G8 exit strategy message bodes well, split less so

Mon Jun 15, 2009 4:58am EDT

By Jo Winterbottom and Patrick Graham - Analysis

LECCE, Italy (Reuters) - Financial markets may take G8 finance ministers' first hints of a move out of crisis mode this weekend as a sign the economy has turned the corner -- and that is exactly what some policy makers may be worried about.

The differences that emerged, just weeks after the world's top countries showed a united front at London's G20, underline the varying pace of recovery among economies and the extent of the risks that still face some governments.

Europe is divided on publishing bank stress tests, there was no sign at all of progress on financial regulation, and the UK and U.S. were left moving swiftly at the end of the meeting to try to rein in the idea that recovery may soon be assured.

"There was an implicit split between the US and UK on one hand and Europe on the other over the pace of unwinding (crisis measures)," said Simon Derrick, head of currency research, Bank of New York Mellon in London.

"The US and the UK were saying it's too early to talk about when," he added, saying the split had been brewing for some weeks. "The fact (the difference of opinion) is still there is a measure of the deep divisions... and that also could be a concern for investors."

Germany and Canada led the push for ministers to tackle the problem of how to start rolling back huge state spending and hiking interest rates, to ensure the credit crisis is not followed by a surge in inflation and a fiscal blowout.

"The issue is to act in time to prevent any inflationary developments playing a major role," German Finance Minister Peer Steinbrueck said. "All of the G8 are aware of the risks for the capital markets."

A surge in long-term government bond yields over the past several weeks showed investors worried about the impact of huge sums poured into economies and some analysts said bond markets would take heart at hints states may cap new borrowing.

"We can price out some of that supply fear. This year is still going to be horrible but ... we can start looking forward to next year and the next," said Peter Chatwell, interest rate strategist, at Calyon in London.

HANDS OFF DOLLAR

U.S. Treasury Secretary Timothy Geithner was among those voicing the most caution, urging his counterparts not to read too much into the initial "green shoots" of recovery and that it was too soon to begin withdrawing stimulus policies.

Governments should keep their foot on the accelerator until clearer signs of recovery are more firmly established, he said.

"I don't think we're at the point yet where we have a recovery in place," he

said.

"What you can say is, that the force of policy actions that have been put in place and in the pipeline have brought about a very important reduction in concern about the prospects of a deep recession globally."

Going into the meeting, concerns had been rising about mounting losses for the dollar caused by the mountain of debt the United States is issuing and will continue to issue.

Russia had also knocked the US currency backward by saying it was ready to reduce the share of US bonds in its holdings.

But there was little mention of the dollar from policymakers and what there was, notably Russian Finance Minister Alexei Kudrin, seemed aimed at lending support.

Bank of New York Mellon's Derrick said he heard in what comments they were the will among leaders to support the idea of a strong dollar. But, as officials privately admitted on the sidelines of the meeting, there is a general understanding that the greenback will come under further pressure sooner or later.

Derrick forecasts the dollar to weaken past 1.50 to the euro and toward 1.80 against sterling in 12 months, but he said that could come a lot faster and certainly before the end of the year.

"If you take a first look at the Russia comments, they look ok," he said. "But as you put it into context, it doesn't mean anything more than that they've been told to be quiet."

Ministers also returned to concerns over speculation, this time focusing on commodities and oil markets, but using similar language to that previously aimed at currency markets.

POLITICAL PRESSURE

The communique's language on exit strategies took care to note that each country would come out of the last year's crisis in different shape and at a different pace, and analysts said that was at the base of the split among leaders.

Germany and the UK face elections within the next year, while Geithner and the Obama administration are trying to maintain momentum in policies implemented right at the start of their watch that have managed to ease at least the scale of the crisis.

London and Washington, whose banks lie at the heart of the crisis, are more concerned than the Europeans to keep their eyes open for signs of a second wave of banking troubles, unemployment and insolvency as the real recession sinks in.

"The Anglo-Saxon countries (US, Canada, UK) and Japan seem more willing to consider further stimulus if the recovery doesn't pick up steam," said Eswar Prasad, senior fellow with the Brookings Institution in a note.

"These countries are also taking a more guarded approach to financial regulation."

The meeting's other sore point was the Europeans failure to find a common public line or strategy on testing the vulnerability of their banking systems -- so-called "stress tests" which have boosted confidence in U.S. lenders.

These issues, however, are likely to drag on into further summits, with G8 heads of state hosting another broader round of talks in Italy next month.

"There is general agreement on the need for an overhaul of financial sector regulatory frameworks but it is becoming clear that domestic politics in each country will determine how far each country is able to go," the

Brookings Institute's Prasad said.

"It will be difficult to move from agreement on principles to specifics about how to coordinate regulatory frameworks across countries."

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