

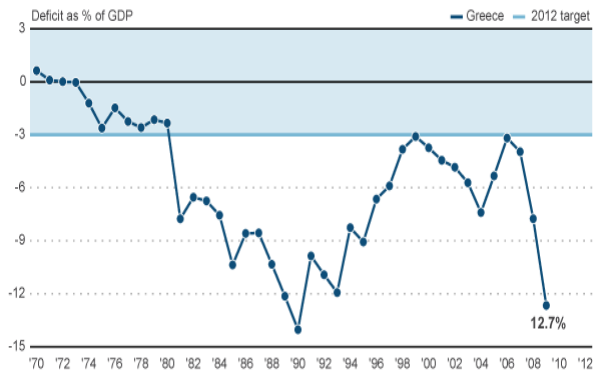
INSIDE DEBT

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Tuesday, February 16, 2010

CHART OF THE DAY

Greece aims to cut deficit by 3% by 2012



Athens has announced fuel tax increases, cuts in public pay and pension reforms as it strives to deliver on a commitment to reduce its public deficit from 12.7 percent of GDP to less than three percent in 2012, starting with a four-point cut this year.

TODAY'S TOP NEWS

- Fed's Hoenig says U.S. fiscal strains pressuring Fed
- New York factories gain; China sells US debt
- EU tells Greece more deficit cuts may be needed
- EU gives U.S. bank plan wide berth, eyes some products
- JGB futures hit 7-wk high after strong 5-yr auction
- UK inflation soars to 3.5 pct, BoE says it will fall
- **For more stories please click here**

ECON WATCH

FOR WEDNESDAY FEBRUARY 17

ET	Indicators	Unit	Reuters	Prior
04:30	GB Claimant count change	k	-10.0	-15.2
04:30	GB ILO unemployment rate	%	7.8	7.8
04:30	GB Avg wk Earnings 3mth yy	%	0.8	0.7
05:00	EZ Eurostat trade, EUR	bln	5.0	4.8
07:00	US Mortgage market index	ind	-	613.1
07:00	US Mortgage refi index	ind	-	2893.9
08:30	US Housing starts number	mln	0.58	0.557
08:30	US Building permits	mln	0.62	0.653
08:30	US Import prices	%	0.9	0.0
08:30	US Export prices	%	0.4	0.6
08:30	CA Wholesale trade	%	0.5	2.5
09:15	US Industrial output	%	0.7	0.6
09:15	US Capacity utilization	%	72.6	72.0
14:00	US Federal Budget	bln	-47.0	-63.46
14:00	US FOMC Minutes of the meeting - Jan 26-27			
	GB BoE - Minutes of Feb 3-4 MPC meeting			
	JP BOJ Two-day Monetary policy meeting starts			

MARKETS TODAY

TODAY'S TOP STORY: The ballooning U.S. budget deficit and growing mountains of federal debt will increase pressures on the Fed to hold interest rates low and make it harder to avoid inflation, a senior Federal Reserve official said. **For more please click here**

TREASURIES: U.S. government debt prices rose after the president of the Federal Reserve Bank of Minneapolis said inflation would remain "relatively tame."

- 30-yr bond prices rose 10/32 to yield 4.64 pct, down from 4.66 pct.
- 10-yr Treasury prices were up 8/32, yielding 3.66 pct.
- 5-yr Treasury prices rose 4/32 to yield 2.31 pct.
- 2-yr notes were up 2/32 to yield 0.81 pct, down from 0.83 pct.

FOREX: The euro rebounded against the dollar to post its biggest one-day gain since July, as traders bet the single currency had slipped too far in recent weeks over worries about Greece's public finances.

- Euro was up 1.27 pct at \$1.377, after touching a session high at \$1.3775 earlier, the biggest one-day gain since July. It rose 1.46 pct to 124.15 yen.
- Against the Swiss franc, the dollar fell 1.06 pct to 1.0659 francs, which was the biggest one-day fall since Nov. 25.
- The dollar gained 0.17 pct to 90.15 yen.
- Against the Australian dollar, dollar fell 1.52 pct at \$0.9019, strongest since Jan. 28.

CORPORATES: U.S. corporate bond spreads were little changed as ongoing worries about sovereign debt offset some increased risk appetite after regional manufacturing data bolstered the economic outlook.

- The CDX.IG-13 index tightened by about 2 bps to 98 bps.
- Simon Property Group's 5.65 pct notes due in 2020 widened 16 bps to 217 bps.
- Investment-grade corporate bond spreads have crept wider for four straight weeks, ending on Friday at 191 bps over Treasuries, the widest level since Dec. 29, according to Merrill Lynch indexes.

STOCKS: U.S. stocks rose as the latest batch of earnings and regional manufacturing data brightened the economic outlook and enticed investors back into equities.

- Dow rose 1.68 pct to 10,268.81, S&P was up 1.8 pct to 1,094.86 and Nasdaq gained 1.4 pct to 2,214.19.
- Chevron Corp was up 2.79 pct at \$72.99. Shares of Merck & Co gained 2 pct to \$37.66.
- Simon Property was up 3.92 pct at \$74.82.
- S&P financial index rose 2.46 pct, S&P energy index was up 2.66 pct.
- JPMorgan rose 2.88 pct to \$40.07, KBW bank index jumped 2.93 pct

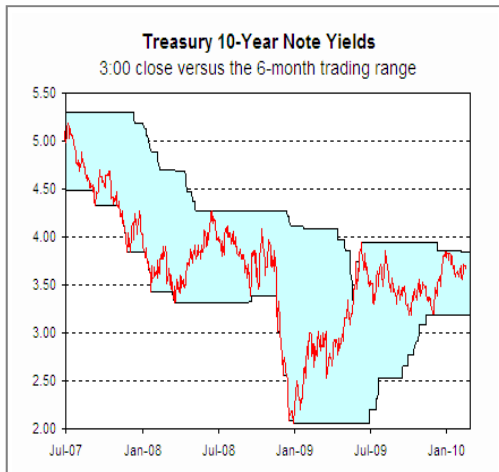
C & E: Oil prices jumped above \$77 a barrel, responding to a weaker U.S. dollar, stronger equities, and growing tensions over sanctions against Iran.

- U.S. crude prices jumped 3.98 pct to \$77.08.
- Gold rose 1.67 pct to \$1,118.85 an ounce.
- Reuters-Jefferies index was up 2.56 pct at 274.77.

- **For MARKET SNAPSHOT click here**
- **For NEXT UP click here**
- **For DEEP DIVE click here**



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.045	0.015	0.046	-0.006
3-Mo Bill	0.095	0.075	0.096	-0.004
6-Mo Bill	0.175	0.165	0.178	0.002
1-Year	0.320	0.318	0.325	-0.007
2-Year	100.133	100.164	0.807	0.055
3-Year	100.047	100.078	1.359	0.094
5-Year	99.750	99.789	2.304	0.148
7-Year	100.313	100.359	3.075	0.180
10-Year	99.641	99.703	3.668	0.234
30-Year	99.766	99.828	4.640	0.203

EQUITIES

	INDEX	CHANGE
DJIA	10236.31	137.17
NASDAQ	2208.28	24.74
S&P 500	1091.37	15.86

OIL

	PRICE	CHANGE
NYMEX	77.1	2.9
BRENT	74.7	2.2

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.723	0.013
Jun-10	99.605	0.000
Sep-10	99.400	0.005
Dec-10	99.085	0.005

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.210	O/N	0.210
2-Week	0.200	2-Week	0.210
1-Month	0.190	1-Month	0.220
3-Month	0.220	3-Month	0.240
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.210	10:00 AM	0.140
2-Week	0.200	3:00 PM	0.139
1-Month	0.220		
3-Month	0.220		

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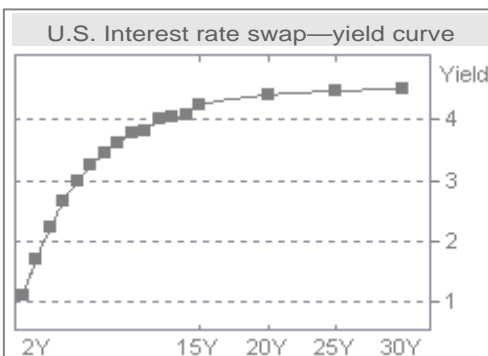
	SPREAD		RATE	
2-Year	27.75	31.75	1.08	1.10
3-Year	33.00	37.00	1.68	1.70
5-Year	31.50	35.50	2.61	2.62
7-Year	15.00	19.00	3.22	3.22
10-Year	7.75	11.75	3.74	3.73
30-Year	-15.25	-11.25	4.49	4.46

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.48	-0.13
CBOT 10 yr	117.86	-0.22
CBOT 30 yr	117.13	-0.44

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.150	-	-
1-Month	0.180	0.280	0.127	0.137
3-Month	0.220	0.400	0.146	0.156
6-Month	0.250	0.450	0.173	0.183
12-Month	0.600	1.000	0.319	0.329



CURRENCIES

	BID	ASK
Euro	1.3756	1.3758
Sterling	1.5778	1.5782
JP Yen	90.12	90.14
Swiss Franc	1.0669	1.0672
Can Dollar	1.0442	1.0448
Mexico	12.8567	12.8670

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2163
High	0.1500	3m	0.2506
Low	0.1000		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.875	12/01/2012	10.5 0	0.94
3-Year	1.375	09/01/2013	16 15.5	1.52
5-Year	2.875	09/02/2015	32 31.5	2.66
7-Year	5.125	18/10/2016	25.75 25.25	3.33
10-Year	-	-	- -	-
30-Year	6.625	15/11/2030	32.25 31.5	4.96

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	15/12/2011	6 5	0.87
3-Year	1.75	22/02/2013	23 21.5	1.58
5-Year	2.625	20/11/2014	19.5 18	2.55
7-Year	5.25	15/09/2016	25.5 24.75	3.33
10-Year	3.75	27/03/2019	24.5 23.5	3.93
30-Year	6.25	15/07/2032	37.75 37.25	5.02

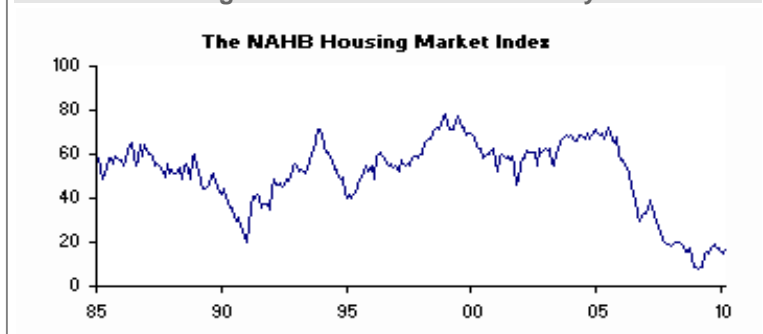
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.1100	105.1300	2.641
FHLMC	5.0	105.1200	105.1400	2.628

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1500	105.1700	2.971
FHLMC	5.5	105.2100	105.2300	2.845
GNMA	5.5	106.0100	106.0300	3.449

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

Fed's Hoenig says U.S. fiscal strains pressuring Fed

Growing mountains of U.S. government debt will increase pressure on Federal Reserve to hold interest rates low, making it harder to avoid inflation, a senior Fed official said.

Hoenig also urged the U.S. central bank sell some of the assets it has acquired to help counter the worst economic downturn since the 1930s. Holding them for an extended period will invite pressure from politicians to use Fed powers to aid other ailing sectors of the economy, he said.

In remarks that helped lift prices for U.S. government debt, Kocherlakota said the U.S. economy would likely grow at a pace close to 3 percent over the next two years, slower than many private-sector economics predict.

He said the jobless rate was unlikely to drop below 9 percent this year and below 8 percent in 2011.

Hoenig focused on the potential for the budget deficit, which is projected to rise to \$1.56 trillion, or 10.6 percent of the economy this year, to tip the United States into another crisis.

Hoenig said fiscal policymakers would need to embark upon the difficult path of cutting spending and increasing revenues.

If not addressed, the deficit problem could sap the Fed's ability to maintain the value of the dollar, he warned.

EU tells Greece more deficit cuts may be needed

European ministers told Greece it may need to take further steps to bring a swollen debt under control and calm "irrational" financial markets, as wage cuts already announced by Athens sparked another strike.

At a European Union meeting, finance ministers from Germany, Austria and Sweden led the charge, with Germany's deputy finance minister saying Greece should mimic Ireland and Latvia, both of which are slashing spending and wages savagely.

A statement issued by the ministers after the meeting, suggested clearly that the 30 days they have given Greece to prove itself before reporting back will in any case end with demands for more budget cuts or tax hikes, or both.

The ministers said nothing about specific support measures or aid, opting instead to heap pressure on Greece in return for the promise to support it if things get out of hand, a pledge made by European leaders last Thursday.

Asked what would happen if Greece faced difficulty raising money in the weeks ahead, Proell said the matter was an affair for Athens to handle first but Europe stood behind it.

Greece will then have to report back again in mid-May and every three months thereafter.

JGB futures hit 7-wk high after strong 5-yr auction

Japanese government bond futures rose to their highest this year after the Ministry of Finance's five-year note auction showed strong investor demand for government debt.

The market turned around after the auction attracted bids 3.64 times the offer, its highest since the November issue, despite the fact that it was a second re-opening of the No.87 issue and investors already hold large amounts of the paper.

The MOF sold 2.4 trillion yen (\$26.6 billion) of the current five-year note with 0.5 percent coupon, creating the largest single JGB issue to date.

March futures rose 0.09 point to 139.70 after climbing as high as 139.76, their highest since Dec. 30. The five-year yield edged down 0.5 basis point to 0.505 percent, after slipping to 0.500 percent, while the 20-year yield inched up 1 basis point to 2.170 percent, a three-month high. The 5-year/20-year yield spread widened to 167 basis points at one stage.

New York factories gain; China sells U.S. debt

The NY Fed's "Empire State" general business conditions index rose to 24.91 in February, the highest level since October and up from 15.92 in January.

The inventories index rose sharply, to zero from negative 17.33, its highest reading in more than a year.

Overall, net capital inflows into the United States rose to \$60.9 billion in December, from an inflow of \$30.9 billion the prior month, but foreigners cut purchases of long-term securities, the Treasury said. The data also showed that China has now been a net seller of some \$45 billion of U.S. Treasuries over the last five months.

Japan overtook China as the biggest foreign holder of U.S. Treasury debt in December for the first time in more than a year. Japan, by adding \$11.5 billion, raised its total holdings to \$768.8 billion, surpassing China for the first time since August 2008.

Separately, U.S. home-builder sentiment rose more than expected in February. The NAHB/Wells Fargo Housing Market index rose 2 points to 17 in February, the group said in a statement.

EU gives U.S. bank plan wide berth, eyes some products

Banks in the European Union won't face a ban on proprietary trading, the bloc's executive body said, but it warned the sector to check its ethics.

Securitized products and derivatives will also come under closer EU scrutiny, officials said.

An EU document prepared for the meeting showed there was no consensus to back the U.S. plan which would conflict with the universal banking model in Europe, which houses proprietary trading and commercial banking under one roof.

British Finance Minister Alistair Darling, Luxembourg counterpart, Jean-Claude Juncker, and Barnier stressed the need to implement a global deal on regulation agreed by the G20 last September. The G20 has asked the Financial Stability Board to come up with proposals to limit contagion risks from systemically important banks by October, which could include capital surcharges and a levy on banks towards a bailout fund.

Separately, world leaders want banks and financial firms to pay up for government interventions -- past and future -- to stabilize the international financial system. While details are sketchy, some form of bank balance sheet tax appears to be gaining ground.

UK inflation soars to 3.5 pct, BoE says it will fall

British inflation surged further above the BoE's target in January, forcing BoE Governor Mervyn King to write a public letter where he said inflation should still get back on track later this year.

Official data showed CPI rose to 3.5 percent in January from December's 2.9 percent -- in line with economists' expectations, after a rise in value-added tax on Jan. 1.

But this increase to a 14-month high still took inflation more than a full percentage point above the BoE's 2 percent target, obliging King to write a public letter to finance minister Alistair Darling explaining the rapid price rises. Finance minister Alistair Darling replied to King that the Treasury also expected inflation to fall below 2 percent by the end of 2010.

Core inflation, excluding food and energy, rose to only 3.1 percent from 2.8 percent, which Loynes said was perhaps a sign that "the vast amount of spare capacity in the economy is starting to weigh down on underlying price pressures".



TODAY'S TOP NEWS

Canada tightens mortgage rules, says no bubble yet

Canada will bring in new mortgage rules to cool the country's red-hot housing sector, citing the need to prevent a property price bubble even as it gave assurances the market is stable.

Finance Minister Jim Flaherty said he was concerned that new homebuyers may overextend themselves and also wanted to discourage the "tendency by some to use their homes as an ATM machine."

Flaherty announced three changes to the rules for government-backed insured mortgages he hopes will prevent the kinds of problems that caused the U.S. housing market collapse.

The changes include the requirement that borrowers will need the resources to qualify for a five-year fixed-rate mortgage even if they go with a lower variable rate.

The government will also lower maximum amounts that can be withdrawn when borrowers refinance mortgages to 90 percent from 95 percent of the value of their homes. And it will require a minimum down payment of 20 percent for insured mortgages tied to non-owner occupied properties bought for speculation.

Australia RBA sees risks to US and EU, upbeat on Asia

A top Australian central banker said financial sectors in the U.S., UK and Europe risked growing loan losses as economies there struggled, but crucially the outlook for Australia and Asia was much stronger. RBA Assistant Governor Guy Debelle said there was a marked contrast between the balance of risks for Asia and that for the rich North Atlantic nations.

Debelle said a significant risk for the North Atlantic economies was that weakness in their economies would feed back into the financial sector through losses on loan books.

"The experience of previous cycles indicates that the commercial property cycle takes a long time to unfold, and we may have some way yet to travel," Debelle warned.

There could also be a blow to public confidence if banks continued to report losses even after receiving substantial support from tax payers. These risks were not present in Asia, said Debelle, given bank balance sheets had remained in sound condition and there was no impediment to credit provision.

Japan finmin wants 1 pct inflation, BOJ help

Japan's finance minister said he would like to see price growth of 1 percent and urged the BoJ to cooperate in beating deflation, putting fresh pressure on the central bank for more action to support a fragile economy.

BOJ Governor Masaaki Shirakawa said the central bank was willing to cooperate, but he offered few clues on what it would do beyond keeping monetary conditions very easy.

Kan's view on prices is roughly in line with that of the BOJ, which defines price stability as annual consumer inflation of 2 percent or below and around 1 percent.

The central bank clarified its definition of price stability in December to say it would not tolerate zero inflation, let alone price falls, in its most aggressive statement on deflation since it ended quantitative easing in 2006. The BOJ is seen likely to keep interest rates at 0.1 percent and hold off on any new initiatives at a rate review ending as it expects Japan to avoid another recession despite a likely slowdown early this year.

German investor morale falls less than expected

German analyst and investor sentiment fell less sharply than expected in February, a closely watched survey showed, suggesting Europe's largest economy may be more resilient than feared.

The ZEW economic think tank's monthly poll of economic sentiment fell for the fifth month running to 45.1, down from 47.2 in January as renewed risk aversion in financial markets weighed on sentiment.

But the index figure which was based on a survey of 278 analysts and investors was well ahead of a consensus forecast in a Reuters poll of 40 economists for a fall to 42.0.

An economic sentiment reading for the broader euro zone fell to 40.2 from 46.4 in January and a ZEW economist said this may reflect concerns about debt woes in Greece and other euro zone countries.

Carsten Brzeski at ING Financial Markets thought market nervousness could also have hit investor sentiment in Germany, though he said the economy's underlying trend "remains good".

NEXT UP

PREVIEW-U.S. housing starts to rise in Jan, permits to fall

The median forecast for housing starts is for a rise to an annual rate of 580,000 units in January after having fallen to 557,000 units in December. Forecasts range from 530,000 to 630,000 units.

This suggests that housing starts likely rebounded in January, though analysts caution that inclement weather may cause the strength from permits to be slow to feed through to ground-breaking activity.

Building permits are expected to have dropped in January.

The median forecast for building permits is for a slip to 620,000 units in January after having risen to 653,000 units in December. Forecasts range from 540,000 to 670,000 units.

The housing market is recovering from a three-year slump that pushed the U.S. economy into its worst downturn since the Great Depression. But the government-driven recovery is showing signs of exhaustion, amid high unemployment and a flood of foreclosed properties.

Housing starts are below the pace of new home sales, while the inventory of houses under construction dropped to a record low in December.

Poll-Investors cut equity exposure as China, Greece weigh

Investors slashed their equity overweight positions this month and raised their cash and bond allocations as fears about China's growth and the Greek debt crisis weighed on risk appetite, a survey showed.

According to a monthly fund managers poll from BofA Merrill Lynch, investors' net equity overweight position fell to 33 percent this month from 52 percent in January.

The survey, which polled 200 fund managers who manage assets totaling \$502 billion, showed cash overweight positions rose to 12 percent compared with 8 percent underweight, while those who underweight bonds fell to 39 percent, back to December levels, from 48 percent. Two thirds of respondents thought that it was unlikely that Greece would default on its debt, with 58 percent seeing a last-minute bailout as most likely. A net 35 percent of investors are overweight emerging market equities, down from 47 percent in January.

The poll showed 42 percent of fund managers now expect the Fed will leave interest rates unchanged until 2011, up from 17 percent in November, while 45 percent believe the ECB will be on hold until 2011, up from 17 percent in December.



DEEP DIVE Commentary and Analysis

Greece an ideal Goldman client; profitable and culpable

By James Saft

Goldman Sachs has a lot to be thankful for - huge bonuses, massive taxpayer subsidies, unrivalled political influence - but in Greece they have finally found nirvana: a highly profitable business partner who can also credibly serve as the villain in the piece.

Goldman is widely reported to have arranged a swap transaction for Greece early in the last decade structured in such a way as to provide the country with \$1 billion upfront in exchange for higher payments much later.

That later bit is key - it helped to mask over-borrowing by Greece from the euro zone's budget watchdogs in Brussels, not to mention from Greek taxpayers and the buyers of Greek debt, all of whom have a right to fully understand the risks of a country incurring liabilities which perhaps it may struggle to repay.

Greece's deficit has grown to such a size as compared to its ability to generate revenue that it will now require a rescue package from its euro zone partners, or if not may face the dire possibility of a default or exit from the currency union.

Other banks, mind you, are likely to have facilitated similar deals, and if they didn't I'm betting it wasn't for lack of trying.

The New York Times has reported that Goldman arranged other deals for Greece, the common denominator of which seems to have been getting money upfront.

Greece paid Goldman about \$300 million in fees for a 2001 deal that helped it borrow "billions," according to the Times, a set of figures that implies this deal was either enormously large, fantastically complex or that Greece was, shall we say, price insensitive.

Goldman has been pilloried, often rightly, for its role in the crisis, and its presence at this particular road traffic accident is an invitation to construct a story line in which once again evil bankers loot and pillage their way through society.

That would be wrong. Greece has to shoulder its own blame. It borrowed too much and did some of it in costly ways whose principal benefit seems to have been obscurity. It is one thing for a badly educated Californian to blame a bank for lending her ten times her income to buy a house, it is quite another when we are talking about a country, not to mention one within the euro.

LEGAL AT THE TIME

"We're trying to change the course of the Titanic," Greek Finance Minister George Papaconstantinou said ahead of meeting with euro zone finance ministers in Brussels on Monday. "People think we are in a terrible mess. And we are."

Asked about a European Commission claim that Greece had not told the EU about the deals arranged by Goldman Sachs, Papaconstantinou said: "The kind of derivatives contracts reported by some newspapers were legal at that time. Greece was not the only country to use them."

Get that - "Titanic," "mess," "legal at the time." You really can't make this kind of stuff up.

I'm not saying that someone who structured one of these deals does not deserve to take a loss, or that the derivative market does not need better disclosure. All of this is true.

Greece, though, is a grown up nation and the way in which it mismanaged its finances are its own responsibility. The primary problem in this particular slice of the ongoing financial scandal is the dysfunctional way in which the euro zone works.

When it comes to sovereign nations, you cannot expect banks to impose fiscal discipline, much less to make nations deal honestly and openly with one another. Nor can you expect a bank to serve as a policeman of a nation on behalf of its taxpayers.

It would be enormously satisfying on one level if banks which

structured or invested in these deals took losses as a result of a Greek default. Those who did the structuring are likely to have sold off their exposure to others anyway, and a Greek default, though perhaps deserved, is not very likely. The consequences for Greece, for the euro zone and for investors would be too dire.

As for investors in Greek debt, again the Greek government has the primary responsibility for disclosure. Of course if Goldman or another bank had material information about the state of Greece's finances it should be obliged to disclose this to buyers of that exposure.

The logic of the euro zone, which has no exit mechanism, is such that many investors quite conceivably would have bought Greek exposure anyway on the expectation of the bailout they are about to benefit from.

There is a hierarchy of responsibilities, and countries in the end have to come higher than banks.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

Blame game over giddy China savings takes a twist

By Alan Wheatley

Greece's big budget deficit has plunged the euro zone into crisis, while rating agencies wonder whether Washington's fiscal profligacy could one day cost the United States its AAA rating.

China has a different problem: its government is under attack for conservative spending policies that, critics say, are damaging long-term productivity prospects and contributing to the economic imbalances underlying the global financial crisis.

The International Monetary Fund and World Bank have long called for China to ramp up social spending so its citizens have less need to save for a rainy day and can consume more. Still, recent advice to Beijing from the Organization for Economic Cooperation and Development was remarkably blunt.

"Looking ahead at the exit from the ongoing fiscal stimulus programs, it will be important not to revert to budget surpluses," the OECD said in a report this month. "China's public finance position is remarkably strong and can readily accommodate a permanently high level of government spending."

The OECD reckons that China, which is not a member of the Paris-based forum of industrial democracies, entered the economic slowdown with a general government surplus in 2007 of more than 5 percent of GDP, reflecting buoyant tax revenues and tight-fisted spending policies.

China may have rapidly increased outlays on welfare pensions and health, but it has barely scratched the surface. "Greater public spending on education in particular can help both to boost productivity and to reduce inequality," the OECD said.

Despite implementing a 4 trillion yuan (\$585 billion) stimulus program, the government's budget deficit last year was just 2.2 percent of GDP, below its target of 3 percent.

If spending slows as the pump-priming ends, the OECD fears that surpluses could return and lead to a renewed widening of China's current account surplus, a sore point with the United States and Europe.

HOT TOPIC

Just how far the government is to blame for a surge in China's national savings rate last decade is controversial.

Many economists had attributed the increase to higher corporate profits as enterprises, feasting on cheap loans and labor, made the most of a boom in global demand.



DEEP DIVE Commentary and Analysis

But recently revised statistics showing the flow of funds through China's economy between 1992 and 2007 have reopened the debate.

Calla Wiemer with the Center for Chinese Studies of the University of California, Los Angeles, says a leap in the national savings rate to 51.4 percent of GDP in 2008 -- by far the highest of any major economy in the world -- largely reflected increased household savings due to changing demographic and income patterns.

The flow of funds also shows government saving surged to 10.6 percent of National Disposable Income in 2007 from just 4.5 percent in 2004. Big increases in revenue were either saved or used to pay off debts to the neglect of social welfare spending.

"For the sake of the long-run health and well-being of the Chinese people, government needs to spend much more on public consumption," Wiemer wrote in the most recent edition of the China Economic Quarterly journal. "The scale of the increase in government spending that is called for is enormous, and the resulting stimulative effect on the economy could thus be substantial."

Stephen Green, head of Greater China research at Standard Chartered Bank in Shanghai, arrives at a similar conclusion.

Green says a rise in total government income to 35 percent of GDP in 2007 from 25 percent in 1995 was necessary given the parlous state of state finances in the early 1990s.

"But the problem is that the government is also keeping more of the benefits of growth, rather than spending them. And this amounts to a significant, but hidden 'unbalancing' of the economy. It has to be among the diagnoses of China's imbalances and its low consumption problem," Green wrote in a recent note.

NOT SO SURE

Interpreting Chinese statistics, however, is tricky. Louis Kuijs, a

World Bank economist in Beijing, says he cannot reconcile the purported leap in government savings with other fiscal data and surveys of Chinese households and industry.

And UBS economist Jonathan Anderson says the flow of funds breakdown is particularly inconsistent with China's well-regarded survey of industry.

Both he and Kuijs remain of the view that corporates explain the lion's share of the jump in national savings.

"I don't want to rule out anything, but it doesn't feel right to me. When we look at the way China was growing -- this capital-intensive, industry-led growth -- I don't have the sense that that pattern of growth was already starting to change in 2005," Kuijs said, referring to the apparent shift in the structure of the economy around mid-decade.

Despite the disagreements, China-watchers concur that the government must refocus its spending from physical capital to human capital to sustain long-term growth.

Whereas the OECD advocates more education spending, a new IMF study concludes that, to reduce precautionary savings, the priority should be on public health care.

Each additional yuan in government health spending boosts urban consumption by two yuan, according to IMF economists Steve Barnett and Ray Brooks.

Green at Standard Chartered supports more spending on both health and education. He also favors cutting taxes and fees that discourage business and reduce wages.

"While we are under no illusions that this agenda is realistic today, these issues are bubbling under the surface and will have to be dealt with one day.

"If they are not, then as the economy recovers and government revenues pick up again, not only will the old imbalances reassert themselves, but the risk of the large, wealthy, and unwieldy bureaucracy stifling the economy will inevitably rise," he said.

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