

Rundt's World Business Intelligence

Copyright 2011, by S.J. Rundt & Associates, Inc. All rights reserved. This document may not be copied or transmitted electronically in part or full without express, written permission from the publisher

No. 2,783

November 3, 2011

TRENDS TO KEEP AN EYE ON Page 2

Cuba – a noteworthy new step in economic liberalization; **Russia** – at the door of the WTO, at last; **United Kingdom** – new banking rules have their supporters, but also face headwinds.

ARGENTINA Page 2

The regime has further tightened restrictions on the foreign exchange market in an effort to hold back the slow but steady flight of capital from the country. More than likely the government will eventually be forced to condone a more rapid depreciation of the peso.

GREECE Page 4

Eurozone partners will do everything in their power to prevent a Greek exodus from the Eurozone, because the consequences would be so dire. But now that the possibility has been openly discussed and acknowledged, the question is whether November 3, 2011 will eventually be remembered as the day on which the Eurozone started to fall apart.

ITALY Page 6

PM Berlusconi, having left nearly empty-handed for the G-20 conference, is under intense pressure to come up with a much more detailed and comprehensive economic reform program for Italy than he has done to date. Whether he can actually deliver, though, is now in doubt, even though he may still win the next confidence vote in parliament.

JAPAN Page 8

The yen remains a safe-haven currency, a role strengthened by Switzerland's decision to clamp a firm cap on the franc. In the near term the markets will be cautious in seeking to drive the yen higher, But there is little doubt that the pressures will soon become pronounced again.

LIBERIA Page 10

Although Pres. Sirleaf's opponent in the run-off election on November 8 still says he may boycott that contest, the odds are that the balloting will be held on schedule and the incumbent will win re-election. The economy has been improving, but it has a long way to go.

PAKISTAN Page 11

The IMF has ended its lending program without disbursing the final tranche, because the government has been unwilling to undertake the required fiscal reforms. The Finance Ministry says the money is not needed, but this is whistling in the dark at a time when assistance from other Western sources is in question as well.

UNITED KINGDOM Page 13

The recovery will continue to struggle to gain momentum, but this will not persuade the government to ease up on its fiscal policies. Rather, the BoE is launching a second round of monetary easing. Fiscal discipline and CB bond purchases are attracting investors seeking a haven from Europe's debt crisis.

YEMEN Page 15

The economy is in a free-fall that is conjuring up the risk of a humanitarian disaster, kept at bay only because neither Saudi Arabia nor the West wants Yemen to fall apart. Pres. Saleh's position has become precarious, but repeated announcements of potential deals have led nowhere.

EXCHANGE MARKET TRENDS Page 17

FX FORECAST/MISCELL. Page 17

STATISTICAL TABLES Pages 18-20

International interest rates, spot and forward exchange rates, Euro, SDR, gold.

Trends You Should Know About

CUBA

In a rather remarkable liberalization, the regime has granted Cubans the right to buy, sell, swap, donate or pass on to heirs their homes for the first time since the early days of the 1959 revolution, in a reform that promises to lead to the creation of a real estate market and to an instant capital formation for Cuban families. To date, people have been allowed to own their homes, but not to sell them for money (except that there was a lively black market for swaps, often involving cash as the wealthier traded up). Now, the new law is likely to attract money from Cuban exiles for their family members to buy homes and small pieces of property, either for the family or as a bet on Cuba's future. The liberalization is the most meaningful yet in President Raul Castro's efforts to unshackle the economy piecemeal without abandoning the Communist system.

RUSSIA

The last major hurdle to Russia's entry into the World Trade Organization, which Moscow has been pursuing since 1993 (just two years after the collapse of the Soviet Union) has been removed with the agreement by Georgia to a compromise under which an independent company, working together with Georgian and Russian Customs officials, will monitor trade flows through the disputed Abkhazian and South Ossetian territories. A working group on Russia's accession will now review the bid at a session set for November 10-11 and a final decision (undoubtedly positive) is expected after a meeting of WTO ministers on December 15.

UNITED KINGDOM

The debate is still raging about the pros and cons of the recent proposal by the Independent Commission on Banking, appointed by a government rattled by the scale of the UK banking crisis and the fact that the sector is equivalent in size to about 500% of gross domestic product, for a sweeping overhaul of the industry. The task of the group and of the ICB chair Sir John Vickers was to find ways of lowering the risks of such a crisis happening again – to alleviate the too-big-to-fail problem, make banks less failure-prone, and limit collateral damage when

failure does occur. The Commission wants banks to separate their deposit-taking operations from investment-banking services, stopping short, however, of completely breaking up the companies.

The central conclusion is the recommendation of a so-called ring-fence around a bank's traditional deposit-taking and lending businesses. Riskier activities, such as structured finance, investment banking and even some corporate lending would be placed outside this fence. A bank's ring-fenced operation is to have its own board of directors and equity capital equivalent to 10% of risk-weighted assets. But the banks are to be able to choose which non-core activities they want to put outside the ring-fence, with a deadline of 2019 to implement these changes. The two types of operations would be separately capitalized and report results as if they were two separate companies. Capital from the investment banking unit could be injected into the retail business, if needed, and the two could share customers and expertise, but all transactions between the groups would be done at arms' length.

The debate concerning the advantages and disadvantages will not be over soon. On the negative side, one has to assume that both the ring-fenced and non-ring-fenced units will face higher funding costs as a result of the higher capital requirements, the loss of implicit state support, the loss of diversification benefits, the subordination of bondholders to depositors and the costs of the new governance structures. But the ICB is counting on the emergence of a viable market for so-called "bail-in" debt, so that banks can meet the stepped-up capital requirements. The ICB also assumes that investors will accept far lower returns on equity rather than demand that banks shrink their balance sheets. No doubt, the whole thing is a gamble of which the outcome remains difficult to predict. But the Commission still argues that the long-term benefits – especially a healthier banking industry with less probability of government bailouts, will outweigh the near-term costs.

Argentina

The regime has further tightened restrictions on the foreign exchange market in an effort to hold back the slow but steady flight of capital from the country. This is just one in a series of measures taken

so far to preserve hard-currency reserves, which are a key pillar of the government's finances. More than likely the government will eventually be forced to conduct a more rapid depreciation of the peso. The question then will be whether it will still be able to control the descent.

We discussed last week that the regime of President Cristina Fernandez de Kirchner, in its first official post-election act, issued a decree ordering energy and mining companies in the country to repatriate and convert into pesos all their export earnings. The measure eliminated loopholes to a 1964 law granted to mining companies for the past eight years, under which they were allowed to keep abroad 70% of these revenues.

The reason for the clamp-down was capital flight averaging USD 3 billion a month that has become a slow but steady drain on the Plata Republic's official international monetary reserves. These assets are now down to about USD 47 billion and Banco de la Ciudad has gone public with an estimate that in October alone the country lost USD 3.7 billion, the same as in September, and that capital flight for all of 2011 will amount to some USD 22 billion, or about double the merchandise trade surplus Argentina managed to score in 2010.

Capital Flight

Behind the exodus is that better-heeled Argentines have lost all confidence in the government's official inflation statistics, trusting private calculations (these days often "published" via leaks to members of congress, since the economists proffering numbers differing from the official version risk being sued and even criminally prosecuted by the regime). These reports put monetary erosion at between 25% and 30%, while the government's numbers still are in single digits. No wonder Argentines are starting to revert to their time-tested way of hedging against the eroding value of their currency, which has always been buying dollars.

In its latest attempt to tighten forex controls, the government has ordered foreign investors buying Argentine companies and real estate to deposit the full amount of the transaction in Argentina. Insurance companies will have to bring all offshore investment home, and they will have to do so before the end of the year. Moreover, starting next Monday, the tax agency Afip will vet all requests to purchase foreign currencies at the nation's banks and foreign exchange houses by cross-checking the amount of

the purchase with the buyer's declared income. Theoretically, residents are allowed to buy up to USD 2 million of foreign exchange per month, but while the government has sought to boost the supply of dollars on the domestic market, it will presumably continue to make it more difficult to buy foreign currencies.

Trouble Spots

The regime's concern is that it needs the Central Bank's hard-currency reserves as a pool supporting its finances. The budget for 2012, for instance, calls for the use of USD 5.67 billion from the reserves to pay creditors, after the authorities borrowed about USD 9.7 billion in the current year. Also, if money keeps flowing out of the country bank lending could become squeezed, which would be bad news in an economy that relies on consumer spending as the main driving force and in which personal loans and credit cards make up one-third of bank lending.

The problem is that the quick succession of new regulations, assertedly imposed to "deter money laundering and foreign exchange transactions related to tax evasion," will be seen by the people as a battening of the hatches before a major devaluation of the peso is announced, as happened so many times in the past. Argentines are, of course, well aware that the relative strength of the peso, especially compared to the real of neighboring Brazil, is a problem that will have to be resolved sooner or later. While the official exchange rate of the ARS stands at 4.2355 per USD 1.00, the unofficial, black market has been quoting historic lows in the neighborhood of 4.4950 for some time.

Hurdles For Legitimate Payments

Meanwhile, even without people suspecting a crisis brewing and rushing to withdraw cash from the banking system, the dollar purchase regime, introduced just one month short of a decade since Argentines had their bank deposits frozen as the country headed for default on USD 100 billion in debt and a massive devaluation, the new rule to use the tax agency to deter capital flight will delay many regular outbound payments, even though this is not the purpose of the restriction.

Buyers of foreign exchange needing Afip approval will not only have to pass the income check, they will also have to declare what the cash is for. Economy Minister and Vice President-elect Amado Boudou insists that any "implementation delays" will be transitory, but past experience offers good reasons for doubting this. (11/03/11)

Greece

The country's Eurozone partners will continue to do everything in their power to prevent a departure by Athens from the Eurozone and ultimately also from the European Union, because the consequences of such a move would be disastrous and would likely last for years. But now that the taboo has been broken and the possibility has been openly acknowledged by policy makers such as Merkel and Sarkozy, the question is whether November 3, 2011 will eventually be remembered as the day on which the Eurozone started to fall apart. The political mess in Athens has certainly heightened the risks.

The leaders of Greece's Eurozone partners, particularly Germany's Chancellor Angela Merkel and France's President Nicolas Sarkozy, who had planned to make the latest arrangements to bail out Greece and strengthen the European Financial Stability Facility (EFSF) an item on the agenda but not necessarily the focal point of the G-20 summit in Cannes, were thrown for a loop when they learned that Greece's Prime Minister George Papandreou had decided to submit these arrangements to a referendum in his country. Like a flash of lightning out of a blue sky the news made it instantly questionable whether Greece would accept the bailout conditions, as the latest opinion polls clearly showed that a majority of the people took a negative view of the deal.

The unexpected turn of events jeopardized the entire mechanism of the enhanced EFSF, since under these circumstances no one would be willing to give Europe the resources for the Fund (Germany and France had hoped to rope cash-rich nations such as China and Japan into the operation and have them make contributions to the financial rescue operation). In a troubling sign, the Fund, which raises money for its activities on financial markets, on Wednesday had to pull a bond offering, citing unfavorable financing conditions. Mr. Papandreou had made the pledge on Monday night in a speech to lawmakers in his fractious PASOK party, but did at first not set a date for the plebiscite. Later, a target deadline of January was mentioned, and this raised the specter of a period of several months of uncertainty.

The response among Greece's Eurozone partners was swift and stern. Led by Germany and France,

Europe's economic and political anchors, they immediately cut off financial aid. Athens was due to receive a tranche of EUR 8 billion from its existing EU/IMF bailout facility by mid-November. Mrs. Merkel made it clear that the aid would now be disbursed only after Greece had met all the conditions and the outcome of the referendum was clear. President Sarkozy issued a similar-sounding statement, saying that the Greeks would get no more Eurozone rescue aid – “no French taxpayer money, no German taxpayer money” – until the question is answered. Greece has to make EUR 8 billion in bond payments in December, of which the first one is due on December 19, so without the financial help Athens could run out of money within weeks.

Most importantly, after many months of mounting sovereign debt problems throughout the Eurozone's periphery, during which it was pretty much taboo in official circles to even mention the possibility of one of the group's members leaving the single-currency arrangement (in a December 2009 legal opinion, the European Central Bank said that an expulsion “would be so challenging, conceptually, legally and practically, that its likelihood is close to zero), Angela Merkel minced no words when she told reporters after crisis talks, just hours before the start of the G-20 summit, that “the referendum will revolve around nothing less than the question: does Greece want to stay in the euro, yes or no?”

A Reckless Gamble?

By that time, PM Papandreou had agreed to bring the referendum forward to as early as December 4. He, too, was saying that the vote would be “not a question of only a program...” but “a question of whether we want to remain in the Eurozone.” All this, understandably, stunned the financial markets, as the hardball tactics for the first time broke with the doctrine that a member of the Zone cannot leave and that the euro is designed to last forever. In press comments around the world, Mr. Papandreou's startling decision was called perplexing, reckless, a gamble with the country's future, dangerous, frivolous, even unconstitutional in light of the fact that the Greek constitution does not allow plebiscites on economic issues, only on matters of great national importance. From a strictly political point of view, though, it was more like a Hail-Mary pass.

As head of a government and a Socialist party that have made an art form out of the exchange of public-sector jobs and favors for votes, he had agreed to implement a painful austerity regimen because he had no choice, but he has studiously postponed real structural re-

forms, well aware that downsizing and reforming the public sector would be political suicide. Faced, now, with yet another difficult vote over the debt deal, he essentially had three options, namely (a) continue on the established course, which has been leading to public unrest, rapidly growing unpopularity and dwindling governmental strength, or (b) call for early elections that he knew his party would lose by a landslide, or (c) call for a referendum that just might have a positive outcome, giving his government new legitimacy and a new lease on life and making it easier to pursue the tough policies Greece's Eurozone partners demand.

Mentioning the Unmentionable

What he apparently did not reckon with is that these partners would not – and could not – accept uncertainty and paralysis until his government gets its act together. What he also, probably, did not expect is that they would be so frustrated with him and his administration, which has failed repeatedly to meet the fiscal targets set by the international lenders, that they would actually air the possibility of the Hellenic nation having to leave the Eurozone. It has long been argued by many in academia that Greece should default on its debts and abandon the euro in favor of a resurrection of the old drachma. The argument usually is that Greece's problem is not just one of unsustainable debt, but a chronic lack of competitiveness. The country cannot return to growth, so one hears, unless this competitiveness is restored.

Most of the options that could accomplish this are seen as requiring a major real currency depreciation. A steep and sustained debasement of the euro is highly unlikely. Just as improbable is a rapid reduction in Greek unit labor costs via structural reforms, which under the best of circumstances take quite a while to make their full impact felt. A third option would be a rapid deflation in wages and prices, but this would lead to years of economic depression and make the public debt even more unsustainable than it already is. Hence, so the argument goes, why not follow Argentina's approach, which in 2001-02 abandoned a one-to-one link between the peso and the US dollar after first imposing a limit of about USD 250 a week on cash withdrawals from banks.

Greece Is Not Argentina

The powers that be in Buenos Aires ended peso convertibility in January 2002 and created an artificial exchange rate of ARS 1.4:USD 1.00. At this rate, all dollar bank accounts were required to convert and dollar debts were converted into pesos. Since the free-market ex-

change rate eventually settled near 4 pesos per dollar, most capital losses had to be borne by savers, not banks. Following this pattern, one hears, the reintroduced drachma's value could fall sharply, the new exchange rate would make Greek workers internationally competitive, producing a decline in living standards somewhere between the 18% needed to match Portugal's and the 50% required to reach Bulgarian levels. The country could return to strong economic growth within a year, it would achieve a solid foreign trade surplus, tourism would flourish, and a debt restructuring similar to Argentina's could then be undertaken which would reduce the present value of the obligations by about the same percentage as the Greek reduction in living standards.

The argument goes on to say that all this might well encourage the Eurozone's other weak economies to impose the austerity measures and reforms needed to make themselves competitive. But this is where this line of thinking goes from wishful to truly fanciful. To begin with, under the European treaties the only way a country can quit the Eurozone is to leave the European Union as well. This would deprive Athens of access to much-needed EU funding and the benefits of a single market. Secondly, after what has already happened it is hard to see how the authorities in Greece could prepare the exit from the Eurozone in complete secrecy. Failing that, they would risk a catastrophic run on the banks.

Disastrous Consequences

In a modest way, such a run is already taking place. The country's bank deposits fell by 14% last year, and roughly EUR 1.5-2.0 billion has been leaving the banks every month more recently. Central Bank figures suggest that the pace picked up considerably in October this year, when an estimated EUR 10 billion of current deposits took to flight. While the early numbers reflected largely well-heeled Greeks moving money to traditional havens such as Cyprus and Switzerland, the more recent withdrawals seem to have been made by increasingly strapped middle class citizens drawing down savings to survive, but money is still being funneled also into purchases of gold coins and storage in safe deposit boxes, or being squirreled away in mattresses.

Already, travelling Greek business people complain that their credit cards, issued in Athens, are being rejected abroad. It does not take a whole lot of imagination to figure out what would happen if Greece moved seriously toward an exit from the Eurozone. The government would have to take draconian measures, including the imposition of a deposit freeze and tight border controls.

Third, while Athens could legally redenominate assets and liabilities held under Greek law into drachmas, assets and liabilities held under international law would have to be individually negotiated in a process that could take years. Greece does have very substantial external debts that could force many of the country's companies into bankruptcy and would, most likely, cut all of them off from the international capital markets.

Fourth, Athens would not only have to recapitalize its banks but also find a way to fund its own borrowing. It is still running a fairly sizeable primary budget deficit (before debt interest payments) and unless organizations such as the IMF declared themselves willing to keep financing such shortfalls, which seems highly improbable, the government would have to fund itself by printing money, in the process risking hyper-inflation. There would also be considerable logistical challenges, ranging from the printing and distributing of new banknotes and coins to the updating of cash registers, automated teller machines, and computer networks.

Economists at Credit Suisse claim that the cost of Greece leaving the euro could be up to 20% of GDP. Their colleagues at UBS have figured out that the new currency would almost immediately drop in value by some 60% while borrowing costs would surge by at least seven percentage points, raising havoc with the balance sheets of companies. The cost would be as much as 11,500 euros a person in the first year outside the euro, and EUR 4,000 in subsequent years. And what about other members of the Eurozone's endangered periphery getting the message and hurrying to undertake the reforms needed to make themselves competitive? More likely they would quickly be caught up in similarly catastrophic bank runs and the ensuing chaos would conjure up the nasty specter of a disorderly breakup of the Eurozone.

The European Central Bank and all private and official-sector creditors would have to write off their claims on Greece and the other failing debtor nations in one fell swoop and the resulting credit squeeze would make that which followed the Lehman bankruptcy in 2008 look like child's play. The resulting chain reaction would be quick, dramatic and uncontrollable, taking the global financial system into totally uncharted territory. Given all this, Germany and France will most likely fight to keep Greece in the Eurozone, their harsh comments earlier this week notwithstanding.

Fortunately, under Greek law parliament must approve a proposal for a referendum. Mr. Papandreou did not consult Cabinet colleagues before he made his an-

nouncement, and so it came to pass that Finance Minister Evangelos Venizelos led a revolt against him, arguing that Greece's euro membership was an historic achievement "and cannot depend on a referendum." The Socialists began last Tuesday with a majority of only three seats in parliament. By the end of that day, one had resigned from the Party and three others had declared that they reject the idea of the plebiscite, leaving Papandreou short of the support he would need to carry it out. Papandreou promptly retracted his decision to hold a referendum.

He now faces a vote of confidence in parliament later today, but even if he wins, early elections are likely to be held in the not too distant future. He is reported to have struck a deal with his Ministers to step down and hand power to a negotiated interim coalition government if they help him to win today's confidence vote. In a rare show of a will to compromise, the opposition leader Antonis Samaras of the New Democracy Party declared himself ready to back the formation of such a transition government to lead Greece to an early balloting, and he also said that parliament should first ratify last week's EUR 130-billion bailout deal. So, for now, at least, the storm has blown over, but nothing has been resolved. Once again, only time has been gained, and the respites are getting shorter and more prone to unexpected twists and turns, which is troubling, to put it mildly, considering the enormity of what is at stake. (11/03/11)

Italy

Prime Minister Berlusconi, having left nearly empty-handed for the G-20 conference in Cannes, is undoubtedly under intense pressure to come up with a much more detailed and comprehensive economic reform program for Italy than he has done to date. Whether he can actually deliver, though, is now in doubt, even though he may still win the next confidence vote in parliament.

How quickly moods in the financial markets can swing these days! Late last week, with the euro doing well in the foreign exchange markets and European equities staging a much-needed rebound, it was easy for Eurozone leaders to believe, momentarily, that with their latest accord to try and deal in earnest with the sovereign debt crisis and the mounting threats against the euro they

had finally done enough to restore investor confidence in the single-currency arrangement. But reality returned with a vengeance on Friday, when it became clear that the long “letter of intent” the Italian Premier had submitted to his Eurozone peers failed to convince them and the markets (for background, see last week’s issue of these Briefs).

Italy was forced to pay more than 6% to borrow money for ten years, against less than 4% a year earlier. The problem dragged into the early part of this week, when investors shunned Italian debt again on Monday and the yield on 10-year Italian bonds rose by 0.21% to 6.10%, more than four percentage points above the yields on benchmark German bunds and above what many economists regard as the “sustainability threshold.” Simply put, doubts that Italy in the longer run will be able to keep servicing its EUR 1.9-trillion debt have not gone away. Italy needs to roll over EUR 300 billion of this mountain of obligations next year, and it is clear that a sustained rise in yields threatens to hit refinancing costs and sentiment, adding to worries that Italy could be the next crisis casualty needing emergency loans.

Too Big to Be Bailed Out

The problem is that the country is widely regarded as too big to be bailed out, so other Eurozone leaders, led by Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France, have been leaning heavily on Sig. Berlusconi to come up with a more convincing package of reforms. So have political forces at home, renewing their calls for the formation of a “technical government” comprised of bipartisan technocrats to replace PM Berlusconi’s administration and get economic overhauls through the legislative mill. The embattled Premier responded to this with renewed promises of decisive action and Italian banks led a recovery in European equities based on talk of a bond swap by the Bank of Italy and the news that the Italian Cabinet would meet Wednesday to discuss ways of ensuring the swift passage of measures to boost Italy’s growth and cut its debt. But again, the more buoyant mood did not last.

Already on Tuesday, even though the European Central Bank (acting with the Italian Mario Draghi in his first day as the institution’s president) intervened heavily as a buyer of Italian bonds and acquired an estimated EUR 5 billion of the paper, the premium Italy pays to borrow over Germany rose to a new euro-era high of 455 basis points, with investors fretting that the latest Eurozone deal was unraveling after Greece called a referendum on the measure (see country entry in this issue). It was clear to the markets that Italy could not count on the heavy

support from the ECB for long and that the risk was rising that it may be shut out of the markets for funding if yields rose to anywhere near 7%.

Deepening Divisions

It was then the Italy’s President Giorgio Napolitano met with leaders from the political opposition, exploring various options if Mr. Berlusconi proved not to be up to the task. On the other hand, the painful increases in financing costs appeared to concentrate the minds of the leading politicians in government and a Cabinet statement released after emergency meetings on Wednesday said that a series of “urgent measure to support the Italian economy” had been examined and that the Cabinet had agreed to fast-track changes previously proposed by Sig. Berlusconi.

Alas, by Wednesday night the Premier had to realize that he had failed to overcome internal government divisions and push through immediate legislation on structural reforms. Disagreements between Finance Minister Giulio Tremonti (insisting on fiscal discipline) and Mr. Berlusconi (backed by other Ministers) prevented such a deal from being struck. Instead of a decree that would have entered into law almost immediately with the President’s signature, the Cabinet merely agreed to introduce certain measures into a financial stability law that is already before the Senate, but could still be a couple of months away from approval.

Growing Threat to the Euro’s Survival?

In essence, therefore, Sig. Berlusconi went to Cannes with empty hands, armed with nothing more than a rather vague plan to sell state property, slash red tape, and roll out infrastructure projects. Considering that the latest public opinion polls show his confidence rating at a low 22%, with results suggesting that if elections were held now 45.5% would vote for the opposition as against 35.5% for the ruling coalition parties, it is not even clear whether he can still muster the political support to pass in parliament the minimalist plan that was approved on Wednesday.

In Italy, President Napolitano released a statement acknowledging that he is looking at the degree of support for reforms from outside the government coalition. Opposition parties have told him that they would back an interim government of technocrats, possibly one headed by Mario Monti, a former European Commissioner. So far, Berlusconi has refused to quit and Napolitano, while he has the power to dissolve parliament in principle,

cannot remove the Premier unless the administration loses a major parliamentary vote. But this would seem to be less and less difficult to arrange, so Berlusconi has probably arrived at the point where the days of his government could be numbered. One critical vote is scheduled for next Tuesday, to sign off the 2010 budget. This will not be a confidence motion, but it is important for government business and a defeat would emphasize the administration's inability to pass even non-controversial legislation.

The Government's Days May Be Numbered

In Cannes, his Eurozone colleagues – though focused in much of their discussion on Greece – are surely not pulling any punches in making it clear to him what is at stake. To him and many Italians, the Apennine Republic does not really deserve the treatment it has been getting from the financial markets. Italy has a fiscal deficit that is projected at a manageable 3.9% of GDP for 2011 and is receding. The government is running a primary surplus that is stronger than are those of other Eurozone members and the official aim of having a balanced budget by 2013 still seems within reach. The Italian economy is not in recession, but is growing – if only anemically.

In the eyes of other Eurozone leaders and of the markets, though, the main worry is that investors may stop buying Italian debt paper at rates the country can afford to accept. Were they to stop doing so, a debt pile would become questionable that is too large for even Germany to absorb. Berlusconi likes to say that Italy is not Greece, and indeed, it is not. It is a founding member of the organizations that became the European Union and part of what is considered the core of the group. While Merkel and Sarkozy may contemplate – even explicitly – the possibility of Greece leaving the Eurozone, Italy would be a problem of an entirely different dimension. The attacks coming from the financial markets are pushing the country to the brink, and persisting doubts about the government's ability to do what is needed will keep the pressures high. (11/03/11)

Japan

In the very near term the exchange markets will still be cautious in seeking to drive the yen higher, not sure about the extent to which the Nipponese authorities are willing to go in their fight to cap the

unit's rise. But there is little doubt that the upward pressures will soon become pronounced again, especially now that the Eurozone bailout has been made highly questionable by the Greek government's toying with the idea of holding a referendum on the matter. The yen remains a safe-haven currency, a role that has been strengthened by Switzerland's decision to clamp a firm cap on the franc.

Japanese officials have struggled all year to contain the yen's exchange market ascent, which has been undermining the economy by making the export sector less competitive overseas. After a massive round of direct market intervention on August 4, in which the Bank of Japan peppered a cool 4.5 trillion yen into the market to take steam out of the exchange rate, an all-time high for a single day, Finance Minister Jun Azumi declared repeatedly that the government, finding itself in the midst of "currency wars," would take "decisive steps" to fight speculators and prevent a further appreciation of the yen. On Thursday last week, the Bank of Japan added 5 trillion yen to its JPY 50-trillion asset purchase program in one attempt to lessen the unit's buoyancy. The Bank also decided to keep the benchmark overnight lending rate between zero and 0.1%.

All of the additional funds are to be used to buy Japanese government bonds in the hope that the extra liquidity will not only ease the pressures on the yen but will help to stimulate an economy that contracted more than the government initially estimated in the second quarter of this year. Real GDP shrank at an annualized rate of 2.1% in the three months through June, rather more than the 1.3% that had been reported earlier. Coming just as the nation recovers from the March earthquake/tsunami disaster in the Northeast that left around 19,000 dead or missing, with economists hoping that a rebound in production and rebuilding demand in July-September ended a three-quarter slump in gross domestic product and the Bank of Japan predicting that growth would accelerate in the next fiscal year, the market surge of the yen, with its negative impact on exports, has come at an especially unfortunate time and the ardent desire by government officials to bring it to a halt is certainly understandable.

No Cooperation From Other Countries

One of Tokyo's problems is, though, that while the Group of Seven rich countries joined last March in a concerted intervention to stabilize the yen following the natural disasters and the nuclear melt-down in Japan, this

kind of orchestration is not likely to be repeated now. And, forced to act alone, Japan finds its intervention to be not nearly as persuasive. Just the same, when the Bank of Japan's economic stimulus by way of a further liquidity expansion last week proved to be ineffective in reining in the yen, the institution on Monday, after the dollar had fallen to a post-WWII record low of JPY 75.31 in early Asian trading, came into the market with yen sales estimated at JPY 3 trillion (or USD 38.5 billion) to cap the rise (by one account, that of the Asahi newspaper, the intervention reached JPY 10 trillion).

In its first effect, this intervention sent the yen down as much as 5.1% against the dollar, lowering the exchange rate to a more manageable 79.50. A factor was that Finance Minister Azumi let it be known that there "was a lot more where that came from." But even so, the welcome result, predictably, did not prove to be durable. For one thing, Japanese companies were quick to take advantage as the intervention offered them an opportunity to offload dollars and buy cheaper yen. For another, there were plenty of market participants still seeking shelter from global risk and reacting to the monetary loosening taking place in other countries. Next in line to take advantage and pile into yen were hedge funds and individual investors.

Solid Safe-Haven Role

The yen is a currency with much less exposure to the Eurozone and its banks than, say, the US dollar, which greatly enhances its safe-haven role when Europe's problems are paramount in everyone's mind. In this respect, it shared a special role with the Swiss franc, but the Swiss National Bank shocked investors in September by announcing that it would intervene with unlimited amounts to prevent the Swiss franc from rising higher. This move appears largely to have succeeded, with the CHF holding below the National Bank's target level, and the fact that the franc now has an effective ceiling undoubtedly contributed to the yen's travails, making it even more a target than it already was.

The Japanese authorities, no doubt, had hoped that some of the pressure would be taken away by the agreement Eurozone leaders reached last week on a new and expanded bailout plan, but such hopes were quickly dispelled when it became clear that this accord had too many holes to offer reliable assurances. Investor sentiment became further unsettled – and the yen's attractiveness as hedge currency further enhanced – when the Greek government raised a huge question mark over the whole issue with its decision to submit the bailout play to

a referendum, of which the outcome is seriously in doubt. Adding to the problems for the Japanese government, not only can Japan not rely on other leading industrial nations to join it in an orchestrated intervention that could be effective in constraining the yen, but even last Monday's unilateral effort by the Bank of Japan was greeted with dismay in Paris, where officials have been warning of the difficulty of achieving agreement on currency issues at this week's G-20 summit in Cannes.

Unworkable "Swiss Approach"

French officials have made it clear that they have found Tokyo's intervention "unhelpful" as they are trying to achieve coordinated positions among the G-20 nations. The Obama Administration has been trying to raise a posse of nations to arm-twist China into permitting a more rapid appreciation of the yuan. It fears that Beijing will be able to point to Japan (in addition to Brazil and other countries with strong currencies that have been attempting to cap their ascent) as it rejects the pressure. In any event, Japan is highly unlikely to follow the Swiss lead on currency intervention and announce an explicit exchange rate target for the yen, since (a) the yen is not (yet) trading at extreme levels in real, trade-weighted terms (as the Swiss franc was when the National Bank laid down the red line), and (b) Japan still has more policy options.

Chances are, the Finance Ministry (which is responsible for these decisions, instructing the Central Bank on what to do) will continue to intervene periodically and unilaterally, while undertaking further quantitative easing measures at home to curtail the strength of the yen. But this is not to say that it does not view the exchange rate problem as a serious matter. While companies in Japan have been relatively quick to rebuild factories and restore supply chains after the March disasters, the strength of the yen, underscored by a 15% gain against the dollar and one of 21% versus the euro in the past couple of years, has seriously undermined the revival for many exporters.

Tactical Rather Than Strategic Plan

With the authorities using a tactical rather than strategic approach to the problem, it may be assumed that the yen, with interruptions, will continue to strengthen and that the currency dilemma will get even worse in the months ahead. Central Bank intervention of the kind undertaken by the BoJ three times so far since September 2010 tends to have only short-lived effects, and the amounts needed to achieve even this result grow with time, as the markets get used to the approach. The Bank of Japan's most recent Tankan survey seemed to suggest

that there has been a marked rebound in corporate sentiment, but a closer review of the document shows that looking beyond the near term business leaders are not nearly as optimistic.

Short-term, the manufacturing sector has rebounded more quickly than most analysts had anticipated. Industrial production has grown in each of the past five months and some companies have been hiring temporary workers and have been operating extra shifts to make up for the post-disaster slow-down. Domestic demand is expected to be bolstered by recovery-related spending. The government is preparing its third supplementary budget of the year, expected to be worth about YPY 12 trillion (USD 156 billion), earmarked mostly for the reconstruction of the battered Northeast coast. Some private economists believe that the extra spending will add two percentage points to GDP growth in 2012. But because Japan remains highly dependent on exports for growth, it is highly vulnerable to the economic woes afflicting the United States and Europe, the effects of which are compounded by the yen's strength. (11/03/11)

Liberia

Although President Ellen Johnson Sirleaf's opponent in the run-off election to be held on November 8 still says he may boycott that contest, the odds are that the balloting will be held on schedule and that the incumbent will win re-election. Voting in the first round was free and fair by the accounts of all outside observers, which made democracy an early victor. Remarkable, though, was the strong showing by an ex-warlord, who will now play a significant political role. The economy has been improving under Ms. Johnson Sirleaf's stewardship, but it has a long way to go.

Liberia went to the polls last month almost exactly eight years after the end of a devastating civil war that had left the country a shambles. The balloting pitted the incumbent President Ellen Johnson Sirleaf against a field of 14 candidates, so it was fairly predictable that she would not win an outright majority in the first go-around and that a run-off would become necessary. Just days before the elections she received the news that she had been selected, along with other women, to receive the Nobel Peace Prize, but while this did much to embellish her in-

ternational image, it seems to have had little effect at home, in a country where nearly half the population cannot read and where about 8,000 United Nations troops are still deployed to safeguard the peace.

Strong First-Round Showing

Ms. Johnson Sirleaf wound up winning 44.6% of the vote, against 32.2% for the runner-up, William Tubman, a Harvard-educated lawyer and former UN envoy, whom she will have to defeat again in the run-off. International observers have said that the voting was free and fair, making it clear that an early victor in the election was democracy in Africa, the more so as only late last year, in neighboring Cote Ivoire, a military conflict erupted between two leading presidential candidates after the incumbent refused to step down, having lost his re-election bid. While the ballots were still being counted in Liberia, parties running against the ruling Unity Party issued a statement alleging fraud and saying that "if the process continues we will not accept the results." It appears, though, that "the process" was concluded successfully and without much further ado.

Among the reasons why this is particularly noteworthy is that Liberia, a West African republic founded by freed American slaves and their children, is still under the shadow of a civil war that cost at least 250,000 lives and shrunk the economy by 90%. In 2005, in the first vote after this conflagration, the country elected Ms. Johnson Sirleaf, a Harvard-trained economist, as Africa's first female president, and she has achieved much in turning the nation's fortunes around. According to the International Monetary Fund, the economy will score real GDP growth of 5.9% this year, following gains of 5.6% in 2010 and 4.6% in 2009. Good relations with foreign governments have brought reconstruction help and relief of USD 6 billion of debt.

Much Has Been Achieved

Official international monetary reserves, which were a negligible USD 72 million at the end of 2005, have been creeping upwards thanks to increased interest on the part of the Liberian diaspora (via homebound remittances) and foreign investors. They currently stand at about USD 340 million, at which level they cover roughly two months' worth of imports – still a precariously thin cushion, but a better one than the country had until a short while ago. The President was able to attract to Liberia several big-name international investors, including AccelorMittal SA and Chevron (which is looking for oil offshore), bringing in billion-dollar deals. Delta Airlines

last year added Monrovia, Liberia's capital, to its list of destinations. So did Air France. Living conditions of most people have been showing marked improvement, year-to-year. So have virtually all developmental, governance and social indicators that the IMF monitors.

A Long Way to Go

There has been measurable progress in the construction of paved roads, the rehabilitation of primary and secondary laterite roads, bridge building, the establishment of health facilities as well as of schools and colleges, the provision of safe drinking water, and much more. But, of course, all is not positive. While Ms. Sirleaf has been boasting of a policy of "zero tolerance" with regard to corruption, little has been achieved, for all practical purposes, to rein in graft – so little, in fact, that Transparency International still ranks Liberia as the most corrupt country in the world. Nepotism and crony-capitalism still abound and Liberia is so dependent on foreign aid that this assistance, currently valued at about USD 425 million annually, surpasses the national budget of USD 396 million.

This may go some way in explaining why a former warlord, Prince Johnson, was able to put in a strong performance in the first round of the elections and has thereby gained a platform for exerting a considerable measure of political influence. Outside the country, he is best-remembered as the rebel leader who by Liberia's Truth and Reconciliation Commission in 2009 was put at the top of a list of "Most Notorious Persons," accused of killings, extortion, massacres, assault, destruction of property, torture and rape. The picture that best defines him is one from a tape showing him grinning and drinking Budweiser beer while his soldiers cut off the ear of then-President Samuel Doe, not exactly a salutary personage, in other words, regardless of what one may think Mr. Doe may or may not have deserved at the time.

Close-Fought Contest

Prince Johnson, though, is not the one whom Ms. Sirleaf is scheduled to face in the run-off. This is former Justice Minister Winston Tubman, who did well in the first round (after a campaign notably light on policy discussions and formal platforms) not so much because of his own popularity, but because of that of his running mate and Vice-Presidential candidate George Weah, who narrowly lost to Ms. Sirleaf six years ago, when he tried to gain the Presidency. Mr. Weah is a former soccer star whom Ms. Sirleaf's supporters used to deride because of his lack of educational credentials. Since then, though, he

went back to school and has completed a business administration degree from the Miami campus of DeVry University.

He and Mr. Tubman have sought to appeal to Liberia's legions of unemployed youngsters (four out of five adults in Liberia have no formal job and the average annual income is still only USD 300). They have also blasted the incumbent for the perceived corruption of her administration. So they will, if all goes according to script, give Ms. Sirleaf a good run for her money in the second round of voting next Tuesday. As of latest reports, Mr. Tubman's party, the Congress for Democratic Change, is still saying that it will boycott the runoff after claiming the first round was fraudulent. Mr. Tubman himself is still saying that he may withdraw even after his demand for the resignation of the head of elections was met. When push comes to shove, though, he is likely to participate in the balloting, and the odds favor a victory by Ms. Sirleaf. (11/03/11)

Pakistan

The IMF has ended its emergency lending program to Islamabad without disbursing the final tranche, because the government has proven to be unwilling to undertake the required fiscal reforms. The Finance Ministry says the money is not needed, but this is whistling in the dark at a time when assistance from other Western sources is in question as well. As popular discontent with the traditional political leadership is rising, a maverick able to attract massive crowds to rallies is becoming a man to keep an eye on.

It was almost exactly three years ago that Pakistan negotiated a USD 11.3-billion loan package with the International Monetary Fund in the midst of a run on the rupee in order to avoid an all-out balance-of-payments crisis. This arrangement was originally meant to last to the end of December, 2010, but when the Pakistani government found itself unable to push through the economic changes it was supposed to make to improve its fiscal situation it asked for an extension through September this year, which the Fund granted. For all practical purposes, though, the accommodation has been suspended since the end of last year, and now the extended deadline has

passed without Pakistan implementing the measures demanded by the IMF, such as overhauling the tax system and cutting back the huge amounts the government pays on subsidies, e.g., for electricity.

Home-Made Instead of Imposed?

The Finance Ministry says that the IMF's demands have become "too tough" and that the government will instead push on with a homegrown "fiscal reform" package. The IMF evidently does not believe that this package will prove to be very effective, and the subsidies, as they are currently applied, reward large (politically well-connected) companies rather than the poor. The Fund also holds that the government urgently needs to reduce its reliance on local banks for finance. As we pointed out in our report last week, the government's tax take currently is a mere 9% of GDP, one of the lowest ratios anywhere, and only about two million Pakistanis out of a population of 180 million pay any income tax at all, forcing Islamabad to rely on aid donors to bridge the fiscal shortfalls.

To protest the persistent refusal of the authorities to increase revenues, and concluding that with elections due within 16 months this state of affairs is unlikely to change, the IMF since last year has withheld the disbursement of the last USD 3.5 billion in loans from the support package. It has now ended the accommodation without making the final disbursement. The Finance Ministry insists that the country does not need the money and can make due with the (still healthy) inflows of homebound remittances by expatriates and official international monetary reserves of currently about USD 16.5 billion, enough to cover imports for about five months. In reality, though, Pakistan is headed for growing international liquidity problems, especially if relations with the United States do not improve.

Trouble Ahead

To begin with, the end of the IMF program means that Pakistan will have to start making repayments on its borrowings from the Fund early next year, with the first USD 1.2-billion payment likely to have to be taken out of official reserves. Furthermore, the World Bank and the Asian Development Bank have suspended budget support loans totaling roughly USD 1 billion and the Obama Administration recently decided to suspend USD 800 million in military aid in a show of displeasure over Pakistan's shut-down of drone flights from the Shamsi air base in Baluchistan, cutbacks ordered by Islamabad in the number of US military trainers, limits on visas for US

personnel, and other bilateral irritants. US military and civilian aid to Pakistan amounted to USD 4.5 billion in 2010. The money helps to bridge the chronic budget deficit and supports the current-account balance of payments. Officials in Islamabad have been saying that China and other allies will step in to make up for any shortfalls, but to date no specific arrangements have been announced. Chances are, if in addition to the withdrawal of the IMF and of other multilateral lenders the US keeps its purse strings tighter than it did in the past, Pakistan could fairly quickly run, once again, into balance-of-payments and currency trouble.

A New Man to Watch

Interesting in this context is that a man has become the most popular political figure in the country who has been drawing huge crowds to rallies in which he assailed the leaders of both of the traditionally dominant parties, President Asif Ali Zardari of the Pakistan People's Party and Nawaz Sharif of the Muslim League-N. He has been challenging both on issues of personal integrity, demanding that they disclose their assets or face civil disobedience. His political party, Tehreek-Insaf (Justice Party), has no seats in the current parliament. But his criticism of the establishment parties has found a lively echo among voters, especially younger ones, who have grown increasingly disillusioned with the way their country has been governed.

He is a former cricket star and has been a vocal and frequent critic of Pakistan's relations with the United States, claiming that they have been motivated by little more than money, just as these relations have been going from bad to worse. A recent anti-government rally in Lahore, led by him, attracted a crowd reported to have exceeded 100,000 – in the provincial capital of Punjab, which is a traditional stronghold of the Muslim League-N. He opposes cooperating with the United States in the struggle against militants based in the restive Northwestern regions of the country near the Afghan border and says that Pakistan should not send its own forces to conduct operations there. He also is strongly against permitting US drone strikes there, favoring a negotiated peace instead.

Restructured US Approach

In this he appears to be of one mind with some of the high-ranking officers in the Pakistani military, and to an extent, ironically, also with the Obama Administration, which is currently pushing a drive that seeks to combine continued American air and ground strikes against

the Haqqani network and the Taliban with an insistence that the Pakistani intelligence service (ISI) get them to the negotiating table. This somewhat novel strategy has emerged in the midst of a marked increase in the assaults against American targets in Kabul, including the recent suicide attack that killed 10 US personnel, in which the Haqqani network is suspected. The US government appears eager to strike a deal with the militants before the last of the 33,000 US “surge troops” pull out of Afghanistan.

But key elements within the ISI see no benefit in forcing such negotiations because they view the insurgents as the tool with which they expect to maintain influence in the neighboring country once the US and its NATO allies pull all the troops out. US Secretary of State Hillary Clinton has been calling the new approach “Fight, Talk, Build.” Wags in the press have been calling it “Reach a Cease-Fire, Negotiate, Then Wait For the Americans to Leave.” The Pakistanis have good reason to be confused. Recent drone strikes killed the third-ranked leader of the Haqqani network, two senior operatives of Al-Qaeda, and five members of the Pakistani Taliban. Yet, the US wants the ISI to broker a deal with the very militants that Washington is accusing the intelligence service of financing and arming. Chances are, even if they wanted to, the Pakistanis could probably not deliver. (11/03/11)

United Kingdom

The economic recovery will continue to struggle to gain momentum, but this will not persuade the government to ease up on its fiscal policies. Rather, the Bank of England is launching a second round of monetary easing, convinced that the recent uptick in inflation will prove temporary. The combination of fiscal discipline with record-low interest rates and CB bond purchases is attracting investors seeking a haven from Europe’s debt crisis. On the other hand, having had to face a major backbench rebellion on Europe PM Cameron will find it tough to come up with a coherent policy in this area.

The economy did a little better in the third quarter than in the second, growing by 0.5% from April-June, when real GDP inched up by a mere 0.1%, but since

most of the gain has been due to one-off factors, the uptick is not likely to be sustained. Unemployment rose to the highest level in 16 years in August. The ranks of the idle swelled by 114,000 to 2.6 million in the three months to the end of August, raising the national jobless rate to 8.1%. The increase was largely caused by a steep decline in part-time jobs. The number of full-time workers dipped by only 2,000 in the three months, while that of people working part-time receded by 175,000, but this does not change the fact that economic growth is too slow to lead to healthy labor-market trends. Not surprisingly, confidence among small businesses dropped in the third quarter. Confidence in the housing market has fallen as well, with more consumers now forecasting price declines than increases in the next year.

Pressure From Various Sources

In addition to the repercussions it is feeling from the Eurozone crisis, the British economy is also under pressure from the budget squeeze initiated by the government of Prime Minister David Cameron, the nation’s biggest since World War II. The marginal improvement in the third quarter had to do with the fact that some of the negative influences that made themselves felt in April-June were no longer in evidence, such as the supply-chain problems resulting from the March 11 earthquake in Japan and the additional public holiday to mark the wedding of Prince William and Kate Middleton on April 29, but this only means that the fourth quarter this year will be the first to provide an undistorted gauge of growth, and the result will not be very encouraging. On present indications, the economy will expand by less than 1% in the current year and by between 1.3% and 1.5% in 2012.

Against this backdrop, it should not surprise that a number of economists in the UK are urging the government to ease off its budgetary stringency, since the spending cuts take money out of the economy and lead to job reductions. It is highly unlikely that H.M.G. will follow this advice, however, since the Treasury views it as an “enormous advantage for this country of not being in a position of many other countries of having their fiscal responsibility questioned.”

No Veering From Fiscal Austerity

As Prime Minister Cameron put it in an article he recently wrote for the Financial Times of London, “we went into the bust with the biggest structural deficit in the G-7 and came out of it with a deficit forecast to be the biggest in the G-20. It is thanks to the credible plan this government has set out that today we have market interest

rates of just 2.5% -- half what they are in Spain or Italy. Earlier this month [October] the same credit rating agency that downgraded the US confirmed our triple-A rating. This confidence has been hard-won, and it can be easily lost. As Standard & Poor's made clear, the greatest threat to confidence would be if the coalition's commitment to fiscal consolidation faltered. Businesses, investors and families all over the country can rest assured that we will not falter. We will stay the course."

This is all for the good, as the Chancellor of the Exchequer George Osborne's goal of eliminating Britain's structural deficit by 2015/16 looked difficult when it was first announced and has since come to seem tougher still as various analyses, including one by the IMF, have concluded that on the government's own methodology the structural deficit is actually GBP 12 billion larger than the last budget assumed, for an increase by 25%. To get the public finances back to their health at the time of the Budget would require the equivalent of raising value-added tax to 22.5% from 20.0%, but this would almost certainly push the economy back into recession.

QE-2 Instead

So, instead, the Bank of England is injecting GBP 75 billion into the economy in a second round of "quantitative easing" by expanding its purchases of British government bonds (in effect, "printing" money) to GBP 275 billion from GBP 200 billion. All nine members of the Old Lady's Monetary Policy Committee also voted to keep the key interest rate at a record low of 0.5% until further notice.

According to the CB, quantitative easing "works" by encouraging people to switch out of gilts into other assets, raising the price of those and putting downward pressure on sterling. It also improves commercial banks' funding, lowers market interest rates by directly increasing the price of gilts, and improves confidence in the process.

No one seems to know for sure, though, what the effects of QE are on growth and inflation. There may be some boost to economic output, but monetary erosion will be encouraged as well. It is currently estimated that QE-1, for GBP 200 billion, helped increase GDP by between 1.5 and 2.0 percentage points and added 1.5 percentage points to inflation. Although consumer prices ticked up by 4.5% (y/y) in August, their fastest ascent in three months, following a 4.4% rise in July, the Bank of England seems convinced that this is a temporary development that will not last because Britons are seeing their spending power

erased at the fastest clip since the 1970s as wage growth fails to keep up, so that demand-pull factors are not a big risk.

Manageable Inflation

Potentially more problematic is that retail price inflation, a measure of the cost of living used in wage negotiations, accelerated to 5.2% from 5.0% between July and August. But core inflation, which excludes the costs of energy, alcohol, food and tobacco, remained unchanged at 3.1%. And while consumer price pressures are currently being fueled as British utility companies boost electricity and gas prices to take account of rising commodity costs earlier this year, the effect is not expected to be lasting, given the weakness of the economy. In fact, some pundits already predict that after QE-2 the Bank of England will add another GBP 50 billion to the program next February, via QE-3.

Of course, the key question with all this is whether the program will really stimulate business activity, or find the Old Lady of Threadneedle Street pushing on a string. The new Financial Policy Committee has made it a point to urge UK banks to cut bonuses and dividends, rather than cut lending to customers, as they go about strengthening their balance sheets and seek to cope with falling profits. Whether they will actually follow this "advice" remains to be seen, and if they do not, QE-2 will have little effect on the broader economy. The Committee was set this year on a provisional basis to create a better link between monetary policy and banking supervision. The government plans to introduce legislation that will give it formal legal power next year, but it still lacks such authority.

Interestingly, so far -- rather than weakening sterling, as anticipated -- QE-2 has been accompanied by sterling becoming a must-have currency for many risk hedgers and, indeed, Central Banks, as the combination of Mr. Cameron's firm commitment to fiscal austerity and Bank of England Governor Mervyn King's efforts to bolster the economy with record-low interest rates and bond purchases are attracting investors seeking a haven from Europe's debt crisis and from political gridlock in the US. The IMF reports that official international monetary reserves invested in pounds increased by as much as 12% in the first half of this year.

The UK and the EU

On the other hand, the neuralgic question of Great Britain's relationship with the European Union

moved back into the center of British politics as in a major backbench rebellion more than one-fourth of all Tory MPs defied the government and backed calls for a referendum on the UK's membership in the EU. The motion was easily defeated with the help of the unwaveringly pro-Union Labour Party. But it caught Mr. Cameron by surprise and was the largest Conservative parliamentary rebellion since 1986 and the biggest ever on the European question. It means that Mr. Cameron will likely come under increasing pressure from Euroskeptics to renegotiate Britain's relations with the EU in order to "repatriate" a number of powers that have been ceded to Brussels.

The revolt took place before the latest EU effort to resolve the sovereign-debt crisis, inter alia by seeking closer coordination of fiscal policy among the 17 Eurozone members. This has created the odd situation where Germany and France, in the EU, are pushing for closer integration, involving the surrender by Eurozone members of still more of their sovereignty, while Tory backbenchers are pressing for a lessened EU sway over the affairs of Britain.

This raises a real risk for the Cameron government that eventually ties between the UK and the EU will loosen to the point where the 17 Eurozone states will wind up adopting a common approach on certain issues which they will then try to foist on Whitehall. This would probably matter less if the PM had a strong grip on his governing alliance, but as matters stand, he is gaining a reputation (not really deserved) of aloof arrogance among more & more Conservatives, and if he no longer has his party in parliament fully on his side, his position vis-a-vis EU partners is undoubtedly weakened. (11/03/11)

Yemen

Parts of the capital Sana'a have become virtual war zones as the country's elites and their proxies fight for supremacy, but as yet there is no sign that the protracted stand-off is about to be resolved. President Saleh's position has become precarious since his return from Saudi Arabia, but repeated announcements of potential deals involving cease fires and his stepping down have led nowhere. The economy, meanwhile, is in a free-fall that is conjuring up the risk of a humanitarian disaster, so far kept at bay only because neither Saudi Arabia nor the West wants Yemen to fall apart.

Parts of the capital city Sana'a have turned into war zones in recent weeks as battles between the country's elites and their proxies have heated up in a development that began nine months ago, when anti-government protests, at least in part inspired by the Arab Spring, poured oil on the embers of long-standing rivalries between heavily armed groups. There have been several announcements of cease-fires so far, but most did not even see the beginning of an implementation and none have held. Likewise, it has appeared on several occasions as though President Ali Abdullah Saleh was willing to yield to pressure from the West (particularly the United States) and from the Gulf Cooperation Council under Saudi Arabia's leadership to agree to a deal calling for his resignation as President in exchange for immunity from prosecution for himself and his family, followed by early elections, but so far he has stepped back in the last minute, every time, without signing on to such a compromise.

Why he was allowed to return to Yemen after the bomb explosion at his palace that wounded him, the Prime Minister and the Speaker of Parliament and forced him to go to Riyadh for treatment for three months is still not entirely clear. It was widely expected, at the time, that the Saudis would see to it that he does not go back. By some accounts, he tricked his Saudi hosts and left the Kingdom under the pretense of going to the airport for some other reason and then "sneaked" aboard an aircraft under the noses of his unwitting hosts. This, to us, seems highly improbable. More likely, the Saudis, though mistrusting him, allowed him to go back because they felt that he is still a better bet than his fractious enemies, in whose ranks can be found both Shia guerillas along the border with Saudi Arabia and anti-Saudi al-Qaeda operatives.

The Threat of All-Out Civil War

Whatever the real story, his return has led to more divisions, more escalation, and more confrontation. While there seems to be broad agreement that something will have to give, and soon, forces commanded by his son and two nephews (including the air force and the elite army corps) appear to be too strong to be dislodged in the capital. Outside Sana'a, rebels have been making inroads, but this only means that the risk remains high of Yemen making a sudden lurch toward all-out civil war. There certainly is no easy way out of the mess. Even if President Saleh and his family departed peacefully (which still appears unlikely), they would leave behind a country deeply divided by religion, ideology and suspicion.

Central power in Yemen was never fully consolidated and centrifugal forces have time and again proven to be too strong to be fully contained. During most of Saleh's long rule, this state of affairs made for a sort of controlled chaos, with the controls now being under threat from several sources. These include armed rebels in the formerly Communist South, where the blue, red, black and white colors of the once-independent South Yemen are being painted on house walls and into town squares with increasing frequency. People in the South, where most of Yemen's oil facilities are, have long complained about being treated as second-class citizens and sharply rising unemployment in the region has helped to fuel discontent. Sources of conflict also include tribesmen led by the Houti family in the North, where insurgents have been staging intermittent revolts against the government in the mountainous Zaydi Shia heartland around Sa'ada, near the Saudi border. They belong to the Zaydi branch of Shi'ite Islam and have economic as well as religious grievances.

Then there is al-Qaeda – more specifically, al-Qaeda in the Arab Peninsula (AQAP) – which in recent years has made a strong comeback in Yemen and has given rise to justified fears in Saudi Arabia, which shares a 1,800- km border with Yemen, that it is training militants not only to target the West but also to launch attacks in the Kingdom and seek to topple the Saudi royal family. It was in Yemen that a Hellfire missile launched by a CIA drone recently killed Anwar al-Awlaki, the jihadist cleric regarded by Western governments as the most dangerous figure in the global al-Qaeda network after Osama bin Laden, who was killed in May.

Never one not to capitalize on an unexpected chance to blow his own horn, President Saleh was quick to play up his government's role in the operation against Awlaki, insisting that its success was possible only thanks to intelligence supplied by it. The idea, obviously, was to portray Saleh and his people as an invaluable ally against al-Qaeda and to justify the years of anti-terrorism military aid they have been receiving from Washington and elsewhere. Clearly, the beleaguered regime is trying to convince the West that it is still the best option for continuing the fight against al-Qaeda. Washington has appeared to be unimpressed by such arguments, however, and the same can be said for the European capitals, where demands that Saleh step down continue to be made.

On the Way to Hell In a Handbasket

The Yemeni economy, meanwhile, which was exceedingly poor already before the violence began, is

rapidly going from bad to worse. For some time, analysts have reported alarming declines in the country's two most vital resources, oil and water. The lack of water, in particular, is causing pressing problems in a land that is still heavily agricultural. Prices for basic goods have skyrocketed, with those for wheat and flour now up 120% since the protests erupted last January. Gasoline is available only sporadically and frequently just in the black market at prices that are a multiple of what they were before the uprising began.

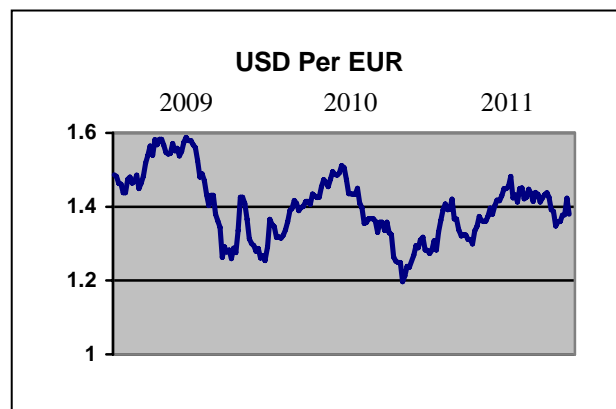
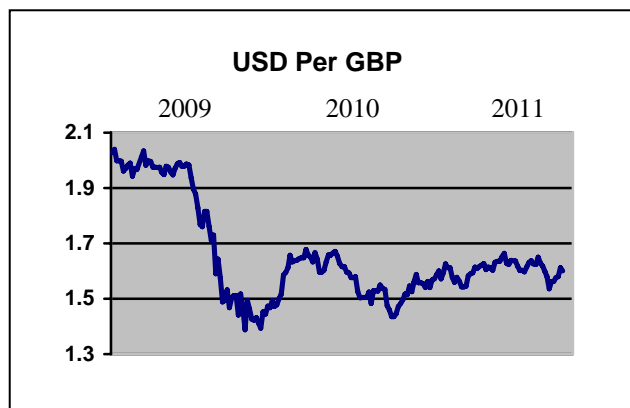
Lack of water and rising fuel costs have made it much more expensive for farmers to grow and transport goods for sale, and the soaring food prices have made these products harder to sell in a land where an estimated 50% of the population ekes out a living on USD 2 or less per day. Hundreds of local companies have had to shut down because of the fighting and close to two dozen foreign investors have pulled up stakes and left, with a number of others having cut their staff, according to the Ministry of Trade. The Ministry estimates that a million jobs have been lost since January (in a country of just 24 million people). Tourism, which used to account for about 4% of GDP, has come to a standstill.

From Bad to Worse

Factories have had to idle their assembly lines because of a lack of fuel. The government now has to import fuel, which has increased the monthly import bill to around USD 500 million. The currency, the rial, has been taking a dive and the regime is increasingly forced to raid official international monetary reserves, which at their peak in 2008 were well over USD 8 billion, but which are now said to be down to around USD 4.5 billion. The World Bank said in July that it was suspending its USD 120-million-a-year aid disbursement program in Yemen because of the "current political and security environment."

Aid agencies have been struggling to garner sufficient resources to deal with growing developmental and humanitarian problems, in part because of donor concerns about rampant corruption. The WFP has had to slash its food distribution program because of funding shortfalls. At risk at this point are also USD 300 million annually that the US used to provide, mostly for security, and USD 1.5 billion from Saudi Arabia (although Riyadh and other Arab governments did step in recently with donations of financial aid, food and gasoline in an effort to avert a humanitarian disaster). – (11/03/11)

Exchange Market Trends



Short-Range Outlook

US DOLLAR, GENERAL: The dollar's near-term fluctuations have become virtually impossible to anticipate, given the turmoil in the FX markets that has erupted with the quick-shifting developments in Greece. On balance, we think that the greenback will hold within recent ranges.

EURO: The EUR has recovered somewhat since the Greek government has backtracked from its decision to submit the latest bailout plan to a referendum, but the respite is not likely to last long. The uncertainties emanating from Greece will persist.

JAPANESE YEN: In the very near term, the FX markets will be hesitant to test the upside of the JPY's exchange rate, considering their risk that the BoJ may resume its massive direct intervention (see country entry in this issue). The yen's underlying trend remains strong, though.

CHINESE YUAN: A persistently strong outlook for the short term, helped by the Eurozone's looking to Beijing for financial assistance.

CANADIAN DOLLAR: The currency will continue to fluctuate with perceptions of the global economic outlook.

Medium-Term FX Forecast – Miscellaneous

Currency	11/02/11	End-Dec 2011	End-Mar 2012	End-Jun 2012	End-Sep 2012	End-Dec 2012
Euro	1.3795	1.3700	1.3900	1.4000	1.4000	1.3800
British pound	1.6003	1.5900	1.6000	1.6000	1.6200	1.6100
Canadian dollar	0.9889	1.0200	1.0200	1.0200	1.0000	1.0000
Rand	7.8797	7.9000	7.9500	7.9500	8.0000	8.0000
Turkish lira	1.7534	1.7550	1.7600	1.7700	1.8000	1.8000

World Currency Tables

Foreign Units Per US\$

Country	Unit	11/03/11	12/31/10	%	Country	Unit	11/03/11	12/31/10	%
Algeria	DZD	73.3099	74.6008	1.76	Kenya	KES	97.1750	80.5500	-17.11
Angola	AOR	95.1550	92.3127	-2.99	S. Korea	KRW	1114.90	1148.955	3.05
Argentina	ARS	4.2555	3.9775	-6.53	Kuwait	KWD	0.2739	0.2826	3.18
Australia	AUD	0.9645	0.9970	3.37	Lebanon	LBP	1505.50	1500.50	-0.33
Bangladesh	BDT	75.8005	70.486	-7.01	Malaysia	MYR	3.1258	3.1139	-0.38
Bolivia	BOB	6.9200	7.0000	1.16	Mexico	MXN	13.3747	12.3566	-7.61
Brazil	BRL	1.7378	1.6918	-2.65	Morocco	MAD	7.9656	8.4695	6.33
Brunei	BND	1.2677	1.3056	2.99	N. Zealand	NZD	1.2614	1.3387	6.13
Bulgaria	BGL	1.3797	1.4873	7.80	Nicaragua	NIQ	22.7809	21.8416	-4.12
Burma	MMK	6.4100	6.4350	0.39	Nigeria	NGN	156.996	154.685	-1.47
Canada	CAD	1.0112	1.0097	-0.15	Norway	NOK	5.6075	5.9738	6.53
CFA-Franc	CAF	464.755	498.829	7.33	Pakistan	PKR	86.6480	85.7450	-1.04
Chile	CLP	494.529	459.950	-6.99	Paraguay	PYG	4212.50	4650.00	10.39
China	CNY	6.3481	6.6450	4.68	Peru	PEN	2.7066	2.8180	4.12
Colombia	COP	1905.075	1937.955	1.73	Philippines	PHP	43.0450	44.1055	2.46
Costa Rica	CRC	513.269	503.555	-1.89	Poland	PLN	3.1405	3.0238	-3.72
Czech Rep.	CZK	18.0993	19.2777	6.51	Romania	ROL	3.0469	3.2268	5.90
Denmark	DKK	5.3945	5.6829	5.35	Russia	RUR	30.4738	30.5879	0.37
Dom. Repub.	DOP	38.296	37.375	-2.40	Saudi Arabia	SAR	3.7504	3.7502	-0.01
Ecuador	ECS.	1.000	1.000	0.00	Singapore	SGD	1.2677	1.3056	2.99
Egypt	EGP	5.9705	5.7868	-3.08	Slovakia	SKK	21.8377	22.9715	5.19
El Salvador	SVC	8.7475	8.7475	0.00	South Africa	ZAR	7.8797	6.7547	-14.28
Europ. Union	EUR	0.7249	0.7627	5.21	Sweden	SEK	6.5950	6.8604	4.02
Fiji	FJD	1.7490	1.8598	6.34	Switzerland	CHF	0.8799	0.9588	8.97
Guatemala	GTQ	7.8338	7.9885	1.97	Taiwan	TWD	30.035	29.955	-0.27
Honduras	HNL	18.950	18.895	-0.29	Thailand	THB	30.685	33.155	8.05
Hong Kong	HKD	7.7673	7.7772	0.13	Trin.Tobago	TTD	6.3998	6.3701	-0.46
Hungary	HUF	219.932	211.979	-3.62	Tunisia	TND	1.3998	1.4559	4.01
India	INR	49.1397	45.165	-8.09	Turkey	TRL	1.7534	1.5461	-11.82
Indonesia	IDR	8862.555	9047.550	2.09	U.A.E.	AED	3.6730	3.6730	0.00
Iran	IRR	10720.00	10404.05	-2.95	Ukraine	UAH	8.0200	7.9760	-0.55
Israel	ILS	3.6597	3.5920	-1.85	Uruguay	UYU	19.2500	19.855	3.14
Jamaica	JMD	86.0800	85.325	-0.88	Venezuela	VEB	4.2947	4.2947	0.00
Japan	JAP	075.890	082.975	9.34	Vietnam	VND	21005.6	19497.8	-7.18
Jordan	JOD	0.7096	0.7078	-0.25	Zimbabwe	ZWD	378.100	379.605	0.40

Selected International Interest Rates

As of 11/03/11

	USD	GBP	CAD	EUR	CHF	JPY
CB Rate	0.75		1.25			0.50
Prime Rate	3.25	0.50	3.00	1.50	0.50	1.48
Euro-Currency Deposit Offered Rates						
	USD	GBP	CAD	EUR	CHF	JPY
1 Month	0.46	0.78	1.63	1.30	0.61	0.15
3 Months	0.41	1.04	1.71	1.52	0.68	0.73
6 Months	0.82	1.29	1.90	1.74	0.80	0.34
1 Year	1.14	1.77	1.87	2.06	1.20	0.56

NEW YORK	LONDON	TORONTO
Federal Funds 0.08	Interbank/Sterling	Treasury Bills
Commercial Paper	1 Month 0.66	1 Month 0.85
30-59 Days 0.05	3 Months 0.98	3 Months 0.89
60-89 Days 0.14	6 Months 1.33	6 Months 0.94
90-179 Days 0.22	1 Year 1.83	1 Year 0.96
Bankers Accept.	Sterling CD's	Corporate Paper
60-89 Days 0.28		1 Month 1.06
150-179 Days 0.38	1 Month 0.72	2 Months 1.09
Certif. Of Deposit	3 Months 0.98	3 Months 1.16
30 Days 0.20	6 Months 1.23	Bankers Accept.
90 Days 0.37	1 Year 1.71	1 Month 1.12
180 Days 0.51		3 Months 1.16
Treasury Bills		FRANKFURT
1 Month 0.01		EURIBOR
3 Months 0.01		1 Month 1.48
6 Months 0.04		3 Months 1.69
1 Year 0.11		6 Months 1.79
5 Years 0.89		1 Year 2.02
10 Years 2.03		

Subscription Information

One year subscription to RUNDT'S WORLD BUSINESS INTELLIGENCE: US\$885.- (plus foreign airmail postage of \$95.- where applicable). Two-month trial subscription to Rundt's World Business Intelligence US\$450.- (may subsequently be applied against a full-year subscription).

To order Tel: 973-731-7502 Fax: 973-731-7503,

E-mail: info@rundtsintelligence.com

Visit our home-page at: www.rundtsintelligence.com

Exchange Cross Rates								
11/03/11	USD	CAD	JPY 100	GBP	SEK	CHF	AUD	EURO
USD		1.0112	0.7799	0.6249	6.5940	0.8799	0.9645	0.7249
CAD	0.9889		0.7712	0.6181	6.5208	1.0025	0.9538	0.7169
JPY 100	1.2822	1.2966		0.8012	8.4548	1.1282	1.2367	0.9295
GBP	1.6003	1.6182	1.2481		10.552	1.4081	1.5435	1.1601
SEK	0.1517	0.1534	0.1183	0.0948		0.1335	0.1463	0.1101
CHF	1.1365	1.1492	0.8864	0.7102	7.4941		1.0962	0.8238
AUD	1.0368	1.0484	0.8086	0.6479	6.8367	0.9123		0.7515
EURO	1.3795	1.3950	1.0759	0.8620	9.0964	1.2138	1.3305	
LdnGold		\$1759.50	Silver		34.879	SDR	1.57605	

11/03/11	CAD	JPY	GBP	SEK	CHF	AUD	EUR
2011 Hi	0.9447	075.89	1.6512	6.0091	0.7618	0.9087	0.6748
2011 Lo	1.0358	084.89	1.5449	6.8956	0.9691	1.0251	0.7698