

# INSIDE DEBT

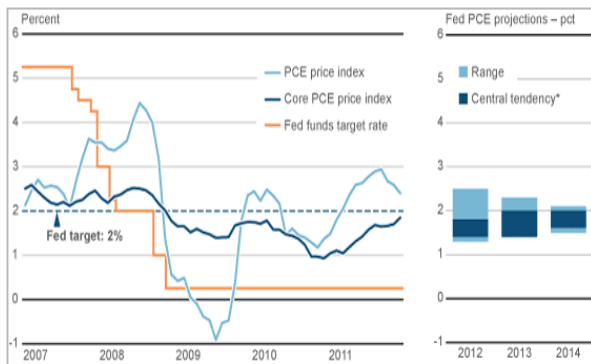
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Monday, January 30, 2012

## CHART OF THE DAY

### U.S. inflation

Click on the chart for full-size image



In December, the PCE price index increased 2.4 percent year-on-year while core prices (which strip out food and energy) rose 1.8 percent. The Federal Reserve, which released its revised projections last week, would like this measure close to 2 percent.

## TODAY'S TOP NEWS

- EU leaders struggle to reconcile austerity, growth
- U.S. consumers fizzle out even as incomes rise
- Spain seen heading for recession as economy shrinks
- France cuts 2012 growth forecast to 0.5 pct- PM
- Euro zone confidence improves, highlights divergence
- China c.bank may skip bill sales due to tight liquidity
- U.S. Fed's Plosser wanted more optimistic outlook - CNBC

## ECON WATCH

FOR TUESDAY JANUARY 31

ET	Indicators	Unit	Reuters	Prior
05:00	EZ Unemployment Rate	%	10.4	10.3
08:30	US Employment Costs	%	0.4	0.3
08:30	CA GDP by industry M/M	%	0.2	0
09:00	US S&P C-S 20 mm sa	%	-0.5	-0.6
09:00	US S&P C-S 20 mm nsa	%	-0.8	-1.2
09:00	US S&P C-S 20 yy	%	-3.3	-3.4
09:45	US Chicago PMI	ind	63	62.2
10:00	US Consumer Conf	Ind	68	64.5
10:30	US Dall Fed Svcs Act	Ind	--	6.7
10:30	US Dallas Fed SvcsRev	ind	--	9

- For EYE ON ASIA click here
- For MARKET SNAPSHOT on Asia click here
- For EYE ON LATAM click here

## U.S. MARKETS TODAY

**TODAY'S TOP STORY:** European leaders struggled to reconcile austerity with growth at a summit that approved a permanent rescue fund for the euro zone and was trying to put finishing touches to a German-driven pact for stricter budget discipline. **For more please click here**

**TREASURIES:** Treasury prices rallied as fears that Portugal could follow Greece into a difficult debt restructuring caused investors to rush to the perceived safety of U.S. government debt.

- "The main concern right now is if the situation in Greece will trickle out to Spain, or Portugal or Italy," said Jason Rogan, director of Treasuries trading at Guggenheim Partners in New York.
- 10-yr notes added 12/32 to yield 1.85 pct from 1.89 pct and 30-yr bonds rose 1-2/32, yielding 3 pct from 3.06 pct.

**FOREX:** Greece's unresolved debt restructuring knocked the euro from a six-week high against the U.S. dollar and drove it to a 4-1/2-month low against the safe-haven Swiss franc.

- The single currency was last down 0.71 pct o \$1.3130, having hit a six-week high in early trade but falling as low as \$1.3074 in the New York session.
- The euro fell to a 4-1/2-month low against the Swiss franc at 1.2034 francs, but traders said large bids were preventing a move toward the Swiss National Bank's franc cap of 1.20. The pair last traded at 1.21.
- Against the yen, the euro fetched 100.23 yen, down 1.11 pct, after earlier touching a one-week low.
- The Australian dollar fell 0.35 pct, off its lows, to \$1.0595, with traders citing selling by leveraged players amid a pullback in risk appetite.
- The dollar extended its losses against the yen and was down 0.44 pct at 76.33 yen.

**CORPORATES:** Corporate bond spreads widened as concerns grew about the state of Europe's finances as Greece and Germany sparred over budget measures for Athens.

- The CDX.IG-17 index widened by 3 bps to 103 bps.

**STOCKS:** Stocks ended slightly lower on stalled Greek debt talks, but an afternoon rally cut losses in a sign of the underlying resilience the market has shown early in the year.

- Dow slipped 7.04 points or 0.06 pct to 12,653.42, S&P dropped 3.35 points or 0.25 pct to 1,312.98 and Nasdaq lost 4.61 points or 0.16 pct to 2,811.94.
- Apple rose 1.3 pct, Thomas & Betts surged 23.05 pct and ABB lost 3.3 pct.

**C & E:** Oil prices fell as traders weighed concerns about difficulties negotiating a deal to restructure Greece's debt against the risk of a rabid halt in Iran's oil sales to Europe.

- Oil was down 0.64 pct at \$98.92 per barrel. Gold lost 0.48 pct to \$1,728.79 an ounce. Reuters-Jefferies index dropped 1.23 pct to 313.91.

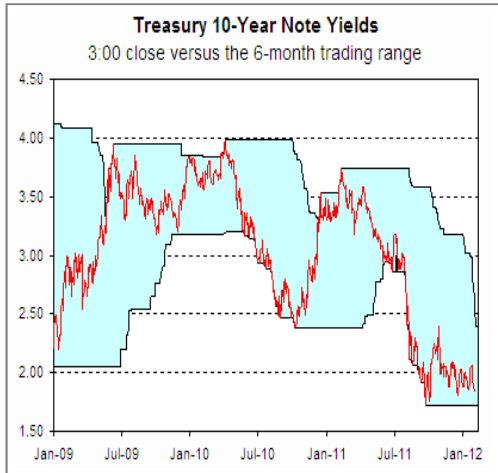
For a video preview of next week's economic events, [click here](#)

**REUTERS INSIDER**

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- For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.060	0.025	0.061	0.000
3-Mo Bill	0.050	0.040	0.051	-0.003
6-Mo Bill	0.080	0.075	0.081	0.001
1-Year	0.110	0.100	0.112	-0.002
2-Year	100.063	100.094	0.219	0.004
3-Year	99.836	99.867	0.306	0.020
5-Year	100.680	100.727	0.737	0.086
7-Year	99.828	99.875	1.276	0.234
10-Year	101.406	101.453	1.842	0.469
30-Year	102.703	102.781	2.987	1.453

EQUITIES

	INDEX	CHANGE
DJIA	12634.35	-27.55
NASDAQ	2809.34	-7.47
S&P 500	1310.95	-5.54

COMMODITIES

	PRICE	CHANGE
NYMEX	98.9	-0.7
BRENT	110.7	-0.8
SPOT GOLD	1729.1	-8.2
PALLADIUM	683.8	-1.8
SILVER	33.4	-0.5

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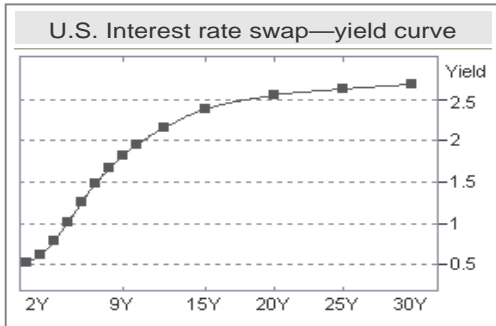
	SPREAD	RATE
2-Year	31.00	0.52 0.55
3-Year	30.25	34.25 0.60 0.63
5-Year	28.25	32.25 1.01 1.04
7-Year	20.50	24.50 1.48 1.50
10-Year	10.50	14.50 1.94 1.96
30-Year	-31.25	-27.25 2.67 2.67

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-12	99.48	0.00
Mar-12	99.53	0.01
Jun-12	99.52	0.00
Sep-12	99.49	-0.01

REPURCHASE AGREEMENTS

G/C	MORTGAGE REPOS
O/N	0.160 O/N 0.180
2-Week	0.190 2-Week 0.260
1-Month	0.190 1-Month 0.240
3-Month	0.190 3-Month 0.260
AGENCY REPOS	i-REPO <sup>SM</sup> INDEX
O/N	0.170 10:00 AM 0.130
2-Week	0.210 3:00 PM 0.122
1-Month	0.200
3-Month	0.210



FUTURES

	PRICE	CHANGE
CBOT 5 yr	123.97	0.08
CBOT 10 yr	132.03	0.31
CBOT 30 yr	144.59	1.16

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.090	0.100		
1-Month	0.250	0.350	0.085	0.095
3-Month	0.350	0.500	0.088	0.098
6-Month	0.630	0.780	0.091	0.101
12-Month	0.900	1.110	0.098	0.108

NYFR<sup>SM</sup> - 10AM

1m	0.2538
3m	0.5308

FED FUNDS

Open	0.0800
High	0.1500
Low	0.0600

CURRENCIES

	BID	ASK
Euro	1.3126	1.3128
Sterling	1.5695	1.5700
JP Yen	76.30	76.32
Swiss Franc	0.9181	0.9184
Can Dollar	1.0026	1.0030
Mexico	12.9890	12.9924

ACTIVE FANNIE MAE AGENCIES

TERM	COUPON	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.5	8/9/2013	2 -1	0.231
3-Year	0.75	12/19/2014	10.5 7.5	0.406
5-Year	1.25	1/30/2017	30.5 27.5	1.037
7-Year		-		
10-Year				
30-Year	6.625	11/15/2030	25 22	3.235

ACTIVE FREDDIE MAC AGENCIES

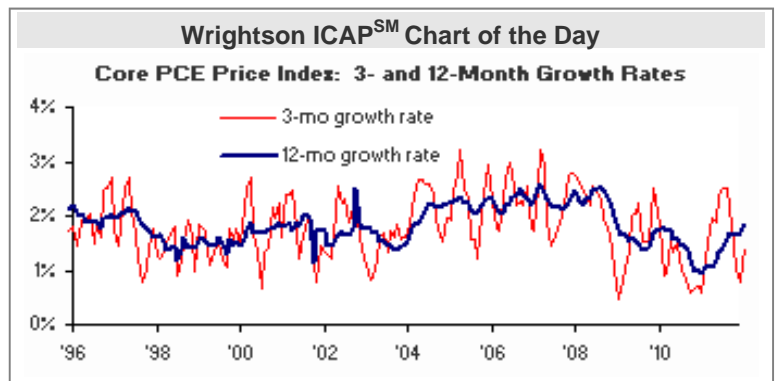
TERM	COUPON	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.375	11/27/2013	7 4	0.282
3-Year	0.625	12/29/2014	11 8	0.411
5-Year	1	3/8/2017	33.75 30.75	1.069
7-Year		-		
10-Year	2.375	1/13/2022	48.75 45.75	2.327
30-Year	6.25	7/15/2032	27.5 24.5	3.26

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	3.5	105.0200	105.0300	2.404
FHLMC	3.5	105.0260	105.0320	2.251

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.0	105.1720	105.1760	1.985
FHLMC	4.0	105.0920	105.0960	2.099
GNMA	4.0	107.2000	107.2000	2.054



## TODAY'S TOP NEWS

**EU leaders struggle to reconcile austerity, growth**

European leaders struggled to reconcile austerity with growth at a summit that approved a permanent rescue fund for the euro zone and was trying to put finishing touches to a German-driven pact for stricter budget discipline.

Officially, the half-day 27-nation summit was meant to focus on ways to revive growth and create jobs at a time when governments across Europe are having to cut public spending and raise taxes to tackle mountains of debt.

But disputes over the limits of austerity, and Greece's unfinished debt restructuring negotiations with private bondholders, hampered efforts to send a more optimistic message that Europe is getting on top of its debt crisis.

Leaders agreed that a 500-billion-euro European Stability Mechanism will enter into force in July, a year earlier than planned, to back heavily indebted states. But Europe is already under pressure from the United States, China, the International Monetary Fund and some of its own members to increase the size of the financial firewall.

European Commission President Jose Manuel Barroso hinted Brussels may ease Spain's near-unattainable 2012 deficit target after it updates EU growth forecasts on Feb. 23.

Portugal's slide towards becoming the next Greece - needing a second bailout to avoid chaotic bankruptcy - gathered pace as banks raised the cost of insuring government bonds against default and insisted the money be paid up front instead of over several years.

**Spain seen heading for recession as economy shrinks**

Spain's economy looks set to slip into recession after contracting for the first time in two years in the last quarter of 2011, highlighting the challenge for EU leaders as they meet to find ways to boost growth while cutting budgets.

Spain has massive unemployment -- around a third of the euro zone's unemployed are Spanish -- and a banking sector that has been hobbled by a collapsed property sector.

On an annual basis, the economy grew by 0.3 percent, slowing from 0.8 percent in the previous quarter but slightly above expectations for growth in a Reuters survey.

The Bank of Spain said it expects the economy to shrink 1.5 percent this year due to stringent cost-cutting aimed at cutting the public accounts shortfall to 4.4 percent of GDP from around 8 percent in 2011.

Spain will miss the official growth target of 2.3 percent in 2012 Prime Minister Mariano Rajoy said. His centre-right government, which trounced the Socialists in November's election, is due to announce new growth targets in March.

**Euro zone confidence improves, highlights divergence**

Confidence in the euro zone's economy strengthened in January for the first time since early 2011, EU data showed, but a recovery in Germany masked a deterioration in France and Italy, highlighting the bloc's diverging fortunes.

Germany has shown more resilience to the euro zone's troubles than many of its neighbours, helped by fiscal prudence, a competitive edge and good demand for its high quality goods.

The divergence complicates the task of EU leaders who are meeting in Brussels to try and sketch a path out of the economic slump.

The European Commission's economic sentiment indicator rose by 0.6 points in the euro zone to 93.4, the first improvement in sentiment since March last year as some confidence returned to services, consumers and construction.

**U.S. consumers fizzle out even as incomes rise**

U.S. consumer spending was flat in December as households put the largest rise in income in nine months into their savings, potentially signaling slower consumption early in 2012.

It was the weakest reading on spending since June, the Commerce Department said, and it followed two tepid gains in October and November.

Still, economists were cautiously optimistic that rising wages as labor markets improve will keep demand supported.

The government said that consumer spending grew at a 2 percent annual pace in the fourth quarter, a pick-up from the third quarter's 1.8 percent rate, which helped lift gross domestic product by 2.8 percent.

Data from the Federal Reserve Bank of Dallas showed a strong rebound in factory activity in the Texas this month, with new orders the highest in six months. Employers hired more new workers and extended hours for their existing workforce.

An increase in wages last month helped lift incomes 0.5 percent, the largest gain since a matching increase in March.

The spending report showed inflation pressures generally contained, with a price index for personal spending nudging up 0.1 percent after being flat the prior month.

In the 12 months through December, the PCE price index was up 2.4 percent - the smallest gain since April 2011.

A core inflation measure rose 0.2 percent last month after gaining 0.1 percent in November. Over the past 12 months, it was up 1.8 percent - the largest rise since March 2010 and just a touch below the Fed's 2 percent inflation target.

**France cuts 2012 growth forecast to 0.5 pct- PM**

France cut its economic growth forecast for this year to 0.5 percent from 1.0 percent to take account of a Europe-wide slowdown, but said its cautious 2012 budget allowed it to avoid further belt tightening measures.

With three months to go before a presidential election, Prime Minister Francois Fillon said that France's 2 trillion euro economy - and the euro zone in general - would return to growth before the end of the first half of the year.

Fillon said the budgetary impact of the growth reduction would be 5 billion euros (\$6.6 billion) but that no further austerity measures would be required because the government had left itself enough room for manoeuvre in its 2012 budget.

The government's new growth forecast is exactly in line with that of Socialist presidential candidate Francois Hollande, who unveiled his economic program for April's election last week.

**China c.bank may skip bill sales due to tight liquidity**

China's central bank has not asked banks about their demand for one-year bills this week, traders said, meaning it may continue to suspend bill sales to avoid draining cash from the financial system amid a lingering cash crunch.

It also conducted reverse bond repurchase agreements to temporarily inject more than 350 billion yuan (\$55.2 billion) into the system to stem the usual Lunar New Year cash crunch, as individuals and business withdrew cash for holiday gifts and bonuses.

Separately, China's Premier Wen Jiabao said the nation's government debt is at an "overall safe and controllable" level, that funding for key projects would be ensured and that applying the brakes to the problem would be done in a way to avoid systemic risks. "Currently, our government debt is overall safe and controllable," he said. "We are taking the issue of managing local government debt very seriously."



## TODAY'S TOP NEWS

**U.S. Fed's Plosser wanted more optimistic outlook -CNBC**

A top U.S. Federal Reserve official said he would have preferred a more optimistic statement on the U.S. economy, after the central bank last week painted a grim picture of the recovery and forecast ultra-low interest rates until late 2014.

"I thought it was a little bit pessimistic. I would have preferred a little more optimism in the outlook," Philadelphia Fed President Charles Plosser said on CNBC. "It's not that we're going to take off like a sky rocket going into this year, but I do think things are looking better," he said, citing a drop in the unemployment rate to 8.5 percent, which is still historically high.

Plosser, a policy hawk concerned more with keeping a lid on inflation than on the labor market, said he didn't see a need to buy mortgage-backed securities at this point. "I'm very concerned about policy (in which) we keep saying that we've got to do more... I worry about this accelerationist view that we have to go ever faster on the pedal of monetary policy," said Plosser, who does not have a vote on the Fed's policy-setting panel this year. "I was unhappy with the calendar date in the statement. I'm still unhappy with the calendar date in the statement. I don't think that's the right way to convey policy," he said, adding he expects rates to likely rise before mid-2013, even as early as this year.

**Euro zone yield spreads over German Bunds widen**

The yield spread between German Bunds and debt issued by other euro zone states widened, with investors worried about the lack of a resolution on the Greek debt swap deal booking profits after last week's peripheral rally.

The Spanish/German 10-year government bond yield spread widened back above 300 basis points after a brief period below that level late last week. The equivalent Italian spread expanded by 30 bps to 436 bps. The yield spread on 10-year Portuguese bonds over safe haven German Bunds topped 15 percentage points for the first time in the euro era. It cost a record 3.9 million euros (\$5.12 million) to insure 10 million euros of Portuguese debt.

"It's just a reversal of the tightening we saw last week. We still don't have a solution on Greece and so there's some good old fashioned profit-taking," one trader said.

**ECB's Mersch plays down rate cut prospects - paper**

ECB governing council member Yves Mersch has played down the prospect of further interest rate cuts, saying in a newspaper interview that the usefulness of additional cuts was limited in the current environment and could even do damage longer term.

Mersch, who is in the race to succeed Jose Manuel Gonzalez-Paramo on the ECB's Executive Board from June, told Germany's *Sueddeutsche Zeitung* that the interest rates were playing a less important role at present.

"Because of the many special measures (the ECB has taken), it appears that the role of interest rates is not so prominent anymore," he said.

"Negative real interest rates over a longer period not only diminish wealth - they put in question the effectiveness of money market funds, which have so far provided short term liquidity," he added.

Economists expect the ECB to cut interest rates to 0.75 percent in the next couple of months and some believe they could go as low as 0.5 percent before the middle of the year. "The purchases of government bonds may have worked temporarily as a stopgap, but they have no long-term future," Mersch was quoted as saying.

**Monetary policy can help long-term joblessness: Fed paper**

U.S. workers who lose their jobs are taking longer than ever to find new ones because so many are out of work and so few jobs are available, according to research from the San Francisco Federal Reserve Bank.

The finding that weak labor demand is at the root of the long-term unemployed problem suggests monetary and fiscal policy can be used to help, the researchers said in the latest Economic Letter from the San Francisco Fed.

That conclusion could feed into policymaking at the Fed, which last week signaled it would hold rates exceptionally low through late 2014. Citing low inflation and high unemployment, Fed Chairman Ben Bernanke suggested he is considering further easing with long-term bond purchases.

Some top Fed officials, like Philadelphia Fed President Charles Plosser and Dallas Fed President Richard Fisher, have questioned whether further easing would do much for jobs.

## NEXT UP

**POLL-ECB's Feb 3-yr tender to hit 325 bln euros**

The European Central Bank will allot 325 billion euros (\$427 billion) in its second three-year refinancing tender due in late February so long as money markets remain stressed, a Reuters poll of traders showed.

In the first of two planned offerings of unlimited cheap money intended to keep credit flowing among banks hammered by the euro zone's sovereign debt crisis, financial institutions took 489 billion euros on Dec. 22 from the ECB.

While short-term lending has improved in recent weeks, money market traders say banks remain reluctant to lend to peers for longer than a month, which means there will be plenty of demand for the funds.

One trader predicted the demand would be as high as 550 billion euros.

The 325 billion euro consensus for the next three-year tender on Feb. 29 is higher than the 263 billion expected in a similar

Reuters poll taken two weeks ago but is still significantly lower than the December refinancing operation. Eight of the 12 euro money markets traders who responded both this week and two weeks ago now expect a slightly higher allotment at the Feb. 29 tender.

The ECB's unprecedented first offering of three-year money appears to have averted a major credit crunch and relieved some of the tension in the system compared with late last year. But it is too early to rule that the additional funds will find their way into lending into a euro zone economy that looks to have slipped back into recession.

Credit is more or less normal in some parts of the euro zone but it remains seriously impaired in others, ECB President Mario Draghi said on Friday.

Traders also noted that elections this year expected in France and Germany, the two strongest economies in the euro zone, as well as a U.S. presidential election in November, have also added uncertainty to the situation.



## EYE ON ASIA

## POLL &amp; PREVIEW

## Taiwan Q4 growth to slow as weak export demand bites

GDP growth is set to slow sharply in the fourth quarter year-on-year, and may contract on a quarterly basis, due to a poor external demand environment.

The outlook for Taiwan's export-led economy has grown increasingly dark of late due to the global slowdown. Taiwan is one of the most open of Asia's exporters, with an exports-to-GDP ratio of 74 percent, making it extra-vulnerable to declines in external demand.

Orders for Taiwan's exports, a leading indicator of actual export demand, contracted in December for the first time in two years, and by more than expected, as a slowdown in China and Europe's continuing financial woes cut demand for the island's hi-tech products.

In November, Taiwan's government slightly cut its economic growth forecasts for 2011 and 2012 to 4.51 percent and 4.19 percent respectively. However a Reuters poll of 24 economists this month put 2012 GDP growth at a median 3.2 percent.

Taiwan's central bank could cut rates at its next policy meeting in March. It kept rates steady at the last meeting in December to support the economy, but did not cut as some had expected as it still saw danger from inflation.

## EVENTS

For Jan 31

## AUSTRALIA

- NAB business condition for December: Prior 1
- NAB business confidence: Prior 2
- Private sector credit final: Expected 0.3 pct Prior 0.3 pct
- Housing credit final: Prior 0.5 pct

## JAPAN

- Construction orders yy for December: Prior 21. pct
- Housing starts yy: Expected -1.5 pct Prior -0.3 pct

## MALAYSIA

- Overnight policy rate: Expected 3 pct Prior 3 pct
- Money supply for December: Prior 12.4 pct

## SINGAPORE

- Bank lending mm final for December: Prior 415.8 bln
- Preliminary unemployment final for Q4: Prior 2 pct
- Business expectations final for Q1: Prior -10 pct

## SOUTH KOREA

- CPI growth for January: Expected 0.6 pct Prior 0.4 pct
- CPI growth yy: Expected 3.6 pct Prior 4.2 pct

## TAIWAN

- Gross domestic product final for Q4: Expected 2.8 pct Prior 3.42 pct

## THAILAND

- Exports yy for December: Expected -2.35 pct Prior -13.10 pct
- Imports: Expected 18.85 pct Prior -1.90 pct
- Trade account: Expected -0.11 bln Prior 0.22 bln
- Current account: -0.91 bln Prior -0.14 bln
- Private investment index: Prior -6.30 pct

## MARKET SNAPSHOT as of 3:00 pm EST

GOVERNMENT BOND BENCHMARKS					EQUITIES			FORWARDS 3 months <FORWARDS>		
5-Year		10-Year				Close	Change		Bid	Ask
Bid	Yield	Bid	Yield							
Australia	112.301	3.325	116.196	3.852	S&P/ASX200	-	-	JPY	-6.85	-6.35
Japan	99.836	0.334	100.306	0.966	NIKKEI 225	8793.05	-48.17	AUD	-102.72	-102.12
China	102.332	3.010	101.337	3.400	HKSE	20160.41	-341.26	NZD	-49.8	-48.8
Hong Kong	101.100	0.593	98.750	1.331	SHANGHAI	2285.04	-34.08	HKD	-20	-15
Singapore	102.600	0.493	106.150	1.540	STRAITS TIMES	2888.29	-27.97	SGD	-5.4	-5
					SENSEX	16863.30	-370.68	THB	18.25	18.75
INTEREST RATE SWAPS <SWAPS>					DEPOSITS 3 months <DEPOS>			NDF's 3 months <NDFS>		
5-Year		10-Year						Bid		Ask
Bid	Ask	Bid	Ask		Bid			Bid	Ask	
AUD	4.255	4.315	4.6175	4.6725	JPY	0.18	CNY	-0.028	-0.023	
JPY	0.4275	0.4875	0.935	0.995	CNY	5.2	TWD	-0.215	-0.195	
CNY	3.7	3.8	3.67	3.87	AUD	4.6	KRW	1133.9	1134.9	
HKD	0.89	0.97	1.66	1.74	NZD	2.95	INR	50.46	50.56	
TWD	1.03	1.05	1.27	1.32	HKD	0.3	MYR	3.0665	3.0705	
INR	5.9	6.1	5.85	6.25	SGD	0.25	PHP	43.18	43.28	
KRW	3.3975	3.4375	3.545	3.585			IDR	8975	9075	
SGD	1.04	1.08	1.92	1.97						

## EYE ON LATAM

## LATAM TOP STORIES

**Brazil IGP-M price index up 0.25 pct in Jan after Dec fall**

Brazil's broadest inflation index, the IGP-M, rose 0.25 percent in January, following a 0.12 percent decrease in December, the Getulio Vargas Foundation research group said.

The index was expected to rise 0.32 percent, according to the median forecast of nine economists polled by Reuters. Estimates ranged from an increase of 0.28 percent to a rise of 0.4 percent.

The wholesale component of the index, which accounts for about 60 percent of the overall IGP-M, fell 0.07 percent in January, a slower decline than the 0.48 percent drop in December.

The consumer price component of the index, which has about a 30 percent weighting, rose 0.97 percent, speeding up from a 0.71 percent rise in December, with a 1.47 percent rise in food costs and a 0.76 percent rise in transport.

The construction costs index, which accounts for the rest of the index, rose 0.67 percent in January, accelerating from the 0.35 percent rise in December. The labor cost component of that measure in isolation rose by 0.98 percent.

The IGP-M is closely monitored by analysts and investors because it provides a broad look at wholesale and consumer prices in Latin America's largest economy. It also allows investors to watch price trends in the construction industry.

The IGP-M is normally published ahead of Brazil's benchmark IPCA consumer price inflation data for the same month.

**Chile posts Q4 fiscal deficit, 2011 surplus**

Chile's government posted an effective fiscal deficit of 1.5 percent of estimated gross domestic product in the fourth quarter, but reported a 1.4 percent effective fiscal surplus for 2011, the country's budget director said.

Annual state revenue was boosted by higher contributions from private miners after a tax overhaul and steeper average prices for copper, the top export, than in 2010, budget director Rosanna Costa said in a statement.

More than 30 percent of total annual spending occurred in the last quarter of 2011, as it has in most previous years, according to the budget director.

The annual surplus totaled 1.56 trillion pesos (US\$2.995 billion), while the fourth-quarter deficit reached 1.67 trillion pesos.

Central government spending in the world's top copper producer rose 3.2 percent in 2011, compared with the previous year.

**Chile Dec output falls vs Nov, rate cut seen possible**

Chilean industrial production in December suffered its first seasonally adjusted contraction in two months as the euro zone crisis weighed, the government said, and could tip the central bank's scales toward a rate cut.

The monetary authority, however, will watch inflation, which ended the year at 4.4 percent, above the bank's 4.0 percent tolerance ceiling, after an unexpected price spike in December that may have been transitory.

Industrial production fell 0.9 percent in December from November but rose 0.5 percent from the same month a year earlier, state statistics agency INE said, while output of the country's main export, copper, rose.

Industrial output rose 5.4 percent in 2011 from a year earlier, INE said, in its largest annual gain in six years. Industrial production jumped in 2011 as industrial sectors, especially in the first part of the year, recovered from a devastating February

## LATAM MARKETS TODAY

**TREASURIES:**

- Mexican 10-yr notes were up, yielding 5.92 pct and 30-yr bonds rose yielding 7.33 pct.
- Brazilian 10-yr notes surged, yielding 11.42 pct and 2-yr notes gained, yielding 10.08 pct.

**FOREX:**

- Brazilian real was up 0.73 pct to 1.7498 per dollar.
- Mexico's peso added 0.7 pct to 12.9879.
- Chile peso surged 1.3 pct to 490.6 per dollar.
- Colombia's peso rose 0.55 pct to 1,817 to the dollar and Peru sol edged up 0.04 to 2.689 to the dollar.

**STOCKS:**

- MSCI Latin American stock index fell 0.29 pct to 4037.42, retreating from a four-week rally that took it up more than 12 pct.
- Brazil's benchmark Bovespa stock index fell 0.21 pct to 62,770.01.
- Banks, builders and mining companies drove losses; with preferred shares of Itau Unibanco fell 1.69 pct. PDG Realty dropped 1.37 pct and Vale added 0.75 pct. PDG and Vale have risen 21 pct and 8 pct in January, respectively.
- Mexico's IPC index edged up 0.15 pct to 37,241.61.
- America Movil was up 0.33 pct, while Grupo Mexico dropped 0.56 pct.
- Chile's IPSA index fell 0.09 pct to 4,222.4.
- Falabella lost 0.51 pct and SQM slipped 0.17 pct.

## LATAM TOP STORIES

*(continued)*

2010 earthquake, INE said.

While industrial output showed clear signs of slowing, domestic consumption remained robust, with retail sales growing by double digits in December for the first time since June.

Retail sales jumped 10.1 percent in December on the year, and posted an accumulated increase of 11.0 percent in 2011, the INE said.

**Mexico loses \$50 bln/year in illegal outflows-report**

About \$50 billion a year is siphoned illegally out of Mexico due largely to tax evasion and trade manipulation, a report showed on Sunday.

At least \$872 billion has flowed out of Mexico illegally between 1970 and 2010, according to a report from Washington-based anti-corruption advocacy group Global Financial Integrity.

Almost 74 pct of the flows were due to so-called trade mispricing, such as companies manipulating export and import invoices, the report said. Total illegal outflows accounted for close to \$50 billion a year in the last decade, about 6 percent of Mexico's annual economic output, and the group said estimates were conservative because they did not include the proceeds of drug smuggling or human trafficking.

The study said authorities could stamp down on the distortion of trade invoices by using computer software to detect prices out of line with international norms and making buyers and sellers both sign a declaration that they had not manipulated prices.



## DEEP DIVE Commentary and Analysis

**The Siren call of austerity budgets**

By David Cay Johnston

The World Economic Forum opened in Davos amid choruses of central bankers and economists calling for governments to cut spending.

This message of austerity is like the call of the ancient Sirens, whose music lured sailors to shipwreck.

We should take a lesson from Odysseus, who poured wax into the ears of his crew and had himself lashed to the mast of his ship to resist the Siren call.

Austerity supporters are selling the idea that governments, like families, must cut back when income shrinks. But economically, governments are not like families.

Firing teachers, cops and government clerks will, for sure, reduce public spending. But budgets, like the song of the Sirens, are only part of the story. Listen only to the alluring lyrics and, like the many voyagers before Odysseus, we will suffer disastrous consequences - in our case falling incomes and worsening economies.

The full economic story begins with this principle taught to every economics student: spending equals income and income equals spending. Cut spending and incomes must fall; cut incomes and spending must fall.

Those who disagree with this say that only private spending can create wealth and that government spending is inefficient. I think the first argument is wrong, but the second is often true, which is why citizens need to pay close attention to their government.

When private spending shrinks, then either government spending must grow to make up for it or the other side of the equation, income, must shrink.

If we increase spending today by borrowing, we create a claim on future income. Families with debt must divert part of their future income to interest and principal to service that debt or go bankrupt. Governments are different, provided they have monopoly control of their currency. By definition, no sovereign government can ever go broke in its own currency.

**NO TO AUSTERITY**

The United States government, which has a monopoly on its currency, is \$15.2 trillion in debt, roughly the same as the entire output of the economy for a year.

That figure has been sung in a refrain about massive debt threatening to bring down the economy and cause inflation. Facts, however, show otherwise.

The country was much deeper in debt, relative to the size of the economy, in 1946 than it is today and yet what followed was decades of prosperity. The 1946 debt remains and, after six decades of growth, it is inconsequential.

In Japan, government debt is roughly twice annual economic output and yet the country continues to function because real interest rates are at or below zero.

To be sure, conditions can change and interest rates can rise sharply, though central banks have ways to limit that. But that is not the problem today. The problem today is shrinking incomes due to shrinking spending.

Austerity budgets, by reducing government spending, will only make incomes fall more. The only way to make incomes rise is to make spending rise, which in the short run means more borrowing by governments to enable more public sector spending.

After reading the news from Davos, ask yourself why we should listen to the Siren song of the financial elite. After all, the people who steered our financial ship into dangerous waters in the first place were at the very top of this group. We should listen more to those who will suffer from austerity budgets: children who only get one chance at an education, the sick and disabled unable to

support themselves and seniors too old to work.

If, like Odysseus, we wish to row past our current economic straits into a new sea of prosperity, the one thing we must not do is be driven to economic madness by the Siren call of austerity budgets.

(The author is a Reuters columnist. The opinions expressed are his own.)

**Fed-watching gives Asian central banks cause to pause**

By Emily Kaiser, Asia Economics Correspondent

Asia's central bankers have yet another reason to hesitate now that the U.S. Federal Reserve looks likely to keep interest rates low for longer.

Indonesia, Thailand, Australia and the Philippines have all cut interest rates at least once in the past three months to try to shore up economic growth, and many economists predict more easing to come this year from India and South Korea.

But as the U.S. central bank extends the horizon for its first rate hike, it changes the Asian equation. Instead of lowering interest rates, which may have unintended consequences when the Fed is on hyper-extended hold, it may make more sense for some economies to tinker with currency exchange rates.

Forecasts released last week from Fed officials show that it will probably be late 2014 before rates rise from the current level near zero -- considerably longer than the mid-2013 low-rate pledge the central bank had made back in November.

That could provide a "policy breather" for emerging markets if it helps sustain U.S. growth, which is essential to export-sensitive Asia, Philippines central bank Governor Amando Tetangco said on Thursday.

However, the Fed's forecasts are conditional. If the U.S. economy strengthens more than expected or inflation threatens to build, the Fed is under no obligation to stick to a late 2014 timetable for tightening.

"There is still much confusion over what the Fed did or didn't do," said Thomas Lam, chief economist at OSK-DMG in Singapore. "That's going to add another layer of complexity for Asian policymakers."

Asia's central bankers typically set interest rates with an eye on currency values because so many of the region's economies are driven by exports. An ultra-easy Fed probably means a weaker dollar, which eats into Asia's export price advantage.

That is why Lam expects Asian officials to rely on currency market intervention more than interest rate cuts to try to bolster economic growth. In Singapore, where exports are larger than the city-state's entire annual output, the exchange rate is the primary policy tool.

"There's never a disconnect between interest and exchange rates, particularly in Asia," he said. "Most of the Asian economies are export-driven, so even though they have an interest rate policy, exchange rates always play a key role in their decision making."

**OUT OF SYNC**

When the Fed embarked on its aggressive easing campaign, which eventually took rates to near-zero in December 2008, the global financial crisis was raging and the rest of the world was cutting rates as well.

But the world is not really in sync now.

Economies such as Hong Kong, China and Singapore effectively cede some control over monetary policy to Washington because they tightly manage their currencies against the U.S. dollar, which can cause headaches when growth rates diverge.

The Fed's easy-money policy can weaken the dollar, putting a



## DEEP DIVE Commentary and Analysis

drag on Asia's dollar-linked currencies and driving up imported inflation. Hong Kong, Singapore and China are already grappling with inflation rates running above policymakers' comfort levels.

Even those countries that keep a looser grip on foreign exchange rates must be mindful of Fed policy when setting their own interest rates. Cut too far and the gap between the two rates narrows, making it less attractive for foreign investors; hike too much and it could draw an onslaught of speculative money that drives up inflation.

Rahul Bajoria, an economist with Barclays Capital in Singapore, said emerging Asia's rate-cutting cycle was "pretty much done" for now, with the exception of India where domestic growth and inflation are both slowing sharply.

## FOLLOW THE MONEY

The Fed also said it was ready to provide more economic stimulus should growth falter, which economists took to mean it would probably buy more government bonds or mortgage-related securities. It has already more than tripled its balance sheet to \$2.9 trillion through two sets of bond purchase programs.

The second round of bond purchases, launched in 2010, provoked howls of protest from Asian officials, who blamed it for

stoking inflation and sending uncontrollable waves of speculative money into emerging markets. But talk of a third batch has so far elicited few, if any, complaints.

Part of the reason is that Asia's own growth is slowing, unlike in 2010 when it came charging back from the global slump. In addition, some Asian economies such as India and China have been more worried lately about capital flowing out rather than in, and would welcome a little more foreign capital.

In the first four months of 2011, emerging market foreign exchange reserves shot up at a nearly 30 percent annualized pace, according to data from J.P. Morgan. But the pace tapered off in the second half of the year as investors shied away from riskier markets. China's official reserves recorded a rare decline in the final quarter of 2011.

But if the Fed's easy-money stance helps boost U.S. growth and Europe's debt troubles simmer down, Asia could soon be back to worrying about inflation instead of growth, and a wave of foreign money might once again be unwelcome.

"Given the point in the (economic) cycle we are at, I don't think they will be very concerned about capital flows, but six months down the line, the outlook could change once the worst is behind us," Barclays' Bajoria said.

"Policymaking has to be pretty nimble on both sides."

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