APPENDIX 5

Economic and market review for the three months to June 2010 (Sterling Consultancy Services)

The April to June quarter marked a significant deterioration in risk appetite, resulting in substantial market volatility with the potential of a detrimental impact on the global economic recovery. The risk averse attitude was a consequence of growing uncertainty over the financial strength of European nations, prompting concern about the impact of a sovereign default on the banking sector. Many countries had embarked on expansionary fiscal policy at the height of the recession, but as the global economy stabilized, attention turned to the cost of these policies. Of particular concern to investors were those countries with unsustainable fiscal deficits and weak growth prospects, characteristics shared by the Eurozone periphery. Until this point an implicit guarantee for all Eurozone countries had been assumed, but with a potential domestic backlash, many European politicians were reluctant to be seen to finance the wastefulness of other states. With politicians dithering, investors initially discarded Greek bonds, pushing yields over 9%, before selling the debt of other southern European countries. The market reaction galvanized Eurozone politicians; a joint bailout of Greece with the IMF was agreed, while the ECB intervened in financial markets to maintain liquidity, actions that to some extent assuaged investors' concerns. As part of the bailout, Greece was forced to instigate fiscal tightening to reduce its deficit, a requirement that soon became a trend across Europe as countries acted to maintain investor confidence.

The problems of Eurozone nations helpfully diverted attention away from the UK, with the lack of a clear outcome in the General Election largely ignored. Indeed, gilt yields actually declined despite the result because of the safe haven reputation of UK government debt. After much wrangling, the Conservatives and Liberal Democrats formed a coalition, with the primary aim of reducing the UK budget deficit. The markets broadly welcomed the outcome.

The UK economy expanded 0.4% in Q4 2009 and 0.3% in Q1 2010, and early indicators signaled a similar, if not more rapid, expansion in Q2. However, as the period progressed it became obvious that slower economic growth would be the primary consequence of the sovereign debt crisis. Its negative impact on global confidence, particularly in Europe, caused a fall in foreign demand for UK manufactured goods. Meanwhile domestic demand remained subdued, with businesses and consumer spending deferred in anticipation of severe fiscal tightening by the new coalition government. It duly delivered, initially implementing £6bn of immediate spending cuts before announcing further stringent cuts and tax rises to take effect from 2011 in an emergency Budget. The government's hard line may be painful for the public, but it convinced credit rating agencies to maintain the UK's AAA rating, reducing the chances of a rise in the cost of borrowing.

The European debt crisis and fiscal tightening amplified the downside risks to the economic recovery, so it was no surprise that MPC members were reluctant to tighten monetary policy by raising interest rates, despite stubbornly high inflation. Bank Rate remained at 0.5% throughout the quarter and could stay there for some time yet.