

No more lunching for free

It is time to pay the bill for the costs that governments incurred while rescuing global economies from the economic and financial downturn, notes **Sachin Patki**.

We have seen some unprecedented moves by central banks around the globe to shore up their economies, with some dipping into reserves and others just printing more money. With recent data in some economies showing that consumers are more resilient than expected and that the economy may have made a turn for the better, it is now time to face the bill for the costs.

For many overextended budgets, the moves may cost a lot in terms of increased costs of borrowing, which taxpayers will have to bear over a long period of time. These costs may come in the form of lower spending in key areas like medical insurance, unemployment benefits, education and infrastructure.

The US corporate news has seen some large institutions like General Motors and Chrysler file for bankruptcy, which will have a short-term impact on unemployment that may get mitigated by temporary summer employment. But the numbers are likely to continue to rise into the fourth quarter of this year. The consumer confidence index rose from its lows of 23 in February 2009 to around 54.90 in May 2009, an indication that consumers feel that the economy will get better sooner rather than later.

This change will have a huge impact on the GDP, as around two-thirds of the GDP in the US is based on consumer spending. A positive flip in consumer spending will have a pivotal impact on the economy.

At the moment, inflation continues to be low. It will begin to get higher, though, given the low interest rate environment in the US. The rise in medium-term and long-term yields indicates that the market is pricing in this impact, with the US Treasury having no other option but to continue to borrow further to fund the budget and trade deficits.

The recent meeting of the G-8 officials (ahead of the big meet scheduled in L'Aquila, Italy from July 8-10) saw reluctance by the Eurozone bankers to undertake stress tests of their balance sheets in their regions, as they feared further negative impact on prospects of recovery. It is suspected that many institutions continue to carry hidden overvalued assets on their balance sheets along with bad debts in the region that could cost up to EUR750 billion.

This speculation has seen the euro give up some of its recent gains and correct lower from 1.4250 towards 1.3800 and 1.3635, with clear support only in the region of 1.3110. A break of this level would yield the older range of 1.2200-1.2890, while a reversal from the support at 1.3110 indicates some buying interest and a potential to recover up to 1.3800.

The sterling has been gaining on the back of a defensive US dollar, but its economic fundamentals do not support the sharp rally from 1.4000 to 1.6470. The rise in US bond swaps puts

the sterling interest rates into a more defensive mode, and for the rest of the year, the sterling may get supported partly from long sterling/short euro positions.

Economic figures for the UK are still abysmal and consumer confidence levels are still at very low levels. Inflation is also still too high and may climb even higher. The Bank of England may make a move on its easier monetary policy as economic conditions improve, though the longer-term cost of funding will continue to rise to accommodate higher inflation now built into the financial corporate model in the UK.

The sterling looks to hold the upside near 1.6570/1.6635 as it tests the downside near 1.6050, 1.5870, 1.5580, 1.5365 and 1.5300. A clear break of 1.6570 would yield a richer range of 1.7330-1.6400 for the near term. The sterling/euro cross looks very well bid as it breaks the near-term resistance of 1.1750 and rallies higher to 1.2010, 1.2320, 1.2435 and 1.2640. Support is at 1.1340, 1.1000, 1.0870, 1.0655 and 1.0580.

The Bank of Japan has maintained its status quo as expected on monetary policy as the economy shows few signs of recovery. It continues to use such measures as buy-back of treasuries and funding of corporations, but in recent weeks, we have not seen too many takers for these funds. The key factor for the Japanese economy is that its overseas export markets are still facing low demand and need to recover enough to provide business to the export-based industries. The yen continues to be directionless, partly due to the global low interest environment, which otherwise uses the low cost yen funding channel, usually known as a carry trade. The recent break above 96.80 seems to have been reversed with a break of the same in a move to 96.25, 95.65 and 93.40.

The recovery in prices of some of the commodities has indicated that price pressures are going to build up as the global recovery builds up momentum. These prices are reflective of the supply demand dynamics, the spare capacity, the lead time to upstream changes to production for soft commodities and the demand for some key items like gasoline, which will impact the pace of the economic recovery.

This rally will benefit the economies of the countries that export these commodities, while the importing countries will get interest rate pressure from imported inflation and defensive currencies. Either way, we are going to see some periods of relief, as the key economies around the world are on the mend. We may see some with positive GDP growth in the month-on-month periods.

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Views expressed are the author's and not necessarily those of Mashreq. Data and comments are as of June 16, 2009.