likely adding to the City of London/rest of UK economic divide.

For many UK economists, the question remains whether the significant coming fiscal policy tightening will just act to slow the UK economic recovery, or whether it will halt it. But, at over 10% of GDP, it is clear that dramatic action needs to be taken to reduce the UK budget deficit to a more medium-term sustainable level. The recent budget estimates that the deficit will decline from 9.9% in FY11 down to just 1.5% by FY16.

In terms of the dramatic cuts to government spending required to achieve these outcomes, my sense was that there is general public support for this policy action by the new government; the citizens of the UK do not want to go down the same path as Greece or Ireland. But recently there have been some signs of protest against the scale of the budget cuts, particularly in the health sector.

As detailed later in the Central Bank section, one of the main concerns for the UK economy is the rate of inflation, which at 4.4% per year to February is well above the BoE's 2% target. Consensus expectations are that inflation will average 4% in 2011, after peaking around 4.5%, before dropping sharply to 2.0% in 2012. Some of the near-term increase in inflation has been caused by 'one-offs', such as the weaker British pound, Value Added Tax ('VAT') increases and rising food and energy prices. But, I was told, underlying inflation is still running at around 3.0% per year and inflation has been persistently higher than the BoE expected.

The concern for the BoE is that this persistent nature of higher inflation will eventually feed into higher inflationary expectations. As a result, and as detailed below, we should expect the BoE to begin to tighten monetary policy not long after the ECB.

Given, therefore, that both fiscal and monetary policy are expected to be tightened in the months ahead, the UK economy is likely to struggle to maintain much momentum in the remainder of 2011 and over the next few years.

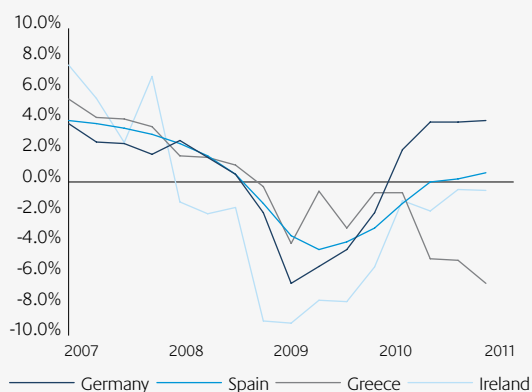
Europe

One of the striking features about the performance of the EU economy is how well much of it has performed, despite the obvious significant debt problems in countries such as Greece, Ireland and Portugal. Total EU economic growth is currently running at 2.0% per year as at end 2010, with a consensus forecast of 1.5%-2.0% per year for both 2011 and 2012. This outlook was seen as being close to potential for the EU area.

However, this growth picture masks a very divergent growth pattern within Europe. Essentially, there is the strong growth of Germany and its near neighbours (referred to by one economist I met as 'greater-Germany'; meaning Germany, Austria, Czech Republic, Poland, Switzerland, Belgium and the Netherlands etc), and then more subdued conditions in the 'peripheral' countries, such as Greece, Portugal and Ireland. These countries are expected to see very limited growth, as they struggle under the weight of deficits and mountains of debt. Somewhere in the middle are countries such as France, Spain and Italy.

For 2010 the German economy grew at a very solid 3.6% per year, with consensus expecting growth of 2.6% per year in 2011. As shown in chart 5, the German economy is clearly outperforming the rest of the EU.

Chart 5: Annual GDP growth rates (%)

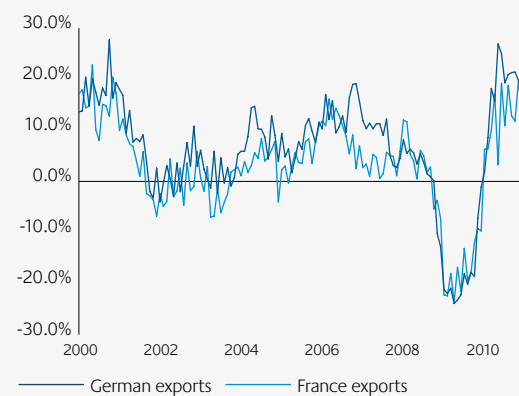


Source: Bloomberg. Data to 31 December 2010.

The strength of the German economy can be put down to both short-term and medium-term factors. In the short term, Germany (and some of its neighbours, including France) has benefitted from the weakness of the euro, which has helped encourage a significant increase in exports to the fast growing emerging economies, especially China, (ie the more internationally exposed economies have done better).

Indeed, in a very real sense Germany is benefiting almost as much as Australia from the rise of China. It is not resources that Germany is exporting, but transport equipment (cars, trucks and trains), machinery, chemicals, electrical devices and telecommunications equipment.

Chart 6: German and French exports (%/yr)



Source: Bloomberg. Data to 31 January 2011.

The German economy has also benefitted from the very low level of interest rates in the EU (ie currently 1%) that owe more to the softness of economies in 'southern' Europe, rather than the stronger north.

On a more medium-term structural basis, the German economy is now benefitting significantly from the positive effects of re-unification and significant reform of the corporate sector.

This can be seen in the fact that the German unemployment rate is 7.3% as at February, well down from the peak of 8.3% in April 2008. Indeed, at 7.3% the unemployment rate is lower than the pre-financial crisis level of 7.6% and the total number of people employed in Germany is at a record high.

It is over 20 years since the re-unification of Germany, but the real benefits of this dramatic event and the very bold decision to unite the former East and West as equal partners (as demonstrated by the currencies being merged at parity) is now paying very large dividends.

As one German economist I met told me, the real benefit of 'freedom' for the former East has been education, labour market mobility and a surge in the quality of infrastructure. Having real democracy is obviously a major benefit for the people of the former East as well. In addition, there have been solid reforms to the German economy since the recession of 2001-02.

“Indeed, in a very real sense Germany is benefiting almost as much as Australia from the rise of China.”

The benefits of all these reforms are now showing up in a surge in productivity growth, which is manifesting itself in rising wages, but also a decline in unit labour costs. At the same time, German companies have reformed and have become, as one economist described it, ‘ruthlessly global’. Indeed, I am sure that most people could name a number of German companies that are global household names and that are growing strongly in the changing global economy.

Chart 7: German labour productivity and unit labour costs



Source: Bloomberg. Data to 31 December 2010. German unit labour costs nominal GDP. Productivity output per hour. Index = 100 as at 31 March 1991.

The general feeling in Germany seems to be that, after 20 years of significant reforms, the economy is now reaping the rewards of doing the ‘hard yards’. Some of the negative feeling among German people towards the ‘peripheral’ countries comes about because of the view that ‘why should the German tax payer pay for the sins of the governments/people of Greece, or Ireland or Portugal, when they either mismanaged their economies badly, or openly flouted the rules?’ It is hard not to have some sympathy for this view.

The situation in ‘peripheral’ Europe, however, remains very disturbing for those countries. Greece and Ireland have already had to request funding from the EU authorities and Portugal is widely expected to soon have to do the same, given that its net government debt is expected to rise from 58% in 2007 to 79% in 2011 and 93.5% in 2015. The Portuguese government is also in disarray following the recent resignation of the Prime Minister.

Economic growth across these countries is expected to be minimal at best over the next few years, as fiscal policy is tightened and significant structural reforms are put in place.

The middle-ranking countries, such as Spain, France and Italy appear to be doing okay. They face some debt challenges, but not as great as those facing the peripheral nations and while they do have relatively high unemployment rates, their economic fundamentals are in reasonable shape. However, apart from discussions around Spain in terms of debt levels (see below for details), the surprise to me was how little both France and Italy were mentioned in my discussions with economists and central bankers in London, Frankfurt or Zurich. (Although, I am sure if I had have been fortunate enough to visit Paris and/or Rome, this situation would have been different.)

Of course, one of the big issues for the EU economy is inflation (this is discussed in detail in the Central Bank section below). The current EU harmonised inflation rate is 2.4%/yr to February 2011, well above the 2.0% target of the ECB. For 2011, the consensus expects inflation to average 2.2%, while for 2012 this declines to 2.0%.

So the economic outlook for the EU remains very divergent. Germany and its near-neighbours are expected to continue to do well, due to a combination of both strong short-term cyclical factors and medium-term structural positives. The short-term positives will be impacted, however, by the coming tightening of monetary policy. At the other extreme are the peripheral nations, such as Greece, Portugal and Ireland, who will struggle to make any headway under significant fiscal policy tightening. In the middle we have countries such as France, Spain and Italy, which will likely show some modest growth, but will also be held back to some extent by both monetary and fiscal tightening.



Central banks



“Getting the unemployment rate down to 6%, from 9%, would require six years of economic growth around 3.5%... no easy task!”

The US Federal Reserve

Across the road from the White House is a large building with four very large letters emblazoned across it. As can be seen in the photo below, the letters spell the word ‘JOBS’. To me this sign, so strategically placed opposite the President’s residence, neatly sums up what the focus is in Washington – employment growth.

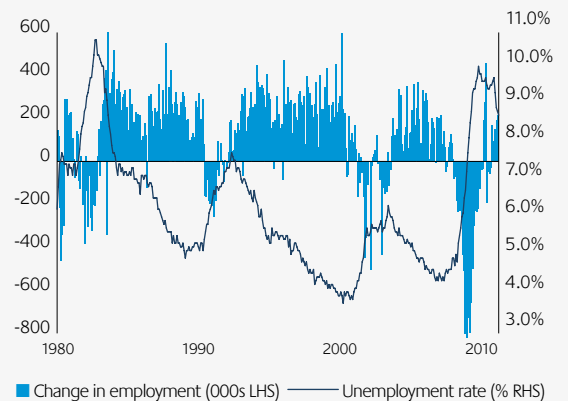
The focus in the US



Source: CFSGAM.

Of course, as shown in Chart 8, there has been some progress on employment creation, with the official unemployment rate down to 8.8% as at March 2011, from a peak of 10.1%. But, even though the Fed is pleased with this progress (noting in their statement of 15 March that “overall conditions in the labour market appear to be improving gradually”), some scepticism remains over the veracity of the data and it is clear that a further significant decline in the unemployment rate is the main focus. Indeed, the unemployment rate is not projected to be below 8% until well into 2012, while the Fed sees a rate of unemployment of 5%-6% as the natural rate (or NAIRU).

Chart 8: US monthly employment creation and unemployment rate



Source: Bloomberg. Data to 31 March 2011.

Further significant declines in the unemployment rate are likely to be the focus for policy makers in the months ahead. I was informed that the rough rule of thumb is that it requires a year of GDP growth of 1% above ‘trend’ GDP growth to achieve a 0.5% reduction in the unemployment rate. Getting the unemployment rate down to 6%, from 9%, would require six years of economic growth around 3.5% (ie with trend assumed to be around 2.5%) – this is no easy task!

It was also impressed upon me that the Fed considers the vast majority of the increase in the unemployment rate as cyclical rather than structural. This surprised me, but it is an important observation and reinforces the Fed’s desire to get the unemployment rate back down to its pre-financial crisis lows.

As also noted in the latest statement from the Federal Open Market Committee (‘FOMC’), the Fed is becoming a little more optimistic on the economic outlook. This was described to me as the recovery looking ‘less fragile, with less downside risk’, while in the 15 March 2011 FOMC statement it was noted that the “economic recovery is on a firmer footing.” But it seems to me that this should not be taken as a sign that the Fed is readying the markets for a tightening of monetary policy.



The US Federal Reserve Building – Washington.

Indeed, it is my view that monetary policy tightening by the Fed remains some way off – most likely into 2012. As detailed below, this is likely to be well after the ECB, BoE and SNB start the tightening process.

It was also pointed out to me that the US economy does face other ‘worries’, especially in relation to the housing market (where prices are declining again), non-residential construction and the poor position of budgets at the State and local level.

Before I go into some detail on how the Fed will eventually tighten policy, it is also worth noting what the Fed is thinking about in terms of the inflation outlook. Of course, controlling inflation is the Fed’s other main policy objective. Unlike most other major central banks, the Fed doesn’t have a formal inflation target, but it is accepted that it considers inflation of close to 2% as the desired rate.

It is clear, however, from discussions with the Fed that it is the core rate of inflation (ie excluding food and energy) that it spends most time focussing on, rather than headline inflation. As shown in Chart 9 below, while headline and core inflation generally move in the same direction, there can be a significant gap between them at times. The current environment is one of those times.

I specifically asked if the Fed was concerned about the recent rise in energy and food prices (and commodities more generally) feeding into inflation. The answer suggested that the Fed was unclear as yet whether the rise in commodity prices was a short-term event and would have no more than a transitory impact on prices, or a more permanent change. I got the impression the Fed would need to see considerably more data on this before they made up their mind. The most important consideration at present seemed to be whether the rise in commodity prices would feed into higher inflation expectations, as this would be more of a concern than a short-term spike in headline consumer price inflation (‘CPI’).

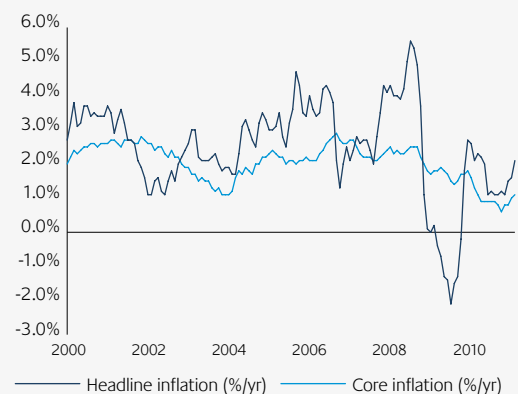
Importantly, it was also pointed out to me that around 70% of all inflationary pressures in the US have traditionally come from wages growth and that given the state of the labour market, there was currently not much risk of higher inflation from this source.

It was also highlighted to me that the expenditure weight of food and energy differs dramatically across income and demographic groups, so it was not appropriate to assume a nationwide inflation problem from higher commodity prices. Indeed, there was some sympathy for the view that higher food and energy prices acted like a tax on consumption, which could have a deflationary effect elsewhere in the economy.

As can be seen in Chart 9, both the headline and core inflation rate in the US are rising at present, but at just over 1% per year, the pace of core inflation remains below the level that would be considered a concern for the Fed.

So the message from the Fed is clear at the moment – it is neither achieving its inflation objective nor its employment objective (ie inflation is too low and the unemployment rate is too high). As a result, monetary policy is likely to remain at its very easy setting for a number of months to come. Policy tightening appears to be a story for 2012 rather than 2011.

Chart 9: US CPI: Headline and core (%/yr)



Source: Bloomberg. Data to 28 February 2011.

Don’t call it QE2 and how the Fed will tighten

One of the first lessons I learnt in my discussions with the Fed is that it is not ‘politically correct’ to call the current phase of policy easing ‘quantitative easing’ or QE2. I then corrected myself and used the term ‘credit easing’. I was informed that this term was ‘better’, but that the Fed refers to its policy action as the Large Scale Asset Purchase program, or LSAP... and so we are currently in LSAP2. Lesson learnt. I used the phrase LSAP2 in the remainder of my conversation at the Fed, but for the sake of this report, let’s just call it QE2.

It seems very likely that the Fed will continue with its current QE2 program, which involves the purchase of US\$600bn of Treasury bonds between November 2010 and the end of June 2011. The Fed sees QE2 as a very important part of providing ongoing liquidity to the US financial system and the economy more generally. It is pleased with the progress in the economy since QE2 began (especially as QE2 seems to have put an end to deflation concerns), but the Fed is far from declaring victory on the economy.

“The message from the Fed is clear at the moment – it is neither achieving its inflation objective nor its employment objective... as a result, monetary policy is likely to remain at its very easy setting for a number of months to come.”

I asked specifically what the chances were of a ‘QE3’. This is currently not on the Fed’s agenda, given the slight decline in the unemployment rate and rise in the inflation rate. I got the impression, however, that if these trends reversed the Fed would be inclined to at least seriously consider further policy action. But it does seem that the political hurdle to put QE3 in place would be quite high.

One of the big issues for the Fed is how it tightens monetary policy – when the time comes for that. From my discussions with the Fed, it is clear that they are firmly of the view that there are two ways in which they will be able to tighten monetary policy:

1. by unwinding the LSAP program and reducing the size of the balance sheet and
2. by raising interest rates.

One of the big questions for the Fed to consider is the order in which it tightens monetary policy and how it best communicates its plans and goals to the market (both within the US and outside the US, especially holders of Treasury bonds) and the American people more generally.

It was suggested to me that the eventual monetary policy tightening sequence could look something like:

1. increase the Federal Funds target rate (this could occur in a number of ways),
2. reduce the Fed’s balance sheet by ceasing to reinvest coupon payments from bond holdings, and
3. reduce the Fed’s balance sheet by selling bonds back to the market.

To provide more detail on this it is instructive to read the “Monetary Policy Report to the Congress” of July 2010. (Note this was prior to the start of QE2 when policy tightening was being discussed, but as we know, further policy easing took place in November 2010.)

In this report the Fed stated that “...tightening will be accomplished partly through changes that will affect the composition and size of the Federal Reserve’s balance sheet” and that “...the Federal Reserve has developed a number of tools that will facilitate the removal of policy accommodation and reduce the quantity of reserves held by the banking system at the appropriate time”.

The tools the Fed has at its disposal to tighten monetary policy are listed below, along with a brief description of how they will operate. There are five options in total. While some of the analysis is technical, it is, I think, important in understanding the Fed’s thinking and what the impact on the financial system and economy more generally may be when the time comes for the Fed to begin the process of returning monetary policy to a more normal setting.

1. Interest on excess reserves rate (‘IOER rate’): The IOER rate is the interest rate the Fed pays banks on the reserves they hold in the Federal Reserve System. The IOER rate is currently 25bp, ie at the outer-bound of the Fed Funds target rate of 0bp-25bp. Theoretically, by raising the IOER rate, the Fed would make it more attractive for banks to hold reserves in the Federal Reserve System, rather than lending these funds out to the economy. Within the Fed, the IOER rate is seen as being very closely related to both the size of reserve balances held at the Fed and the Fed Funds target rate – the traditional interest rate measure of the policy stance (note, the Fed Funds target rate is the interest rate banks use when lending funds to other banks in the system, usually on an overnight basis).

As a result, any increase in the IOER rate is likely to occur in a manner closely aligned to an increase in the Fed Funds target rate and a reduction in the supply of reserve balances by the Fed.

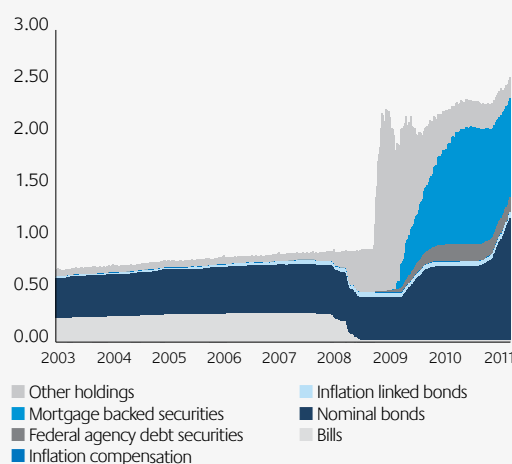
From my discussions at the Fed, this is likely to be the first stage of any move to tighten monetary policy or, more accurately, remove some policy stimulus. So financial market participants and economists will watch this situation closely to see when the Fed begins to openly discuss increasing the IOER rate.

2. Executing term reverse repurchase agreements (‘RRP’): As noted in the July 2010 report to Congress, in January 2010 the Fed tested its ability to conduct a RRP, on a small scale, using Treasury securities and agency debt as collateral. The Fed, therefore, has confidence that it will be able to undertake RRP’s on both Treasury securities and mortgage-backed securities (‘MBS’) with market participants when the time comes to withdraw liquidity and policy accommodation from the system.
3. Issuing term deposit to banks through the Term Deposit Facility (TDF): On 30 April 2010, the Fed announced that it had approved amendments to its regulation of banks that would enable the regional Federal Reserve Banks to offer term deposits to banks that are eligible to receive earnings on their balances at Federal Reserve Banks. By offering a TDF to eligible banks, this will be another way in which the Fed can reduce the supply of liquidity in the economy. It is worth noting that through May, June and July 2010 the Fed undertook a number of very small TDF’s to “provide eligible institutions with an opportunity to gain familiarity with the procedures.”

4. Redeeming maturing and prepaid securities held by the Fed without reinvesting the proceeds: This will likely include, at the first instance, the Fed's holdings of mortgage backed securities and then Treasury securities. By this process, the Fed will be able to shrink its balance sheet, "consistent with the achievement of the Committee's objectives of maximum employment and price stability." It is widely expected, and acknowledged by the Fed, that the first stage of shrinking the balance sheet will be to cease reinvesting the proceeds of maturing bonds and coupon payments.
5. Selling securities held by the Fed: The final stage to monetary policy tightening looks as though it will be the actual sale of securities held by the Fed, noting that such an approach (ie not selling assets until after the target for short-term interest rates had actually been increased) "would postpone any asset sales until the economic recovery was well established and would maintain short-term interest rates as the Committee's key monetary policy tool."

An interim measure prior to the outright sale of securities held by the Fed could be to shift the maturity length of the Fed's securities holdings well down the curve by investing in shorter dated bill and bonds and, in doing so, returning the Fed's balance sheet more closely to the position that existed prior to the financial crisis. The implication here is also that the size of the Fed's balance sheet, over the medium term, is likely to return to pre-financial crisis levels of around US\$1 trillion, rather than the expected peak near US\$3 trillion. This process, however, could take several years to achieve.

Chart 10: US Fed balance sheet (\$ trillion)



Source: CFSGAM, Federal Reserve. Data to March 2011.

Quite clearly, the process of monetary policy tightening, or the withdrawal of stimulus, by the Fed will be a long, drawn-out event and will take many forms. To help communicate the Fed's plan and objectives, the Fed Chairman has recently announced that he will hold a press conference four times a year, following the FOMC meetings where new economic forecasts are included. The first of these new press conferences will be on 27 April 2011.

In addition, more recently a number of Fed officials have stated their views on the eventual pattern of monetary policy tightening. These comments have come from members of the Fed right across the 'hawk-dove' spectrum and can be summarised as follows:

- Charles Plosser, President of Federal Reserve Bank of Philadelphia (a current voter on the FOMC and a known 'hawk') stated on 25 March 2011 that "the apparent strengthening of the US economy suggests it is prudent for policymakers to develop a strategy for the normalisation of monetary policy" and that failure to adjust monetary policy "in a timely manner could have serious consequences for inflation and economic stability in the future".
- Plosser favours what he calls a "systematic approach" to normalising policy, with a framework that is transparent and easily communicated. He noted that such an approach should have four elements: 1) the Fed Funds target rate should become, once again, the primary tool of monetary policy; 2) at the same time, the "volume of reserves in the banking system must shrink to the point where the demand for reserves is consistent with the targeted funds rate". He noted that this would require a "significant reduction in the size of the Fed's balance sheet, with reserve balances falling by US\$1.4tr to US\$1.5tr"; 3) the Fed's holding of securities should return to its pre-crisis state, with short-dated Treasury securities being the largest share; and 4) the Fed should make explicit its inflation objective with a numerical target.
- On 28 March 2011, Atlanta Fed President Dennis Lockhart (a current non-voter and centralist) noted that the current outlook for growth and inflation supported a continuation of the Fed's current strategy, but that he would be "prepared to support a change of policy if evidence accumulates that the low and stable inflation objective was at risk".
- On the same day, Chicago Fed President Charles Evans (a current voter) stated that he would need to see three specific developments before he would change his mind that inflation is likely to remain low and that the current stance of monetary policy was appropriate: 1) "real GDP growing much stronger than his forecast" (which is 4%); 2) "strong improvements in the labour market"; and 3) "evidence that wage pressures on

labour costs were starting to build.” He then went on to state that given there was no evidence of these conditions currently being met that “substantial policy accommodation continues to be appropriate”.

- On 29 March 2011, St Louis Fed President James Bullard (a non-voter and noted hawk) stated that “we are still feeding the fire at the moment, so I think we have to start thinking about turning this around in the near future” and that “if the economy is as strong as I think and hope it will be in 2011, I think it will be time for us to start to reverse the ultra-aggressive and ultra-easy monetary policy”. He suggested that a first step could be to reduce the quantity of bond purchases in QE2 to US\$500 billion, rather than the planned US\$600 billion.
- On 31 March 2011, Minneapolis Fed President Narayana Kocherlakota (a voter and known more as a centralist) offered the view that the Fed Funds target rate may need to be increased by as much as 75bp by the end of 2011. His view centres on a forecast for a 50bp rise in underlying inflation (as measured by the core PCE deflator) ahead of year-end. However, the caveat to this view was that such a tightening would be the right thing to do “if you consider that monetary policy was appropriate at the end of 2010”.
- This is likely where there is considerable debate within the Fed, and at a meeting in Washington, it was pointed out to me that on a simple Taylor Rule model the Fed Funds target rate could have been as low as -3.0%, so that any rise in inflation now must take this into account. Of course, the inability to take the Fed Funds target rate below zero was part of the reason for QE2.
- On 1 April 2011, New York Fed President William Dudley (a voter) echoed more cautious sentiments, when he stated that that while the economic outlook had improved “we are still very far away from achieving our dual mandate of maximum sustainable employment and price stability.” He also went on to note that “we must not be overly optimistic about the growth outlook. The coast is not completely clear – the healing process in the aftermath of the crisis takes time and there are still several areas of vulnerability and weakness”. He nominated housing and State and local fiscal finances as these areas of weakness, while he also mentioned the recent tragic events in Japan and geopolitical risks in the Middle East and North Africa as other potentially limiting factors. These comments were very consistent with the vibe I picked up at both my meetings with the New York Fed and the Federal Reserve.

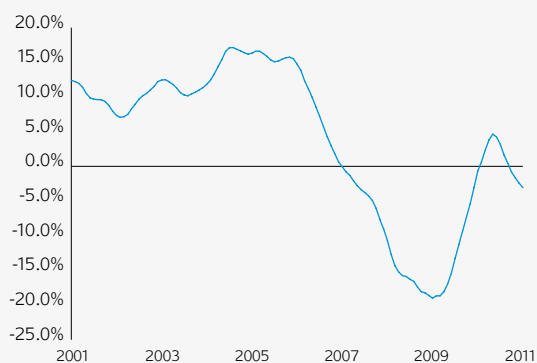
It seems clear from these comments that different members of the Federal Reserve have very differing views on both the timing of any impending tightening of monetary policy and the structure of how policy will be withdrawn.

From my observations and discussions, however, it has become apparent to me that the decision on the timing of policy withdrawal and the methods involved will rest mostly with Fed Chairman Ben Bernanke and Vice-Chair Janet Yellen. In this regard, it is commentary from these two key people that I will be paying most attention to, especially the Chairman’s first planned post-FOMC press conference on 27 April 2011.

From my discussions with the Fed, other key points worth noting include:

- Apart from wanting to get the unemployment rate down and the rate of core inflation closer to price stability (ie a rate nearer 2%), the other main focus for the Fed appears to be the housing market. This sector of the economy was described as still being a ‘worry’, with the recent signs of renewed price declines and falls in home sales likely to be a concern to the Fed. The main worry for the Fed with regard to housing is not only what it means for economic growth, but also what the implications are for the employment market and household consumption and confidence.

Chart 11: Annual % change in US house prices



Source: Bloomberg, S&P Cash Shiller House price index – 20 cities.
Data to 31 January 2011.

- The Fed specifically stated that it is not targeting asset prices in policy deliberations. But it did acknowledge that one consequence of success in the dual mandate would likely be an increase in asset prices (that is, a better outlook for the economy would likely raise equity prices and lower credit spreads).
- The Fed also holds a clear view that the current path of fiscal policy in the US is unsustainable and that remedial action to reduce the US' debt burden is required. Given this, the Fed acknowledges that it cannot set monetary policy 'in a vacuum'.
- The Fed is, therefore, watching political developments in Washington with regard to the budget and tax reform closely. There was agreement that reform of the US corporate tax system would likely be a positive for the economy, but that this needed to be done in a revenue-neutral way.

The Bank of England

The Monetary Policy Committee ('MPC') of the Bank of England (BoE) remains divided in terms of the outlook for monetary policy. Its most recent meeting (on 9/10 March) indicated a split vote; six members voted for no change in interest rates, while three voted for a tightening. Eight members voted for no change in the size of quantitative easing ('QE'), while one voted for an increase in QE. This split was also evident in my discussions with the BoE, but I sensed a growing concern over the level of inflation.

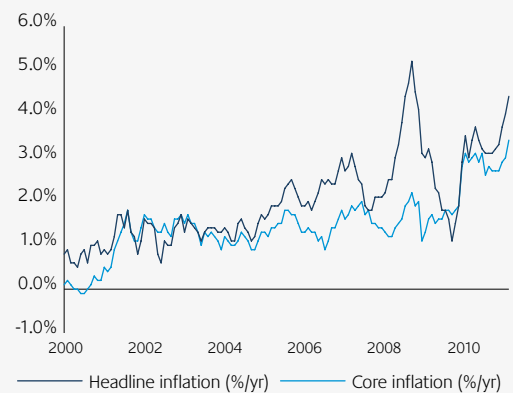
As shown in Chart 12, both the headline and core rates of inflation in the UK have been trending higher and are well above the BoE target of 2%. Much of this increase can be put down to 'one-off' events, such as the rise in commodity prices, the increase in the VAT rate as at 1 January 2011 and the weakness of the British pound.

However, the issue for the BoE is that both the headline and core inflation rates have been above the 2% target for so long that, despite the 'one-offs' involved, this higher inflation rate could become embedded in price expectations and lead to higher inflation in the future. It was also pointed out that core inflation in the UK has been persistently higher than the BoE had been expecting.

It seems to me that given this persistently above-target inflation rate, the MPC will vote to start tightening monetary policy (the cash rate is currently only 0.5%), following on the heels of the expected tightening from the ECB (see below for details). Further rate hikes should then be factored in for the remainder of 2011 and into 2012, perhaps taking the cash rate to around 2.0% – a level that could still be considered neutral at best.

The other issue for the BoE is that it will also need to unwind its QE. This will eventually entail selling £200 billion of bond holdings back to the market. This could still be some time off, even as interest rates are raised; the point was raised with me that the maturity of the BoE's bond holdings is around 12-13 years (much longer than the Fed's) and so they are unlikely to be held on the balance sheet until maturity.

Chart 12: UK headline and core CPI (%/yr)



Source: Bloomberg. Data to 28 February 2011.

“The bottom line seems to be, however, that the ECB views global monetary policy as too loose and it seems willing to very shortly start playing its part in redressing this imbalance.”

The European Central Bank

If the focus in the US Fed is more skewed to employment creation, then when visiting the European Central Bank (ECB) in Frankfurt one is left in no doubt what the focus is – headline inflation.

There is a number of ways that this can be seen: In discussions with senior staff members of the ECB (which I was fortunate enough to arrange); in looking at the sign in the foyer of the ECB that is shown below (it is worth trying the online game at www.ecb.europa.eu/education – hours of fun in an airport lounge); and in reading through the complimentary copy of the 78 page report “Price stability: Why is it important for you?” that can be obtained from the ECB gift shop.

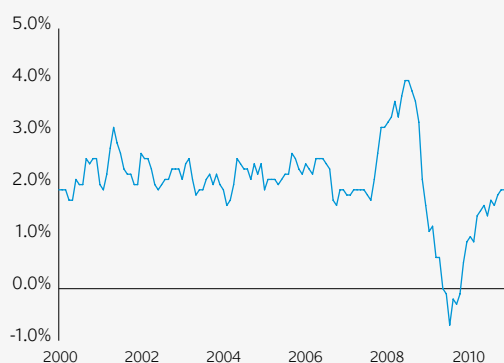
The ECB target is clear for all to see – headline inflation!



Source: CFSGAM.

So the focus on headline inflation at the ECB is everywhere to be seen and is a constant theme in discussions. The mandate for the ECB is ‘price stability’, defined generally as headline inflation at, or just below, 2%. The eurozone annual headline inflation rate recently rose to a preliminary 2.6% in March, up from 2.4% in February and sharply up from the low of -0.7% per year in mid-2009.

Chart 13: Eurozone headline inflation rate (%/yr)



Source: Bloomberg. Data to 28 February 2011.

As can be seen from Chart 13, the annual pace of inflation has been accelerating sharply since the low of mid-2009 and the trend seems clear. In my discussions with the ECB (where I met with both an economist who focused on the macro-economy and another who focused on the fiscal position) it was clear that the ECB was heading rapidly towards a tightening of monetary policy.

This tightening bias was subsequently reinforced by the ECB at its early March meeting, where ECB President Trichet stated that “strong vigilance is warranted with a view to containing upside risks to price stability”. He also stated that “an increase of interest rates in the next meeting is possible”, although he did add that such an increase was “not certain”.

It seems clear, however, that any near-term monetary policy tightening is likely only the first in a series of moves. In my discussions at the ECB it was clear that it holds the view that globally, monetary policy (and fiscal policy for that matter) is too easy and that, along with a number of other central banks, the ECB has a significant role to play in returning monetary policy to a more normal setting. The ECB did acknowledge that the Reserve Bank of Australia (RBA) had led the way in this regard. From my discussions with both the SNB and the BoE, it seems clear to me that other central banks around Europe will follow the ECB and begin to tighten monetary policy once the ECB makes the first move.

On the actual outlook for inflation, the ECB is forecasting inflation to remain above 2% for 2011, but then for it to fall back to just under 2% in 2012. This decline is based, however, on ‘technical’ assumptions on commodity prices, foreign exchange rates and wages – with the risks to these skewed to the upside in terms of their inflationary impact.

On wages, it is worth mentioning that the ECB's primary concern seems to be that wages growth in Germany, which can be justified on increased productivity, could spill over to other EU nations where productivity increases do not exist to the same extent. For the ECB, the critical factor to focus on is inflationary expectations. It is clear that the ECB sees the need to tighten monetary policy to ensure the recent run higher in headline inflation does not become embedded into higher inflation expectations.

The other key factor to appreciate within the ECB is the very strongly held view that the operation of monetary policy (ie raising interest rates) and the provision of liquidity to the distressed sovereigns (ie Greece, Ireland and, most likely, Portugal) and some parts of the banking system (ie the Spanish 'cajas') are completely separate issues.

The progress that has been seen at recent meetings at the level of Finance Minister and Leaders in setting in place a more robust structure to support the indebted sovereigns and further stabilise the banking systems over the past few weeks will only strengthen the ECB's desire to begin tightening monetary policy.

To be clear, the ECB sees absolutely no problem in tightening monetary policy for the EU economy. At the same time, various EU wide authorities will be providing liquidity support to a number of jurisdictions and sectors of the financial system. This is obviously a very different mindset from the Fed, that sees its balance sheet and interest rates as two arms of monetary policy.

The ECB was also happy to talk about the stance of monetary policy around the world; the situation is clearly worrisome. As noted, the ECB made the point that globally both monetary and fiscal policy is too loose, given the expected level of GDP growth and the inflation outlook.

The ECB is concerned that the recent rise in some key commodity prices could be a permanent shift higher (due to the changing structure of developing economies, such as China), and that this permanent shift will have an impact on headline inflation.

In this regard, the ECB suggests it is possible to not tighten monetary policy in response to the initial impact of higher commodity prices on headline inflation, but that central banks must be vigilant to these higher commodity prices feeding into inflation expectations and wage demands.

The danger of this occurring was seen as high now, given that monetary policy around the world was so loose; this is a source of medium-term concern. The focus here was clearly a concern that monetary policy across the emerging world, especially in Asia, was just too accommodating, ie bond yields and bank deposits rates are negative in real terms across Asia. The only obvious exception to this is Australia – a point the ECB was pleased to concede. Indeed, the RBA seems to be held in very high regard among the 'official family' in all the meetings I held in the US, UK and EU.

The bottom line seems to be, however, that the ECB views global monetary policy as too loose and it seems willing to very shortly start playing its part in redressing this imbalance.

For a more detailed analysis of the EU fiscal policy outlook and the operation of EU liquidity and financial support to distressed sovereigns and parts of the banking system, please see the Fiscal Policy section below.

Swiss National Bank

The SNB expects the Swiss economy to grow by around 2% per year in 2011, down a little from the post-recession recovery level of 3.0%/yr as at the end of 2010. The unemployment rate in Switzerland is just 3.6% and the level of employment is at an all-time high. Switzerland has also been enjoying rapid growth in its exports to China and other emerging markets. These exports have been in pharmaceuticals, precision machinery/equipment and watches and jewellery.

The fiscal and debt fundamentals of Switzerland are very strong, with a modest budget deficit (1.3% of GDP expected in 2011) and government debt levels of just 4% of GDP; similar to Australia.

The other important issue for the Swiss economy is headline inflation, which is currently close to zero (0.5% as at February). This is much lower than the SNB's 'price stability' target of around 2.0% and has largely been a function of the very strong Swiss Franc ('CHF').

In essence, the SNB had allowed the CHF to tighten financial conditions, and lower inflation pressures, while the official cash rate remains at a very low 0.25%. Interestingly, through 2009 and to mid-2010, the SNB had been working actively to limit the rally in the CHF, but over the past eight months or so has dropped this policy – that is, as rising commodity prices increased the risk of some inflationary pressures.

“The SNB sees significant political will within the EU to keep the EU and euro currency together.”

When the discussion turned directly to monetary policy, it was clear that the SNB shares the ECB's view that global monetary policy is too easy given the macroeconomic fundamentals. The SNB did note to me that the world economy shouldn't correct one set of imbalances by creating another set and that, one way or another, the world needed to get on the way with normalising monetary policy.

In that regard, it seems clear to me that once the ECB starts this process, the SNB will shortly follow and that the path to higher interest rates in Switzerland will commence shortly.

It was also interesting to discuss the EU-area situation with a 'neutral' observer. The SNB sees significant political will within the EU to keep the EU and euro currency together. Indeed, the Swiss expect EU politicians to continue to work hard to stabilise the situation and regain control. They did note, however, that the more German money that this entailed, the more difficult this would become politically within Germany.

In typical Swiss fashion, the SNB also stated that the learning to be had from the difficulties the EU is facing is that once rules are made, ie the Growth and Stability pact, then these rules need to be adhered to. Problems only arise when people disobey the rules –if you have ever been to Zurich, you will understand that this is the way daily life is run in that city!

537	+3,27	+5,09	642	469	92372	25	21,48	85765	2,8	05/0
835	-1,18	-2,34	875	573	27212	31	26,94	21857	4,9	02/0
137,7	+2,00	-19,00	183,8	125,5	41928	6	22,95	2226	7	05/0
214	+4,39	+18,56	219,8	165,1	153533	12,5	17,12	21406	37,5	15/0
2792	-2,79	+26,22	3019	2025	84690	100	27,92	6379	60	15/0
103,5	+2,99	-18,50	131,5	99,2	16577	-		8618	8	10/0
140,1	+0,07	-7,22	161	128,2	25176	9	15,57	2036	70,5	03/0
790	-0,38	+30,29	872	584,49	32178	37	21,35	87017	12,5	19/0
254,5	+4,73	+18,37	249	193,1	320353	22	11,57	57919	11,5	21/0
49,95	+5,40	+28,62	62	38,1	670	2,8	15,45	8054	14,7	30/1

Fiscal policy

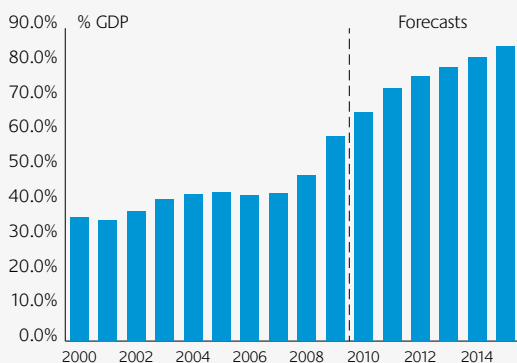
439	-17,17	-5,79	548	420	13794	22	19,95	20096		
65,3	+2,51	-27,04	92	62,5	18441	2,5	26,12	14992	4	04/0
854	+9,49	-10,58	893	573,62	30675	55	15,53	107423	2,25	10/0
975	+5,41	-16,67	1271	910	4133	105	9,29	28061	4	14/0
1065	+5,86	-8,66	1160	902	12532	55	19,36	15851	40	10/0
476	-0,83	+13,88	486,8	362,5	49142	38	12,53	14075	5,5	15/0
214,8	+2,29	-6,61	250	177,8	7728	7	30,69	355		
466	+2,08	+22,15	465	315,09	6237	20	23,30	5132	5,4	18/0
398,3	+3,86	-10,89	536,13	373,81	67870	15	26,55	8957		
145	+4,69	-42,23	297	115	1732	3	48,33	85889	3	03/0
834	+2,84	-5,33	1050	756	4142	55	15,16	120187	12	02/0
15	+11,94	-93,09	20,5	7,55	204095	-		12443	9,5	10/0
1500	-4,46	+11,94	1713	1282	7695	81	18,52	56386	4,25	11/0
372	-1,06	+4,29	411	311	12143	36	10,33	50039	6	06/0
93,55	+3,37	-63,55	259,74	83,6	129848	11	8,50	22385	22,5	03/0
287	+13,89	-35,07	446	203,1	8406	-		3098	7,5	04/0
417,8	+7,93	+9,37	460,1	355	100479	45	9,28	26457	7,5	08/0
328	+9,70	-18,81	458,5	261,2	56178	24	13,67	20179	20	12/0
169,4	-1,51	-53,46	364	163,1	7410	6	28,23	17494	10,5	09/0
4340	=	-23,86	5680	4100	116	400	10,85	8058	4	12/0
812	+3,97	+8,41	889	708	124684	52	15,62	2541	10	08/0
176	-1,12	-55,78	405	160	760	2,2	80,00	30754	4,6	02/10
365,5	+1,81	-15,00	482	336	119	32,6	11,21	239008	3,5	04/0
243,5	-1,74	-91,49	291	238	5472	230	1,06	10023	11,5	03/0
413	+0,49	+1,98	464,9	326	3183	21	19,67	320123	2,8	03/0
42,65	+0,47	-39,93	84	42,05	1164	-		25452	1,2	05/0
214	+2,44	-29,47	310	197,5	8570	9	107,00	97400	1,5	10/0

“... there isn't a politician in the capital who doesn't understand that the US needs to significantly reduce both its annual budget deficit... and its level of government debt.”

United States

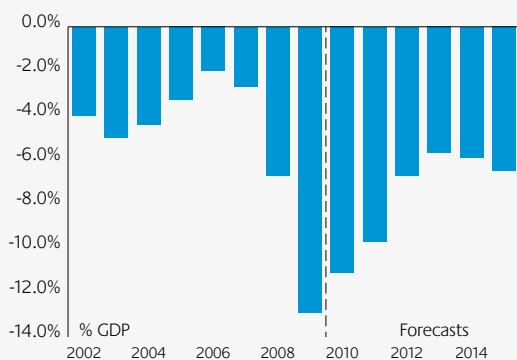
The best quote I heard in Washington was that there isn't a politician in the capital who doesn't understand that the US needs to significantly reduce both its annual budget deficit (estimated on a no-policy change basis at 9.8% of GDP in FY11) and its level of government debt (with total government debt currently estimated at US\$15.1tr or just under 100% of GDP for FY11).

Chart 14: US net government debt as % of GDP



Source: IMF Fiscal Monitor.

Chart 15: US budget deficit as % of GDP



Source: IMF Fiscal Monitor.

The problem is, as I saw it, that there appears to be no co-ordinated plan or strategy to reduce either the deficit or the level of debt. Instead, because of the highly combative nature of the political process, there is a number of politicians running around Washington trying to come up with ways to reduce the deficit, but finding little overall political support to get things done. Because of this, it seems clear to me that substantial progress in repairing the US fiscal position is unlikely to take place until after the November 2012 Presidential election. Paradoxically, along with the unemployment rate, the deficit and debt situation is likely to be the focal point for the 2012 election.

Criticism among financial markets participants centred on the view that the politicians seemed to be focused on the 20% of the budget that was non-defence spending. The 20% of the budget spent on defence and the 55% or so that is social security, health and entitlements were out of bounds. This is bringing the budget debate down to arguments over a handful of spending programs that, even if they were cut aggressively, would not add up to much in the way of repairing the medium-term budget position.

There is also much discussion in the US about the need for corporate tax reform, with the current company tax rate of 35% seen as too high and internationally uncompetitive. Of course, given the budget position, any reform of the corporate tax regime would need to be revenue neutral at least and so this would require a considerable reduction in the number and scale of deductions that are allowable under the current corporate tax regime.

One economist in New York told me that the biggest issue for the future of the US budget was health. He stated that 50% of all health spending was done by the government, with a further 38% by employers and the insurance sector. I had also previously heard that the US spends about 50% more on health than most other major economies, but for no better outcome. (Life expectancy in the US was no better, and in some cases worse, than the rest of major economies).

To improve the health spend and its impact on the budget there needed to be much better price-signalling of the cost of health procedures and a breakdown of the State barriers in healthcare and insurance. In that economist's opinion, the new healthcare legislation by the government would make the situation worse and not better; the government has added 32 million people to the health system without being clear on how this would be paid for.

In addition, a number of the ‘freshmen’ Republicans were making legislation for the ‘continuing resolution’ of government and raising the debt ceiling (currently at US\$14.3 trillion) contingent on introducing significant budget cuts. Given that the debt ceiling is expected to be breached in late April or May (Treasury Secretary Timothy Geithner has since nominated that the US will reach its debt limit no later than 16 May), the politics around this could be increasingly divisive and a source of concern for markets.

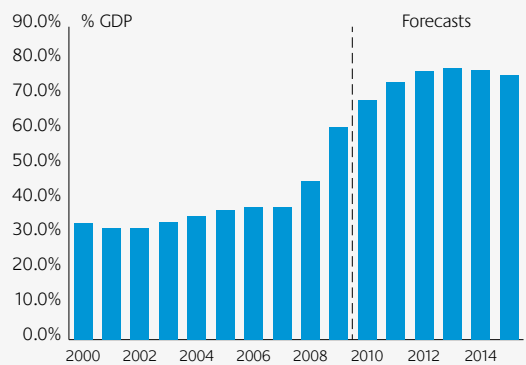
So, unfortunately, it seems unlikely that the US deficit and debt position will be reduced significantly until after the November 2012 election, even though the focus on the debt level in Washington is very high. Without a co-ordinated and bi-partisan strategy, it is hard to see how significant progress can be made. For financial markets, especially the bond market, this is likely to present an increasing risk as the months go by.

United Kingdom

As stated above, the recently elected UK government is embarking on significant fiscal policy tightening. This stance was reiterated at the 2011 Budget in March. The 2010/11 budget forecast was revised to £146 billion, or 9.9% of GDP, while the 2011/12 deficit is estimated at £122 billion (a little over 6% of GDP). The 2011/12 number is £5 billion higher than the previous estimate, due to both lower than expected growth and higher inflation. By 2015/16 the deficit is expected to have fallen to just 1.5% of GDP, although this is higher than the 1.0% estimate shown last November.

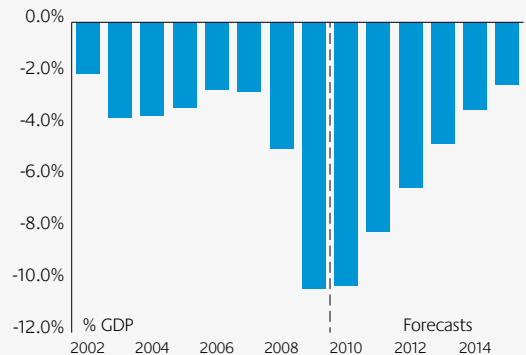
However, the surprises in the Budget were the decisions to reduce the corporate tax rate by 1% from April; to raise the personal allowance before income tax is paid by an additional £630 from April 2012; and to postpone inflation-related increases in the fuel duty and cancelling the above-inflation element. However, because of the ongoing need to reduce the deficit, these measures were funded by an increase in taxes on North Sea oil companies, increasing the levy on banks and clamping down on tax avoidance.

Chart 16: UK net government debt as % GDP



Source: IMF Fiscal Monitor.

Chart 17: UK budget deficit as % of GDP



Source: IMF Fiscal Monitor.

“Put bluntly, the EU authorities can handle having to fund Portugal... but would find Spain much more difficult.”

Europe

To say that the fiscal and debt situation of the EU is complex would be a huge understatement. Since returning from my meetings in London and Frankfurt, the EU sovereign debt environment has continued to evolve. The political crisis in Portugal has brought that country closer to having to formally request support from the European Financial Stability Fund (EFSF). Various Finance Ministers and Leaders are also working hard to formalise changes to the EFSF and creating the European Stability Mechanism (ESM) and other mechanisms to bring some control and order back to EU fiscal and economic fundamentals.

When thinking about the EU ‘debt crisis’ there are four key factors that need to be kept in mind. In various ways, there are being worked through by EU authorities:

1. Fiscal developments
2. The health of the banking system
3. Economic growth outlook, and
4. Political stability.

Fiscal developments, ongoing reform of the banking system and the political outlook are discussed below, with the economic view having been covered above.

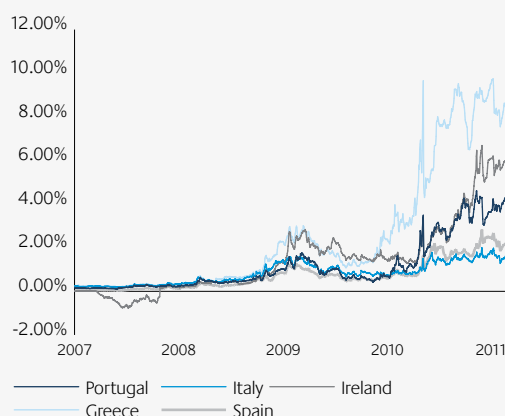
In my meetings in London and Frankfurt, I was informed more than once that the ‘line-in-the-sand’ for the debt issues in the EU was between Portugal and Spain. Put bluntly, the EU authorities can handle having to fund Portugal (with an estimated total net government debt of €135 billion), but would find Spain much more difficult (net debt was estimated at just under €570 billion in 2010).

After failing to get his planned fiscal austerity package through Parliament in late March, the Portuguese Prime Minister, José Sócrates kept to his word and resigned. Most recently the fiscal fundamentals of Portugal have been revised higher and, combined with the political crisis, a formal request to the EFSF cannot be far away. Recent estimates put Portugal’s budget deficit for 2010 at 8.6% of GDP (up from 7.3% previously) with a decline to 4.6% expected in 2011. Total government debt is now estimated at 92.4% of GDP in 2010 (up from a previous estimate of 82.4%) and reaching 97.3% in 2011 (previously 87.9%).

The key short-term issue for Portugal is that it must refinance a combined €9.2 billion of debt in mid-April and mid-June. As shown in Chart 18, the market has clearly increased the cost of this debt for Portugal, making a formal application to the EFSF highly likely. In total, including some financing for recapitalising parts of the banking system, if Portugal was to approach the EFSF for a three year funding deal, the sum involved is estimated to be around €80 billion.

In terms of Spain, fortunately, at 54% of GDP in 2010 and an estimated peak of 72% in 2015, Spain’s net government debt is relatively low (prior to the global financial crisis it was at just 26.5%) and so there is little real threat to Spain’s sovereign debt in the near term. The key issue for Spain is the savings banks or mortgage lenders, known as the ‘cajas’. These banks had been large lenders to the housing market in Spain and they have, not surprisingly, come under immense pressure since the collapse of that market. See below for more details on this issue.

Chart 18: Bond yield spread above Germany (%)



Source: Bloomberg. Data to 1 April 2011.

In my meetings at the ECB, I also had discussions with one of the key people looking at the fiscal and debt situation. He described the increase in government debt levels within the EU from an average near 60% of GDP to an average of 80% as ‘worrying’. He stated clearly, however, that the 60% of GDP government debt limit was still a very important pillar of the Growth and Stability Pact and that the aim of all the reforms being put in place in the EU was to return each country to this level – although he did concede that the range in debt levels across the EU was huge. The ECB representative I spoke with did make the point that, compared to the UK, US and Japan, the level of government debt across the EU as a whole was ‘not too bad’.

In terms of budget deficits, the ECB also made it clear that the 3% of GDP deficit limit will still apply. On current estimates, the EU average budget deficit will be back to 3% of GDP by 2013 and all EU countries – with the exception of Ireland – will be under the 3% limit by 2015. But this is, of course, only the current projection and, as we have seen in recent years, some of these forecasts aren’t particularly accurate!

The ECB also made the point that the countries currently getting financial support, and those that might need to do so in the future, need to have strong incentives to continue to reduce their deficits. Like any good parent would know, bad behaviour should not be rewarded!

In this regard, I was advised to keep an eye out for the April 2011 edition of the ECB's monthly bulletin, which will include an article on 'Ensuring Fiscal Sustainability in the EU'.

As noted, the EU Central Bank heads, Finance Ministers and Leaders have all been working hard in recent months to finalise a Comprehensive Policy Package, although I was warned by more than one economist not to expect this package to 'solve' the EU debt crisis.

On 24/25 March 2011 the EU leaders met and agreed on a package of reforms. These included:

- Euro Plus Pact. This was originally called the Competitiveness pact, but was renamed to reflect that it will go beyond existing EU commitments and will also be open to EU member states which are not yet members of the euro area. The Euro Plus package is mostly about structural reforms that are designed to increase the economic growth potential of the EU region.
- Raising the EFSF lending capacity to €440 billion (although the exact mechanism to achieve this outcome has not been agreed) and agreeing to enable the EFSF to purchase government debt in the primary markets.
- Signalling that the terms and conditions of lending by the EFSF to indebted sovereigns were negotiable, but this would be conditional on the behaviour of the sovereigns in need of the loans, ie Greece had its loan cost reduced by 100bp, with the term extended from 4 years to 7.5 years, in return for a commitment to future asset sales. Ireland's interest cost was not lowered, as the new government did not budge on the issue of increasing the 12.5% Irish company tax rate.
- The operational details of the ESM, which will take over from the EFSF at 1 July 2013, were also agreed, including a total lending capacity of €500 billion.
- The Growth and Stability Pact will be reformed, and new mechanisms to monitor and deal with macro-imbances, as and when they occur in the future, will also be introduced.
- A commitment to bank stress tests was also restated, with governments standing ready to deal with any recapitalisation consequences of these tests.

It must be noted, however, that these agreements must pass through the parliamentary processes of each country. The political uncertainties in Portugal could be one source of concern in this regard, while the April elections in Finland could also prove problematic.

As implied from the above, in 2013 Greece and Ireland and, one assumes, Portugal, will have to transition from being funded by the EFSF to the ESM. Opinions were divided as to whether, at that point, one or more of the sovereigns would be forced to default or restructure its debt, or whether they could continue to muddle through with ESM support.

One issue that was recently pointed out to me is the fact that the distressed sovereigns are still running budget deficits. So if they were to default on some of their current debt outstanding, or force bond holders to take a 'haircut', they would still need to shortly thereafter re-enter the markets to borrow more money – a situation that would obviously see the price for this new debt be raised dramatically.

So, it seems to me, the most likely outcome is actually the 'muddle through' scenario – as the political support among the major EU nations, especially Germany, remains very high to keep the EU-area together and operable. So the most likely outcome remains, in my view, that the plethora of new EU organisations that have been established and the abundance of new 'rules' that are being imposed will continue to provide the financing to distressed sovereigns and parts of the banking system as and when required, but that a medium-term solution to the high level of indebtedness across the EU will remain elusive.

As noted above, with much better fiscal and government debt fundamentals, the key issue for Spain is the savings banks or mortgage lenders, known as the 'cajas'.

These banks are said to have loan losses that have not yet been written down, especially related to housing, where prices could fall by as much as 30%. These banks used to be able to fund themselves through issuing mortgage backed securities into the market, but now are having to source their funding directly from the ECB. Importantly, however, the size of the problems in the 'cajas' is not seen as large enough to bring the sovereign down (unlike in Ireland). These savings banks are estimated to need around €40 billion – €90 billion of capital injection; a large amount of money, but not enough to tip the Spanish government over the edge.

“Countries currently getting financial support, and those that might need to do so in the future, need to have strong incentives to continue to reduce their deficits.”

As I have noted above, there seems to me to be a very strong political will within the EU, especially in Germany, to keep the EU together. In my view there are two main reasons for this:

1. A significant portion of the debt of the ‘peripheral’ countries that have a debt crisis is, in fact, owned by German banks and ‘saving’ the sovereigns is therefore good for German banks, and
2. If the euro was to fail, an independent German currency would likely be significantly stronger than the euro and this could lead to a rapid weakening of the German export sector and the German economy.

It is, therefore, the political challenge for Chancellor Merkel and her ruling Christian Democrats Party (‘CDU’), to keep supporting, funding and restructuring some EU sovereigns and the financial system, while also asking the German taxpayer (ie the voters) to fund a significant part of the cost. The feeling I picked up while in Germany, and as highlighted in recent local elections show, was that the patience of the German people in this regard is being sorely tested and will not last indefinitely.

It is important to note that in two recent regional elections there was a significant swing to the Greens and a loss of ground for the CDU. There has been some suggestion, however, that the good showing by the Greens in these elections could owe just as much to the debate about the future of nuclear energy in Germany, following the tragic events in Japan, rather than be related to the funding commitments of Germany for the rest of the EU.

The general consensus seems to be, therefore, that while Merkel’s CDU and her coalition partners may have had their political position weakened a little, there is not yet a serious threat to the strong political will within Germany to keep the EU together.

Another major area of interest for the EU authorities is, as mentioned above, supervision of the banking system. The first port of call for this will be the second round of ‘stress tests’ for the banking system, which are due to be completed around mid-year, although Ireland has recently completed a further stress test.

In addition, there is a new EU banking supervision architecture currently being established. The EU authorities are in the process of creating the following bodies:

- ESRB. The European Systemic Risk Board is a macro-prudential authority designed to provide logistical and administrative support to the ECB, but will be independent from the ECB. The ESRB will be based in Frankfurt. It will be chaired by the ECB President in its initial five years, will have a general board of 71 people and a steering committee.

- ESA. The European Supervisory Authorities will include three different bodies to manage micro-prudential supervision, these include:

- EBA. The European Banking Authority, which will be based in London, will develop supervisory standards for the EU banks and will help foster supervisory convergence and prevent regulatory arbitrage
- ESMA. The European Securities and Markets Authority will be based in Paris and will be similar to the EBA, but with a focus on markets, with a committee on financial innovation to ensure a co-ordinated approach to any new activities, and
- EIOPA. The European Insurance and Occupational Pensions Authority will be based in Frankfurt and will focus on the insurance and pension industry.

These institutions were operational from 1 January 2011 and will be reviewed after three years of operation.

In addition, the European Banking Authority has recently published the macroeconomic scenarios that will be used for the upcoming second stress tests for the banking system. These include both a baseline and adverse scenario. The adverse scenario includes GDP being 4% lower than the base case and an unemployment rate 1.5% higher – levels that are more ‘stressful’ than the July 2010 stress tests. The 2011 stress tests will also include a 15% drop in EU equity prices and falls in bond prices, with short-term interest rates assumed to be up by 125bp and long-term interest rates by 75bp. Declines in house prices will be country specific. The results of these tests will be published on a bank-by-bank basis in mid-June 2011.

In addition, the four major Irish banks have recently undergone their own stress tests. Based on these tests, the four banks will require €24 billion in capital, which will be raised between 2011 and 2013, but with €19 billion of this amount to be provided by the Irish Rescue Package.

In terms of the Basel III international requirements for the banks, the view was that the EU banks would be able to satisfy the new capital requirements without going to the market or deleveraging their balance sheets. Indeed, the general view was that most of the EU banks would be able to satisfy the new Basel III requirements over the 2013-2019 period. But the concern was that investors could pressure the banks into satisfying the requirements by the 2013 start-up period, rather than at the end of the phase-in period in 2019.

The view was also expressed that some of the new rules are very stringent, especially considering the view that the EU banking system is very mature and profits are relatively low.



The US Treasury Building – Washington.

The US Treasury

As I noted in my blog, the key issue for the US Treasury was the medium-term budget and debt outlook; an outlook that nobody is happy with. The real issue is not the need for medium-term fiscal consolidation, but the path to get there and what this might imply for the short-term fiscal situation – with some concerns that too much fiscal reduction now, combined with eventual monetary policy tightening, could condemn the recovery to being sub-par for many years to come.

As detailed below, the Treasury has, like everybody else in the US, witnessed the political changes towards fiscal policy and the rise of the ‘freshmen’ Republicans. The mid-term election results have sent the message that the American people are not happy with what they see as unsustainable spending, unsustainable deficits and unsustainable debt build up. US voters have seen what has happened to EU economies that have fallen into this trap and they don’t want it to happen to them.

So the need to reduce the budget deficit is clear, but the path is not. Fiscal consolidation will not happen in a straight line and this could create volatility for markets from time to time.

There is some concern that the medium-term fiscal policy outlook and the Fed’s ongoing commitment to QE has negative implications for the bond market, in that bond yields could be pushed sharply higher. However, I was confidently informed that there is little evidence that the Treasury bond market is on the cusp of a collapse that could impede the authority’s ability to keep stimulating the economy.

One of the biggest surprises of the meetings I had in the US was how little the US dollar was mentioned. The recent signs of some stability in the US dollar were seen as a good thing, but the point was made that the Treasury would be happier if emerging Asian economies (ie China) did not have artificially low and pegged currencies.

Politics



United States

As noted, there is little doubt that every politician in Washington is fully focused on the November 2012 Presidential election. I was also told that there is not a politician in the nation's capital that doesn't know that the unemployment rate will be the most important economic number heading into the election. Also, the US budget deficit and the level of government debt are too high for every voter.

The White House – Washington



Source: CFSGAM.

As mentioned, however, there does not seem to be an overall plan or strategy to reduce the unemployment rate (except by the Fed) and to bring the budget and debt situation under control. The lack of strategy, especially with regard to the budget, is creating space for any number of politicians to present their 'strategy' as the right one and to bring on significant political debate. This seems to be especially true of the 'freshmen' Republicans who were elected at the November 2010 mid-term elections and who the Republican leadership are apparently finding difficult to control.

To put this in context, at the mid-term elections, 97 new members of the House of Representatives were elected (out of a total of 435 in the House), of which 92 were Republications. (Note, to pass legislation in the House you need 218 votes, with the Republicans holding 242 seats and the Democrats 193.)

The new House members are generally anti-Obama (some, it was suggested to me, with a racial overtone), anti-Washington and pro-Tea Party. It was also suggested to me (by a pro-Democrat) that the new Republicans don't care if their actions hurt the US economy in the near term, as this would likely help them win the 2012 Presidential election.

But, it was also pointed out to me that the 'freshmen' Republicans were not just elected by registered Republican voters, but that a large number of independent voters (that is, those not registered for either major party) also voted for these candidates.

In the Senate some 'moderate' Republicans and Democrats were attempting to work out a co-ordinated budget package, but progress has been slow.

I have also been asked many times who the likely Republican candidates are for the 2012 Presidential election. As I detail below, by far the most visible Republican throughout Washington is Sarah Palin. However, and this is going to show my personal bias, I think fortunately she was not mentioned as a serious candidate by the political analysts and lobbyists I spoke with.

The names most mentioned were Mitt Romney and Mike Huckabee – both have had a run at the Republican candidacy before – and Jon Huntsman, who has recently returned to the US after being ambassador to China, a post he was appointed to by President Bush (George W) and reappointed to by Obama. Other potential names to keep an eye on include Tim Pawlenty (Governor of Minnesota), Hayley Barbour (Governor of Mississippi) and Mitch Daniels (Governor of Indiana).

The general view was that, this far out, there was a slight edge to Barack Obama being re-elected, as incumbency is usually a significant positive. However, as stated, the level of the unemployment rate and its trajectory will be vitally important for Obama's re-election, as will progress on the budget deficit and debt. It was described to me, however, that the 2012 Presidential election will be a 'knock-out and drag-out fight' that could cause some market volatility until it is run and won.

“The level of political intrigue in discussion about who will replace Jean-Claude Trichet as President of the ECB when his term expires in October was amazing.”

ECB leadership

I have included this section under ‘Politics’ rather than ‘Central Banks’, because the many discussions I had about the future leadership within the ECB seemed to me to have more to do with politics than appointing the best person for the job. The level of political intrigue in discussion about who will replace Jean-Claude Trichet as President of the ECB when his term expires in October was amazing.

Of course, the perceived front-runner for the job was the former-President of the German Bundesbank, Axel Weber. This was not only because he was eminently qualified for the job, but because there is a widespread expectation, certainly within Germany, that given Germany will provide the largest share of the money to the EFSF and upcoming ESM, that Germans should be running the major EU organisations.

So it came as quite a shock when Dr. Weber announced in early February that he would be leaving his position as President of the German Bundesbank and that he would not be standing for the ECB Presidency. I encountered many theories as to why Dr Weber had decided to take this course, but the most often repeated reason was that he was opposed to the ECB’s balance sheet being used to help soak up the debt of stressed EU nations, that is, he didn’t like the idea of the ECB buying government bonds in either the primary or secondary markets, preferring to keep the ECB’s focus on monetary policy and the stability of the financial system, while other government institutions dealt with the issues of sovereign debt. The view was that he clashed with German Chancellor Angela Merkel on this and that, in the end, she did not feel compelled to support him.

So the question now becomes who are the most likely candidates to take over at the helm of the ECB? In my discussions, the name of three current heads of central banks kept coming up: Mario Draghi from Italy, Nout Wellink from the Netherlands and Erkki Liikanen from Finland.

Draghi is currently Governor of the Bank of Italy and is also Chairman of the European Financial Stability Board, a position he has held since April 2006. By all accounts, from my discussions, he is a very talented person and should be the front-runner for the ECB Presidency. But, it was put to me that he was unlikely to win the position as he was not from the ‘solvent north’. Furthermore, from 2002-2005 he was a member of the international management committee of a large US investment bank, of which some in Europe do not hold a positive view. Both of these factors could rule him out of the job.

Wellink has been President of the Bank of Netherlands since 1997 and is well regarded. The Dutch Finance Minister has stated that he would be happy to support Wellink moving to the Presidency of the ECB, but made the obvious point that it could be difficult for a Dutchman to take over the role given that the first ECB President, Wim Duisenberg, was also a Dutchman.

Liikanen has been Governor of the Bank of Finland since mid-2004. Being from the ‘solvent north’ will help his chances, as will the view that he could be a good ‘compromise candidate’. There may be some resistance to the ECB President coming from such a small economy.

The other potential candidate to take over running the ECB could be Jens Weidmann, the man who has taken over from Axel Webber running the Bundesbank. Weidmann is a former student of Weber’s and, until recently, was the economic advisor to Chancellor Merkel. However, at just 42 he will be the youngest ever President of the Bundesbank and is considered too young to run the ECB. It wouldn’t be surprising, however, to see him become the primary candidate next time around and there is the potential for one of the other current candidates to be given a shorter-than-normal term (ie less than the standard eight years) to give Weidmann a few years under his belt at the Bundesbank before stepping up to the ECB position.

As can be seen, therefore, the future of the ECB Presidency remains very unclear. With policy tightening shortly expected to get underway and the debt situation of a number of EU nations still very problematic, this appointment will be a critical one not only for the EU, but the global economy.

Of course, many nations in the EU are undergoing political challenges. As stated, in Portugal the Prime Minister has resigned and the President will need to arrange elections in the next few months. There was obviously a change of government at the recent Irish elections and Chancellor Merkel’s CDU has suffered losses in recent regional elections in Germany. In addition, as mentioned, Finland will hold elections this month.

The bottom line remains, therefore, that the economic and debt consequences of the global financial crisis are now being felt at the political level, as tax-payers (ie voters) make their displeasure known to the political leadership.

I remain doubtful, however, that these political changes will actually lead to a significant reduction in support for the EU. As stated above, I remain of the view that the ‘muddle through’ scenario remains the most likely for the EU. This will, no doubt, from time to time, lead to increased uncertainties and volatility in markets, but it is probably the best outcome that could be hoped for.



Anecdotal stories



Finally, I have included below some of the more interesting anecdotal stories from my travels throughout the US, UK and Europe. They have been included to provide a little further insight into what is happening on the ground in these economies, and I trust that you find them interesting and informative.

The Australian dollar: The first thing you notice about overseas travel these days is how the strength of the Australian dollar makes everything seem cheap, especially in the US. At parity the shopping opportunities available in New York are extensive and the variety attractive. Even in London, bargains can now be found, especially in sporting equipment. My children and my wardrobe were, therefore, major beneficiaries of the increase in the Australian dollars' purchasing power. This is one way, therefore, in which Australians can enjoy the benefits of the changing structure of the global economy, with this trend likely to be in place for a number of years to come.

New York taxi: The first taxi driver I had on the first day in New York was a wealth of information and views. And, given it is a well-worn cliché that taxi drivers are a good indicator of the 'vibe' of a city, I thought I would include some of his anecdotes. He was from Nigeria and spent half of the year there running a restaurant he owned and half the year in New York driving taxis.

His view was that his economic future was probably brighter in Nigeria than it was in New York and, given the political challenges faced by Nigeria, I thought this was a pretty bold statement. He assured me that Nigerian politics would settle down after the April elections (although, by all accounts, the politics of that upcoming election look fraught with danger). Nonetheless, he assured me that there were parts of New York and New Jersey that are still boarded up – both houses and shops – and that he would not venture into. He also stated that, in his opinion, the 'bankers' had done more damage to the economy of New York than had the 'terrorists'.

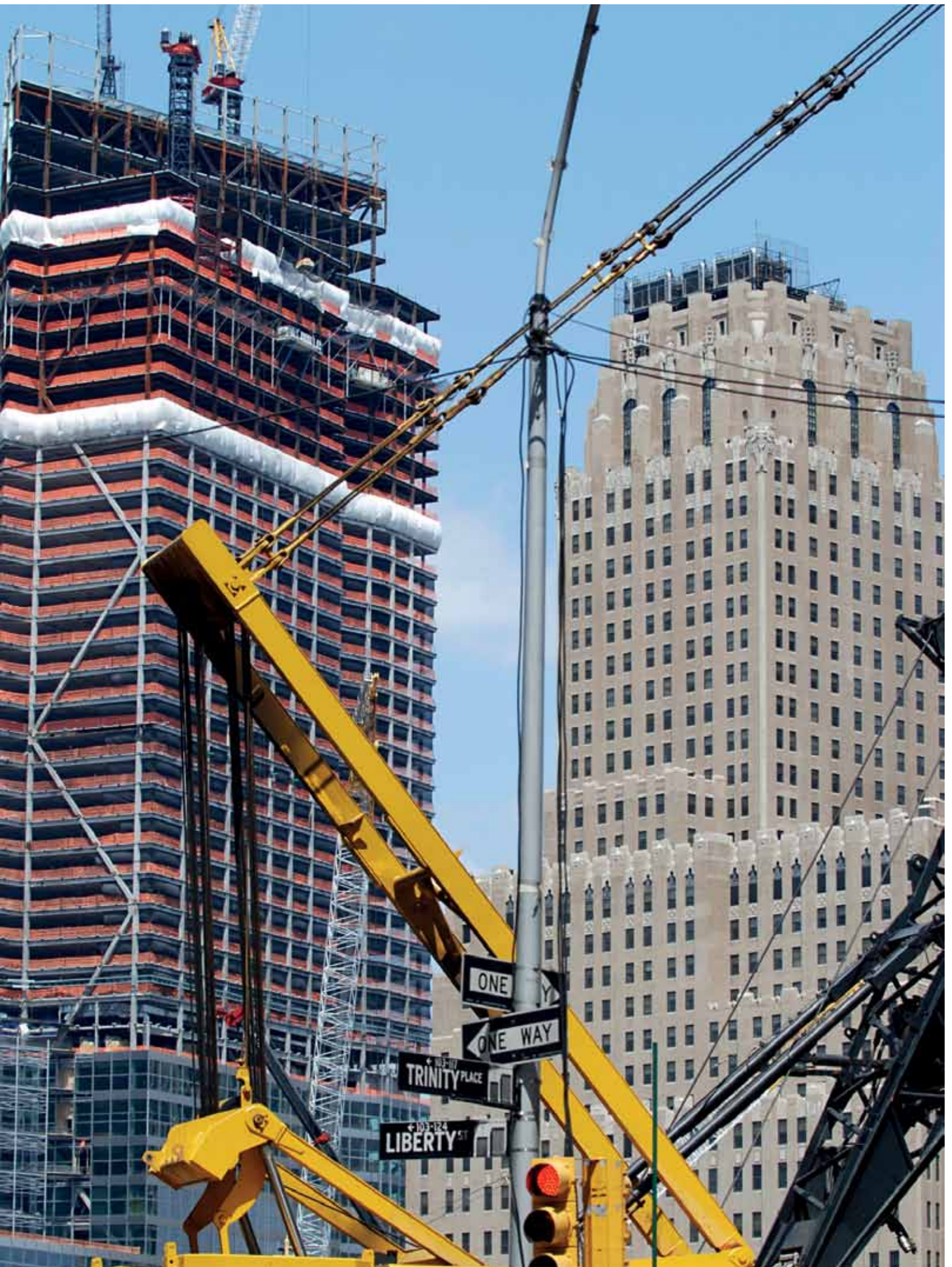
In his view the thing that attracted so many immigrants over the years to New York was the 'great American dream' of owning your own home. In his view, however, the meltdown of the mortgage market due to the financial crisis, and the subsequent sharp reduction

in the availability of credit for new immigrants to be able to even think about buying their own home, would have a big impact on immigration flow into New York, and thus hold back its economic progress. In a sense, this is one way in which we can see the human consequences of the global financial crisis.

He knew enough about markets to ask me – once I disclosed what I do for a living – why Wall St had recovered so strongly even when the economic fundamentals were so weak. When I told him it was partly due to cheap money and liquidity injections from the government/Fed he agreed, but also wondered out loud why the cheap money provided to the banking sector had not found its way down to the 'common people'. He did understand, however, why the banks needed to be 'saved' but remained far from convinced that the fundamental strength of the New York economy was returning.

In-flight Wi-Fi: One of the surprises on my flight from LAX to JFK was the availability of free Wi-Fi on the plane. While phone calls were not allowed, the free Wi-Fi allows people to browse the internet, keep sending and receiving emails and generally was a good way to pass the time. This is a feature of travel that would be extremely beneficial for long haul flights and would be a welcome addition to international carriers and Australian-based airlines.

New York construction: As I mentioned in my blogs, it seems that the only construction of any significance being undertaken in New York City is the new buildings going up on the World Trade Centre ('WTC') site. The two main buildings, one of which is shown below, will be very substantial structures and will occupy the outer limits of the WTC site. The middle of the site will be covered by memorials to the twin-towers and the people who lost their lives in that terrible tragedy on September 11, 2001.



World Trade Centre site.

Washington taxi: Another taxi driver that gave me a good insight into events was in Washington. He was originally from Morocco and was full of information about the political developments in the Middle East and North Africa. From his point of view, the biggest issue for the citizens of these regions was the level of corruption.

He stated that because many of the leaders had been around for so long, lots of people of working age had never known any different political leadership. Modern communications and information has made them realise how poor their political leaders are. He reinforced the view that the level of corruption was a constant source of frustration and acted to hold back anybody with a bit of entrepreneurial spirit or determination to improve the lives of their family.

So he was not the least bit surprised that given an opportunity to turn against the long-time leadership in many countries, the 'people' had responded to the situation very quickly and defiantly.

As an aside, when he found out that I was from Australia, he checked with me that the Queen of England was still our head of state. Without trying to explain the subtleties of our constitution and the role of the Governor General, I agreed that the Queen of England was, indeed, Australia's Queen. He advised me that this needed to be changed and that we should have a revolution in Australia to 'get rid of' the Queen. He was completely dumbfounded when I informed him that that was not the way things are done in Australia and that we actually had a vote in 1999 and decided to retain the Monarchy!

Washington gift shops: While in Washington I had some time to visit some gift shops around the White House. In these gift shops one can buy any number of coffee mugs, caps, t-shirts, books and all manner of kitsch featuring US politicians – including life-sized cardboard cut-outs. In these gift-shops three people are largely featured – Barack Obama, Michelle Obama and... Sarah Palin. It was amazing, and more than a little disturbing, to see the former Vice-Presidential candidate so heavily featured in all the shops. But, as I mentioned above, Palin is not considered a serious candidate for the Republican nomination for the November 2012 election and I could not help but get the feeling that she has peaked way too early.

At this point it is probably worth stating that this was my first trip to Washington – and I was very impressed. On the weekend I had the opportunity to do one of the hop-on, hop-off bus trips. I must say that the Arlington cemetery was very moving, not least for the JFK 'eternal flame', but also for its size. Row after row of gravestones

really sends home the scale of lives lost in US wars, while the tomb of the Unknown Soldier was also especially moving. Apart from that, the Lincoln memorial is truly amazing, as are the WWII and Vietnam memorials. The Capital Building is also very impressive.

But the highlight of my time in Washington (apart from the meeting at the Fed) was visiting both sites of the Aero-Space museum. In the city the museum contains many of the original Apollo vehicles, including a few that were actually on the moon, as well as some original and replica Wright brothers' flyers. In the larger site near the airport the highlights are, without doubt, the Space Shuttle Endeavour, the Black Bird plane that broke the Mach 3 speed barrier and the Enola Gay. It is well worth a visit.

Canary Wharf: I expected to find the financial district of Canary Wharf in London a shadow of its former self. It had been three years since I was in London and to say that much had changed in the financial world over that time would be a bit of an understatement! To my surprise, the Canary Wharf district was very busy and full of economic activity. The line of people to get through security at the two banks I visited at Canary Wharf was about 10 people long and the shops under the main financial area were all very busy and doing a brisk trade.

Most obviously, the Jubilee Line tube station under Canary Wharf was absolutely packed. Trying to get out of there around 5:30pm on a Thursday afternoon was extremely difficult. Because the trains were a little delayed, the platform was so packed that they stopped the escalators and made people wait up-top until a few trains came along and cleared the crowd. In Central London, things also looked pretty busy, especially around the Piccadilly/Oxford Circus shopping area.

I was reliably informed, however, that these signs of economic strength were limited to the centre of London and that in greater London and in regional areas of the UK the economic environment was very different. This proved to be the case on my trip to Edinburgh.

Edinburgh: I always enjoy going to Edinburgh. On this trip I took the opportunity to visit Edinburgh Castle and take a walk down the Royal Mile. As always, this is a great experience, but it was obvious to me that there were very few other people looking at the tourist attractions (albeit it was mid-February). There certainly did seem among the people of this part of Scotland some genuine concerns over the economic future, especially given the deep fiscal policy cuts to come and the ongoing uncertainties with some of the region's most important banking institutions.

Frankfurt: Without trying to offend any of my German readers, Frankfurt is not exactly a party town. As the home of the ECB and a number of very significant German banks, it is, however, an important financial centre. But the open malls along the way to the Opera House are very attractive and the quality of the shops and restaurants is high – and, with the strength of the Australian dollar, not too expensive these days.

As those who have been to Europe will know, a great way to get around is by train. I took the ICE from Frankfurt to Zurich. It takes a little over three hours to make the journey, a little longer than the flight, but the train leaves from the centre of Frankfurt and arrives in the centre of Zurich, without all the hassle of airports. The efficiency of the trains is something to behold. The Frankfurt station master apologised to the customers because the train was running three minutes late, but we were able to make up that time on the trip. One can order a meal from one's seat and connect to the free Wi-Fi... all very efficient. It only makes me wonder why a country like Australia can't seem to get its act together to replicate this fast and efficient system of travel.

Zurich: Zurich often wins international prizes for being the world's most 'liveable' city. It obviously helps if one has plenty of money, which lots of the residents do, but Zurich works, as I have stated above, because of the rules. There are rules for everything – from how to drive on the roads to how to pack recycling (all newspapers/paper/cardboard etc must be stacked in neat piles and tied together with string if the garbage men are to take it away). But the reward for obeying all the rules is that things get done and the quality of living is high.

I also took the opportunity to visit Davos (pronounced Da-Vos by the locals, not Dav-os). Apart from being the centre for economic thought as the town that hosts the World Economic Forum (which was obviously my main reason for going to the region), one can also do a spot of skiing if the opportunity arises. For 50-60 for a day ticket, one can ski on some of the world's best mountains, with groomed runs and no waiting for the fast and efficient gondolas, lifts and t-bars. It certainly puts paying over A\$100 a day to ski on the mountains we have in Australia into perspective!

The mountains in Davos



Source: CFSGAM

Stephen Halmarick – biography

Stephen Halmarick is Head of Investment Markets Research at Colonial First State Global Asset Management ('CFSGAM'), having been appointed to the position in March 2009.

Stephen is the key spokesperson on all macroeconomic themes and broader financial market issues for CFSGAM. As the Head of Investment Markets Research, Stephen works closely with all CFSGAM investment management teams to ensure a broad understanding of the macro environment impacting on markets.

He has over 24 years experience as a financial markets economist, working for companies such as Westpac, SBC Australia, Nomura and, from 1994-2009 for the Salomon Smith Barney Citibank group, where he held the title of Managing Director and Co-Head of Economic and Market Analysis.

Along with his team, Stephen also authors the Travelling Economist series, providing clients with insights and feedback on developments in key economies around the world. Stephen holds a degree in Economics from Macquarie University and a graduate diploma from the Securities Institute of Australia. He is also the current Chairman of the Australian Business Economists (ABE) and has been a member of the ABE Executive Committee for over a decade.

Further information

For further information about this paper:

Investment Markets Research

Stephen Halmarick

Head of Investment Markets Research

Telephone: +61 2 9303 3030

Email: shalmarick@colonialfirststate.com.au

Belinda Allen

Analyst, Investment Markets Research

Telephone: +61 2 9303 3110

Email: ballen@colonialfirststate.com.au

James White

Analyst, Investment Markets Research

Telephone: +61 2 9303 2645

Email: jwhite@colonialfirststate.com.au

Business Development

Joanna Davison

Regional Managing Director, Australia and New Zealand

Telephone: +61 2 9303 7007

Email: jdavison@colonialfirststate.com.au

Matt Russell

Head of Institutional Business Development
and Consultant Relationships

Telephone: +61 2 9303 7024

Email: mattrussell@colonialfirststate.com.au

Ali Karmali

Institutional Business Development Manager

Telephone: +61 2 9303 6070

Email: akarmali@colonialfirststate.com.au

Tracey McNaughton

Specialist – Fixed Interest, Credit and Cash

Telephone: +61 2 9303 2695

Email: tmcnaughton@colonialfirststate.com.au

Trent Koch

Specialist – Infrastructure Business Development

Telephone: +61 2 9303 7653

Email: trent.koch@colonialfirststate.com.au

Institutional Relationship Management

Liz Krajewski

Head of Institutional Relationship Management

Telephone: +61 2 9303 2927

Email: lkrajewski@colonialfirststate.com.au

Dan Bristow

Senior Institutional Relationship Manager

Telephone: +61 2 9303 6311

Email: dbristow@colonialfirststate.com.au

Helen Squadrito

Institutional Relationship Manager

Telephone: +61 2 9303 6142

Email: hsquadrito@colonialfirststate.com.au

Hugh O'Neill

Institutional Relationship Manager

Telephone: +61 2 9303 6116

Email: honeill@colonialfirststate.com.au

Simon Good

Senior Institutional Business Development Manager

Telephone: +61 3 8628 5681

Email: sgood@colonialfirststate.com.au

Harry Moore

Senior Institutional Relationship Manager

Telephone: +61 3 8618 5532

Email: hmoore@colonialfirststate.com.au

Nadene Moore

Senior Institutional Relationship Manager

Telephone: +61 3 8628 5615

Email: nmoore@colonialfirststate.com.au

Internal Client Relationships

Peter Weldon

Head of Internal Client Relationships

Telephone: +61 2 9303 6860

Email: pweldon@colonialfirststate.com.au

Rose Lor-Kershaw

Internal Client Relationship Manager

Telephone: +61 2 9303 2863

Email: rlorkershaw@colonialfirststate.com.au

Mark Rose

Internal Client Relationship Manager

Telephone: +61 2 9303 7431

Email: mrose@colonialfirststate.com.au

This page has been left blank intentionally.

This page has been left blank intentionally.

This page has been left blank intentionally.



