

Schroders

Economic and Strategy Viewpoint

Keith Wade
Chief Economist and
Strategist
(44-20)7658 6296

Azad Zangana
European Economist
(44-20)7658 2671

Global: Will sovereign debt problems bring an end to the Euro project? (page 2)

- As government budget deficits rise to the highest levels experienced during peacetime, markets have begun to question the sustainability of fiscal support. The Euro area has come under acute pressure prompting the European Union to announce a €750 billion rescue package. The European Central Bank (ECB) has also agreed to buy government bonds and increase liquidity to the banking sector.
- The package has been successful in reducing spreads on peripheral government bond markets largely driven by ECB purchases. However, significant funding needs lie ahead and fiscal policy will need to tighten for several years to return debt to more sustainable levels. Essentially the package will buy time for Euro area governments to put their fiscal house in order.
- Along with an accommodative monetary policy and the political will to cut spending and raise taxes, governments need growth to succeed in reducing their borrowing. We look at the prospects and what needs to happen to make the Euro area work. We do not predict the end of the single currency, but believe the price will be much greater fiscal integration, a less credible ECB and a weak Euro (EUR).

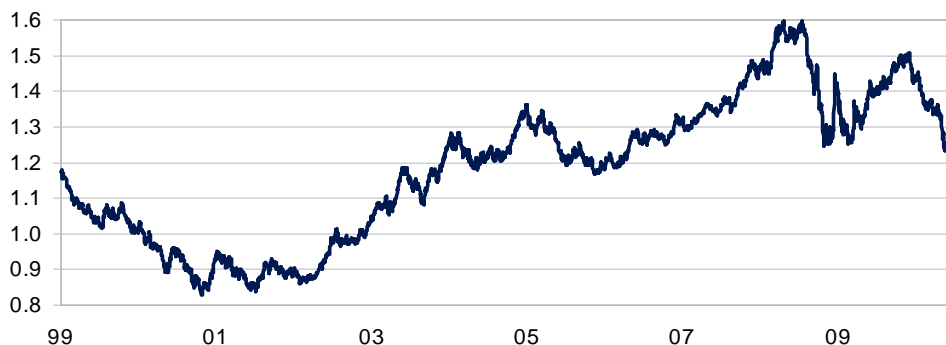
UK: Coalition and economy stronger than expected (page 10)

- Following the general election earlier this month, the UK has a new coalition government – the first coalition since the Second World War. But fear not, the new Chancellor has wasted no time in announcing £5.7 billion of public sector cuts, with more to follow in the forthcoming emergency budget.
- Meanwhile, the Bank of England (BoE) is persisting with its (excessively) dovish language despite inflation continuing to surprise on the upside. However, not all Monetary Policy Committee (MPC) members share Mervyn King's view. The debate centres on the amount of spare capacity in the economy and the new rate of trend growth, which we argue is smaller than the MPC assumes. As a result, we continue to expect an increase in policy rates before the end of the year.

Forecast update (page 16)

- Despite the problems in the Euro area, we have upgraded global growth led by revisions to the US, Japan and emerging markets. Inflation is expected to be quiescent and monetary policy tightening has been pushed out.

Chart: Sharp fall in the EUR/USD



Source: Thomson Datastream, 25 May 2010



Global

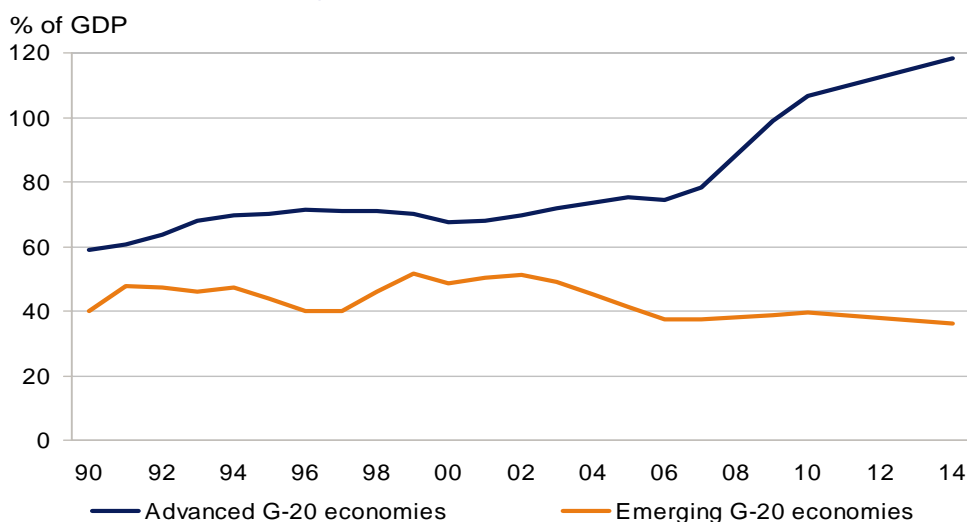
Markets question fiscal support as government borrowing soars in the advanced economies

Global: Will sovereign debt problems bring an end to the Euro project?

The banking crisis, which began in the US some three years ago, has become a sovereign debt crisis. Governments found that they could cushion the worst effects of the banking crisis by allowing their borrowing to increase, but only up to a point. There are limits to Keynesian economics. As budget deficits rise to the highest levels ever seen during peacetime, markets have begun to question the sustainability of government support. Nowhere has the issue been more acute than in the Euro area where debt problems in the peripheral countries are raising doubts about the viability of the single currency.

The International Monetary Fund (IMF) highlighted the problem at a global level in a recent report when they noted that the advanced economies were heading for a collective debt to GDP ratio of 120% by 2014 (see chart 1). All the G7 economies, with the exception of Canada, were heading for individual debt to GDP ratios of more than 90% by 2014. Note the sharp contrast with the G-20 Emerging economies where debt ratios are expected to remain around 40%.

Chart 1: Surge in government debt
G-20 countries: General government debt ratios



Source: World Economic Outlook (WEO), 22 September 09, "The state of public finances cross-country fiscal monitor," IMF, 3 November 2009

Reserve currency status has supported US Treasuries

The financial markets could have focussed on any of the major economies. Many thought that the US would be the first to experience a funding crisis as it was, and still is, running a twin deficit - i.e. current account and budget deficit. There were fears that China would stop funding the US, but instead the US dollar (USD) and Treasury markets have been firm. As noted in our April viewpoint, it is a great advantage being the reserve currency of the world. In addition, as long as China pegs its currency to the USD, it has little choice but to keep buying dollars.

Japan was another crisis candidate with a massive debt to GDP ratio of 220%. However, high domestic savings and an economy which offers little alternative to investors but Japanese government bonds (JGB's) has managed to keep funding its budget deficits.

Vulnerability in peripheral Europe

So instead, the markets have turned on the Eurozone. Not on Germany or France, but Greece and more recently Portugal and Spain. Unfortunately, the link between wolf packs and markets is that both pick on the weakest. The periphery is vulnerable as the boost to growth from the fall in interest rates which followed Euro membership has come to an end – sometimes in spectacular fashion as bubbles, generated by easy money in housing, banking and finance have burst.

Europe raises the stakes

Prompting a major reaction from the EU

However, markets have found that rather than being able to pick off one country at a time, they are now taking on the entire Euro project. The European Union (EU) have raised the stakes. After several weeks of dithering and a gradually deepening crisis – on May 10th the EU announced a €750 billion rescue package. The question now is whether this will be sufficient to calm the markets and save the Euro project.

The €750 billion package consists of €440 billion of government loan guarantees from Eurozone members, €60 billion from the EU's existing balance of payments facility and €250 billion from the IMF. In addition, and contrary to their public stance only a few days earlier, the ECB will take action to intervene in public debt markets (buying sovereign bonds) and will take extra measures to boost Euro area bank liquidity (the 3 and 6 month auction facility to provide unlimited liquidity at a fixed rate). The package also reactivated USD swap lines. Consequently, any Euro area bank can get unlimited funding in EUR or USD.

The package is certainly substantial and, when combined with the €110 billion already announced for Greece, is enough to cover principal repayments, interest and new issuance for Greece, Spain and Portugal over the next 3 years, twice over. Or enough to pay off all the national debt of Spain and Greece.

Although not all the details are available, for example it is not clear how the money will be raised, essentially the package is an enlarged version of what is on offer to Greece – a mixture of loan guarantees and IMF support, which will be tied to strict lending conditions policed through close monitoring.

Strong credits lending their status to the weaker countries

From a market perspective, it demonstrates the extraordinary lengths that the EU is prepared to go to defend the Euro. Effectively the stronger most creditworthy governments are now lending their credit status to their weaker Eurozone counterparts through guarantees and by having the ECB buy bonds in the secondary market.

Consequently, investors betting against Greece (or Spain, Ireland, Portugal) are now betting against the creditworthiness of Germany and France, who will be funding the bulk of the guarantees. Furthermore, it is not just sovereigns who are getting support, the banks also get unlimited funding.

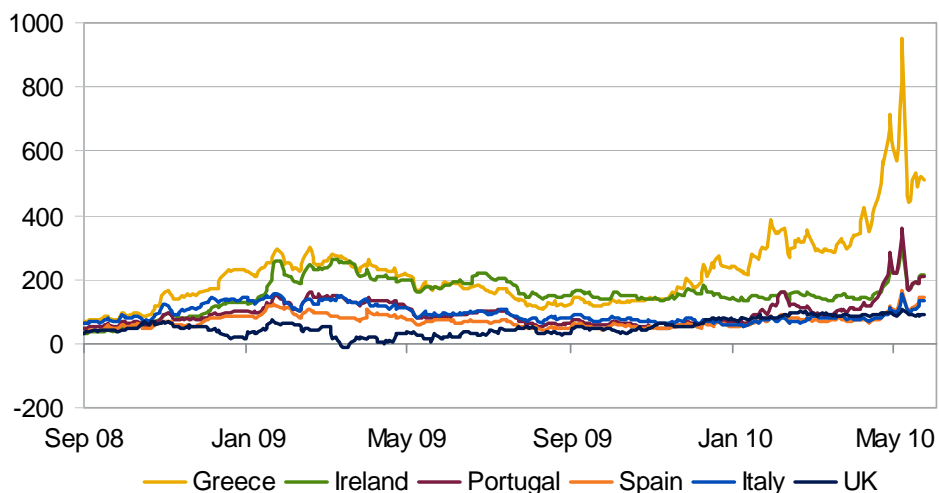
Breaking the spiral of rising rates and increasing default risk

Will it succeed?

The initial reaction has been favourable. Sovereign bond markets have rallied and spreads have narrowed (chart 2). Consequently, the package has had some success in breaking the vicious spiral of rising interest costs and an increasing probability of default. The price though has been a massive transfer of risk from the private to the public sector in the form of the ECB, which has been the principal (possibly sole) buyer of peripheral country debt.

Chart 2: EU package brings some relief – bond spreads narrow

10-year government bond yield spreads over Bunds, bps



Source: Thomson DataStream, 25 May 2010.

The aim is to quell market attacks (hold back the wolf pack) for a period and enable countries to focus on fiscal consolidation without facing escalating interest costs. It is a means of buying time.

Significant funding ahead

This presents a daunting challenge. As we have highlighted before, funding requirements in Europe are substantial with Greece needing to find some 22% of GDP this year and 24% next to roll over existing debt, pay interest and raise new borrowing. Greece is in the worst position, but Portugal and Spain are not far behind with both needing to find around 20% of GDP this year to meet their funding requirements. Notably, both countries have announced further tightening since the EU package was announced.

Looking at the debt and deficit figures it is clear that Greece has the highest level of government debt outstanding. However, primary and structural deficits are substantial for all countries indicating that the deficit will not simply disappear as growth improves (see table 1 on next page).

Table 1: Selected public finances

2010 forecast, % of GDP	Greece	Portugal	Spain	Ireland	UK
General government deficit	-9.3	-8.5	-9.8	-11.7	-12
Primary government deficit	-4	-5.5	-7.6	-8.8	-9.3
Structural government deficit	-8.2	-7.5	-7.8	-8.7	-10.4
Gross government debt	124.9	85.8	64.9	77.3	79.1
S&P sovereign risk rating	BB+	A-	AA	AA	AAA
Memo item: current account	-11.2	-10.1	-5.1	-2.9	-1.3

Source: European Commission Spring 2010 Forecast, Bloomberg, IMF, 11 May 2010

Will the UK stay triple A?

We have added the UK to this table to highlight the vulnerability of the country's AAA rating. There is little to differentiate the UK from the other peripheral economies –the level of gross government debt is similar to Ireland and the deficit is larger than that of Greece whether it is measured as a total or broken down into its structural or primary components.

One difference which helps the UK is a smaller current account deficit for example, Greece and Portugal both have double digit current account deficits indicating a heavy dependence on overseas funding. The UK also runs a deficit but according to the IMF, this is a more manageable 1.3% of GDP. This is also reflected in the higher proportion of domestic holders of UK government bonds (70%) compared to Portugal and Spain (estimated to be around 30%). The UK also has the advantage of a floating currency – i.e. a means of boosting growth not available to individual Euro area countries. Nonetheless, the new UK coalition government face a serious challenge in maintaining the UK's sovereign rating.

New age of austerity ahead

All this implies that fiscal policy will need to be tightened for a number of years to bring borrowing back to more sustainable levels. The IMF estimated that Greece would need ten years of spending cuts and tax increases of around 1.5% per annum of GDP to bring debt to a more sustainable level. For the UK and Spain, the comparable figure was 1% per annum and for Portugal 0.7% per annum. Of course, policy will not be tightened to this degree. Such action would lead to deep recessions and the problem all policymakers face is that they must bring government borrowing down without de-railing the recovery.

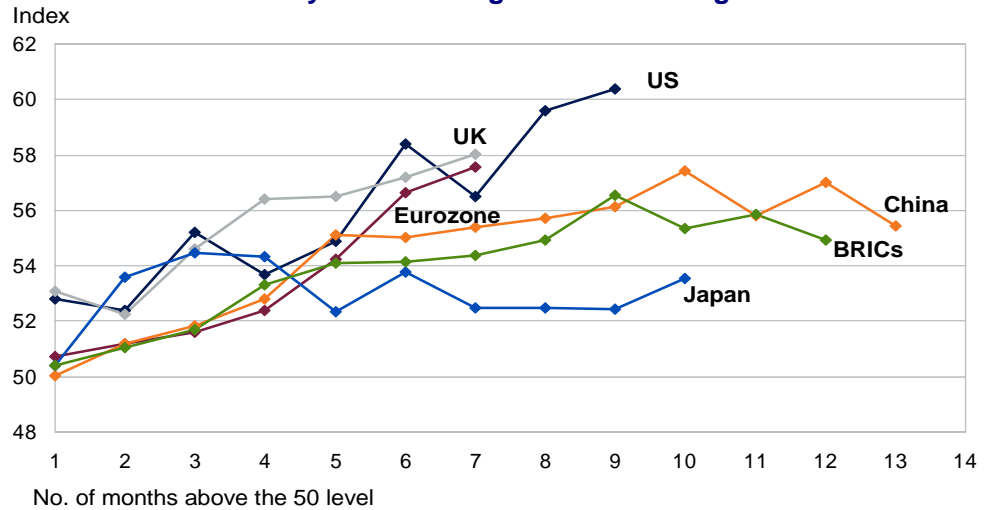
We would identify three conditions for a successful reduction in government borrowing:

- Interest rates must remain low and stable.
- There must be political will to make hard choices as demonstrated by packages announced by Spain and Portugal and earlier in Ireland.
- Europe needs growth. It is very hard to cut budgets when activity is weak as there is the risk of driving the economy into a black hole. Structural reform will be needed to sustain growth in the medium term.

To focus on the growth side. Encouragingly as part of the global upswing there has been a pick up in the PMI's (Purchasing Manager Indices) and business surveys in Europe (chart 3 on next page) However, domestic demand remains weak with retail sales still below their levels of a year ago. Consequently, the current outlook is not very promising and we are forecasting just 1.2% GDP growth this year and 1.5% next for the Euro area.

Fiscal policy needs to tighten for several years

Chart 3: World economy is recovering – manufacturing PMI's



Source: Schroders, Markit PMI, 4 May 2010
 BRIC: Brazil, China, India & Russia
 GDP weights based on nominal GDP in USD from IMF

Fall in Euro will boost growth at the expense of the rest of the world

Support will come from the pick up in the world economy where we continue to see a revival in trade growth and the fall in the euro. This has been the silver lining in the crisis as the Euro has lost some 10% in trade weighted terms since the start of the new year. Estimates suggest that a 10% fall adds 0.5% to Euro area growth if the depreciation is sustained for one year.

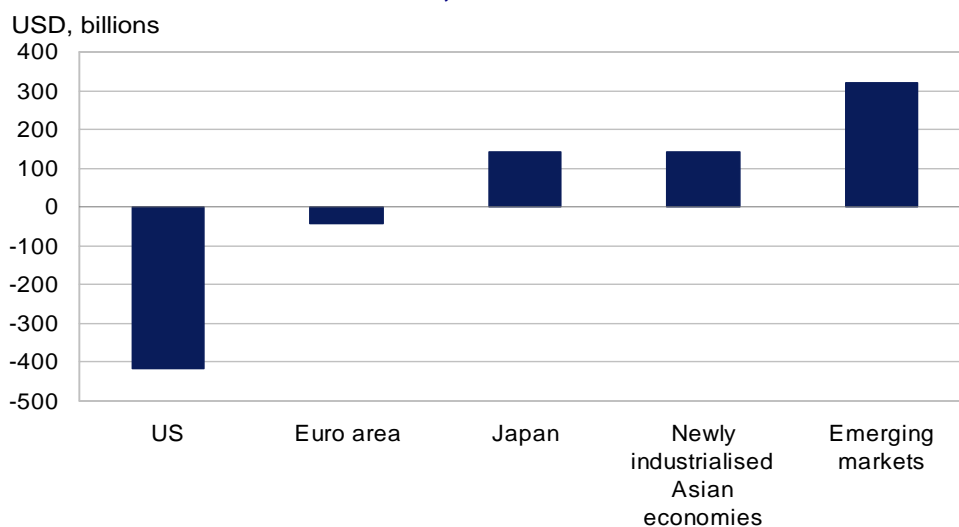
Chart 4: Sharp fall in the EUR/USD



Source: Thomson DataStream, 25 May 2010

Better trade performance will be an offset to tighter fiscal policy, however, such growth comes at the expense of the rest of the world where net exports to the Euro area will be weaker. The crisis in the Euro area is deflationary for the world economy. However, whilst the EU represents some 30% of global GDP, it is not a driver of global demand. Euro area trade with the rest of the world is close to balance (see chart 5 on next page), a reflection of large German surpluses offset by deficits in Italy and Spain. The Euro area will probably now move into surplus and although this will be a drag on global growth, it is not starting from the same elevated base as say the US in 2007/ 08.

Chart 5: Current account balances, 2009



Source: World Economic Outlook Database (April 2010), IMF
 Newly industrialized Asian economies are composed of 4 countries: Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

The fundamental problem

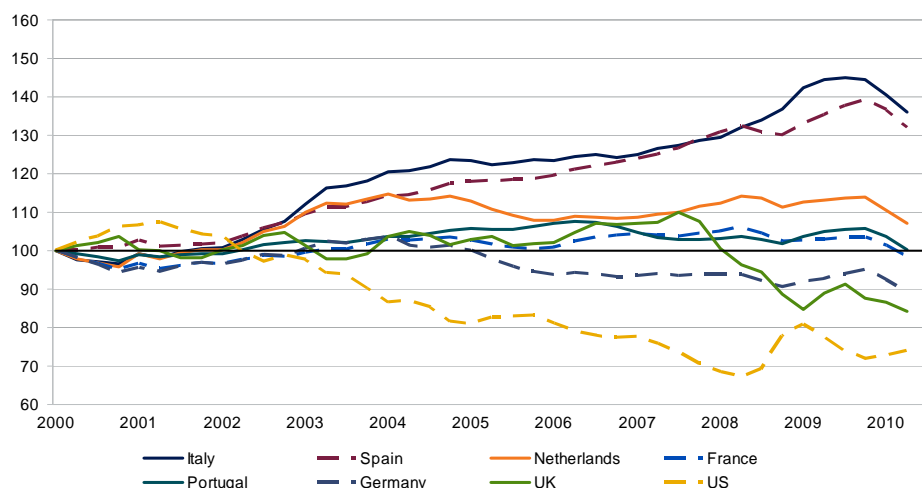
Factors like world trade and currencies are important for driving growth in the near term. In the longer run though the Eurozone will have to address its fundamental problem, which is a lack of competitiveness within the region.

Loss of competitiveness in the periphery has hit growth

There has been too much inflation in the peripheral economies, which has meant a loss of competitiveness against Germany. The wide divergence in relative unit labour costs as a result of a decade of differing wage and productivity performance can be seen in chart 6. Loss of competitiveness has meant weaker trade performance and slower growth.

Chart 6: Real effective exchange rates diverge

2000=100, Relative unit labour costs



Source: OECD, Thomson Datastream, Bloomberg, Schroders, 25 May 2010

Without a floating exchange rate, it is very difficult to regain competitiveness and consequently economists speak of the need for an “internal” devaluation. In practice that means lower inflation than Germany, which effectively means deflation. Note that the UK is more competitive than Germany on this measure only because Sterling (GBP) has devalued, something which is not an option for Eurozone members.

The fundamental problem for the Eurozone is that at its heart is Germany, a deflationary economy which every year gains competitiveness and runs large trade surpluses with the rest of Europe. The periphery runs deficits and net trade drags on growth. The problem was masked by the credit driven boom until 2007 and while the government has taken over the role of the banks by running large deficits, we have now reached the limits of that intervention.

A sustainable Euro requires a mechanism for recycling surpluses

If Portugal and the peripheral countries are to sustain Euro membership over the long run, without special support, they must become competitive and bring costs down. That means liberalising labour markets and reducing wage costs. Alternatively, it would mean a system of permanent fiscal transfers – a mechanism of recycling the surpluses from the core to the periphery.

How will it play out?

No one knows whether the Euro will survive and what follows can only be speculation. Given better debt dynamics, Portugal and Spain may get through and reduce their deficits with minimal support from the EU. However, we still have doubts about the solvency of Greece.

The latest plan for Greece (approved by the IMF on the same day as the €750 billion package was agreed) has the budget deficit falling from 13.6% to just under 5% in 2013 while debt to GDP reaches 149% GDP. Arguably, this in itself is not sustainable as the level of debt is too high and Greece would probably need another package to see it through the next three years.

The real issue though is that the IMF forecast GDP will fall by 4% this year, and 2.6% in 2011 before growing by just 1.1% in 2012. This is a recipe for social unrest as unemployment, which has just gone through 10% is set to soar. Some are forecasting it will double to 20% of the workforce in a year's time (chart 7). The recent riots in Athens will not be the last.

Chart 7: Unemployment rate in Greece



Source: Thomson DataStream, 12 May 2010

Choice between disintegration or greater integration

Against this backdrop, it is hard to see Greece sustaining its fiscal austerity program. They will probably break the conditions and relax spending. After all, Greece is a democracy and there will be intense internal political pressure to change course. The IMF will call foul and threaten to stop lending. There is then the prospect of a restructuring or default. Contagion risk will return and the EU will be back where it started.

Given that it will still be running a primary deficit, Greece will be reluctant to default as the country will still need to access the capital markets. In these circumstances, we believe the EU and IMF will relax their lending conditions. Loans will become aid. There will be political unrest. Not just in Greece, but in Germany where taxpayers will realise that they have to pay more. However, throughout history this has been the pattern of bailouts.

A glimpse of the future?

Therefore, if we fast-forward to 2013 it is likely that Spain and Portugal are surviving, but Greece is likely to be on long-term support. Meanwhile, the ECB will have accumulated significant holdings of peripheral bonds on its balance sheet.

The ECB president Axel Weber, who took over from Trichet in 2011, will probably have resigned as his ability to raise interest rates and tackle inflation will have been undermined by political pressure. He is likely to have been replaced by the head of the IMF, Dominic Strauss-Kahn, who having been so involved with the Euro area, decides to make it a full time job.

In the choice between integration and disintegration the Eurozone members are pursuing integration. In 2013, it is likely that EU governments will be preparing to approve the next Greek budget and there are rumours of another package. However, while it may be trading below parity with the US dollar, the Euro is likely to be intact as the project soldiers on.

UK

UK election yields first coalition government since 1945...

...but the coalition is quick to signal intent of cutting the huge public deficit

Coalition & economy stronger than expected

Six days after the British people went to the polls, a Conservative-Liberal coalition has emerged to form the UK's first coalition government since the Second World War. Barely two weeks later and the new Conservative Chancellor is detailing over £6 billion in public sector spending cuts, sending the markets an early signal that fixing the UK's terrible public finances is a top priority for Whitehall.

Meanwhile in the City, the Bank of England continues to chant its dovish mantra despite inflation continuing to surprise on the upside. The more hawkish members of the Monetary Policy Committee are becoming more concerned over risks of higher rather than lower inflation over the coming years.

General election results in first coalition government since 1945

Gordon Brown's resignation as prime minister and his departure from number 10 Downing Street felt like the end to a Hollywood movie. Thirteen years of Labour party rule came to an end when the party failed to secure a majority following the general election, and to find enough common ground with the left leaning Liberal Democrat party. Instead, David Cameron's Conservative Party won the largest share of the votes and parliamentary seats and formed a coalition government with Nick Clegg's Liberal Democrat party – the first coalition government since the Second World War.

However apart from the warm images of the two coalition leaders, this is not a happy Hollywood ending. Tough decisions have to be made quickly on how the new coalition will tackle the UK's colossal budget deficit. Fortunately, the coalition has wasted no time in setting out a timetable for announcements.

Barely two weeks after the formation of the new government, the new Chancellor of the Exchequer, George Osborne, has unveiled £5.7 billion (0.4% of GDP) worth of public spending cuts. In addition, the Chancellor will hold an emergency budget on 22 June where he is likely to announce further fiscal tightening measures (including our forecasted increase in VAT (Value Added Tax)).

While £5.7 billion is a drop in the ocean when compared to the size of the budget deficit, this is all encouraging so far. Despite the two parties being ideologically opposed to one another, common ground appears to have been found and there is a general consensus on the priorities of the government. However, the honeymoon will undoubtedly end at some point. Differences between the parties will emerge and depending on how the leadership handle these differences, questions may once again arise about the strength, and the sustainability of this government.

Growth revised up, but inflation also higher than expected

Despite all the political uncertainty, the UK economic recovery appears to be on course. Forward-looking private business surveys continue to signal strong growth, and there is more evidence coming through from the real economy that activity is gathering momentum.

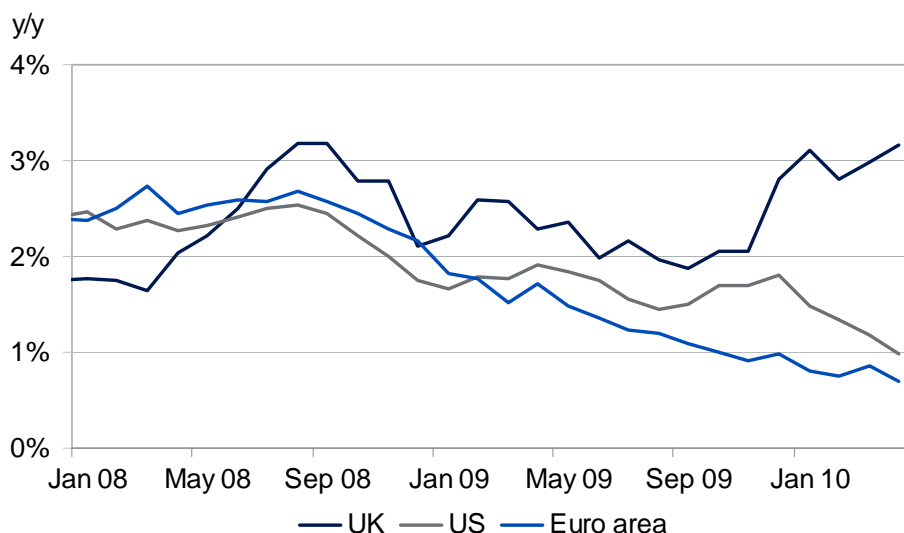
The second estimate of first quarter GDP showed growth in the first three months of the year to be slightly higher than previously estimated in real terms (0.3% versus 0.2% quarter on quarter). As we suggested in the March viewpoint, higher inflation in the first quarter may dampen growth in real terms. Indeed, growth in nominal terms was much stronger at 2.1% for the first quarter, or 8.5% on an annualised basis!

Growth has been revised up, but inflation continues to disappoint

The latest inflation annual data shows consumer price index (CPI) inflation at a 17 month high in April, while inflation based on the retail price index (RPI) jumped to 5.3% - a 19-year high.

The development of core inflation (CPI inflation excluding food, alcohol and energy prices) is particularly troubling. Unlike the US and Euro area, annual core inflation has continued to rise, even after VAT was raised back to 17.5% in January (chart 8).

Chart 8: Divergence in CPI core inflation*



Source: DataStream, 24 May 2010.

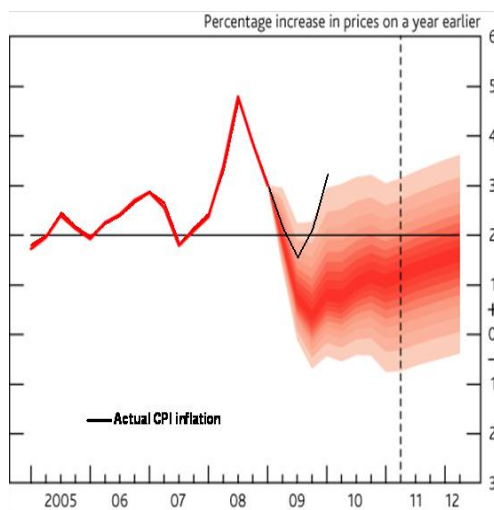
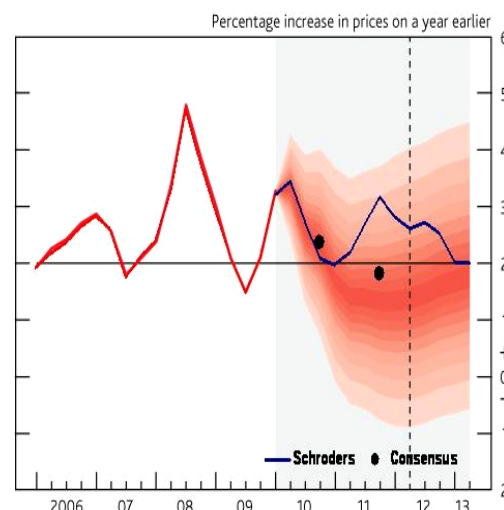
*Core consumer price index inflation excluding energy and food.

Despite the poor inflation data, the Bank of England has persisted with its dovish tone, though one has to question the Bank's judgement and inflation forecast. Does the Bank's inflation fan-chart provide an accurate representation of the Bank's views on the risks around inflation? Or is the chart being used to influence inflation expectations? If it is the former, then we have to be concerned over the Bank's ability to forecast inflation.

BoE gets inflation forecast badly wrong

The Bank of England got inflation badly wrong...

Chart 9 (on next page) shows the Bank's forecast from the May 2009 inflation report. We have also plotted the actual outcome of CPI inflation to highlight the error in the BoE's forecast. At the time the forecast was produced, the Bank of England was aware of the changes to VAT, and had already seen most of the depreciation in Sterling that would eventually feed through to higher inflation. And yet, the Bank had forecast CPI inflation to fall to 0.8% for Q1 2010. While it had actually fallen, inflation then rose to 3.3% - a huge 2.5% error. In fact, the BoE had only placed a 6% probability that inflation could be above 3%, and we can see that the outcome was outside the Bank's 95% confidence interval fan-chart.

Chart 9: May '09 BoE inflation forecast & outturn**Chart 10: May '10 BoE forecast vs. Schroders & consensus**

Source: Bank of England, May 2009 (left) and May 2010 (right) Inflation Reports quarterly year on year inflation forecasts. Consensus taken from HMT comparison of forecasters: 3-month average of latest city forecasts (May 2010). Note that the Schroders forecast assumes VAT is raised to 19% in January 2011. Updated 24 May 2010.

...but continues to chant its dovish tone

Despite the disappointment, the BoE has continued to forecast inflation falling quickly below its central target of 2% annual inflation. Chart 10 shows the Bank's latest forecast taken from the May 2010 inflation report, as well as our own forecast, and the latest point consensus forecasts from the HM Treasury comparison of independent forecasts.

As we have written in the past, we expect headline inflation to fall over most of this year, though not as fast as the Bank of England expects. Our forecast also incorporates a rise in VAT in January 2011, which most independent forecasters have yet to do. However, a recent BBC survey found that 24 of the 28 independent forecasters that contribute to the Treasury's survey expect VAT to be raised, with most expecting a rise to 20%.¹

We continue to forecast a rise in the policy interest rate in November 2010, but we will return to this later.

Why so dovish?

The debate over future UK inflation centres on the amount of slack or spare capacity in the economy

In our view, the debate over future UK inflation centres on the amount of slack or spare capacity in the economy. There is no doubt that the recession has led to a significant amount of capacity being under-utilised. However, we believe that some capacity was lost during the downturn and also that the recession has caused long-term damage to the UK's potential or trend growth.

This debate also seems to be taking place amongst MPC members. Over the past few months, the MPC meeting minutes have shown that there are committee members voicing their concern that there may be less slack in the economy than first thought, and therefore the risks to the Bank's inflation forecast are to the upside.

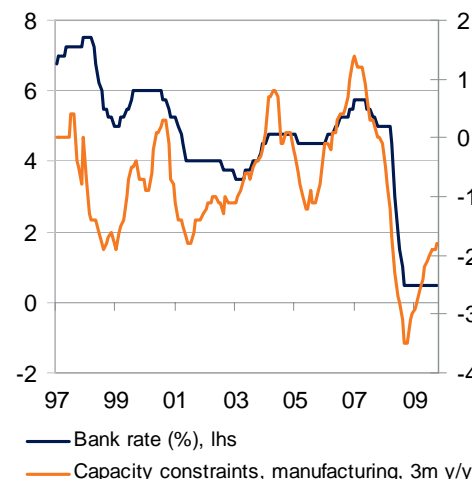
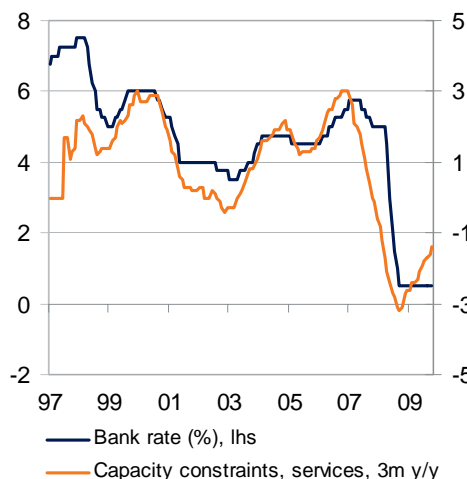
¹ Source: BBC news website, 13 May 2010.

Looking at the evidence, charts 11 and 12 suggest there is still plenty of spare capacity in both the service sector, and the manufacturing sector. Though still at depressed levels, it is worth noting that both indicators have been improving since the end of 2008, which suggests that spare capacity may be being taken out, either because it is being scrapped, or that the economy was growing faster than trend growth.

Chart 11: Service sector capacity constraints vs. BoE policy rate

Chart 12: Manufacturing capacity constraints vs. BoE policy rate

Capacity constraint indicators suggest some slack, but it appears to be shrinking...



Source: Bank of England Agent Scores, 24 May 2010

HM Treasury accepts that there may have been a downward ‘level shift’ to potential growth, but continues to estimate trend growth to be 2.7% per year in real terms, or 0.7% growth on a quarterly basis. As quarterly GDP growth has yet to rise by more than 0.7%, we assume Treasury and BoE officials believe that the output-gap has continued to widen in recent quarters.

This idea becomes difficult to support when we look at charts 13 and 14 (on next page), which show service sector investment intentions and manufacturing sector employment intentions - both recovering and back in positive territory. In theory, both of these indicators should still be negative, especially if there is spare capacity in the economy. Firms should not be thinking of increasing investment or hiring staff if they have lots of capacity that is being under-utilised.

Chart 13: Service sector investment intentions vs. BoE policy rate**Chart 14: Manufacturing sector employment intentions vs. BoE policy rate**

Source: Bank of England Agent Scores, 24 May 2010

...while employment and investment intentions suggest growth is already above trend

If the MPC decide the output-gap is smaller than previously thought, then it will be more concerned about upside risk to inflation

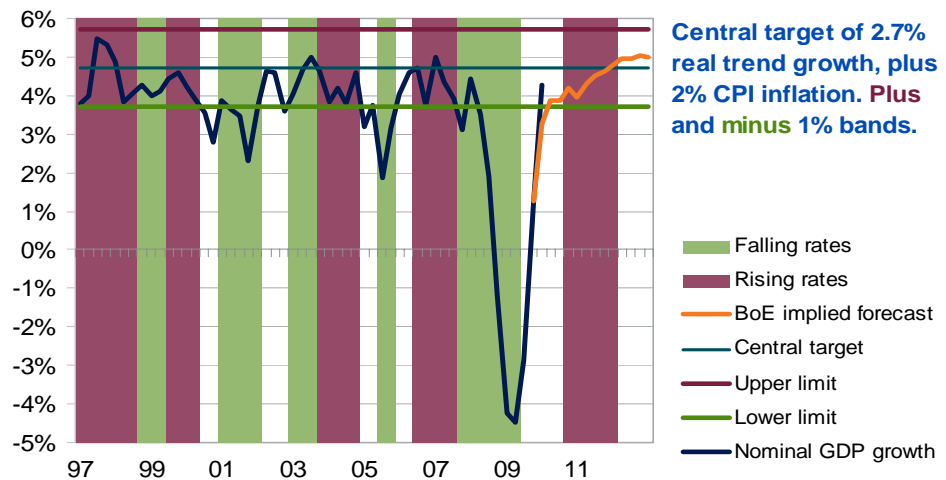
What does this mean for monetary policy?

If enough MPC members come to the view that there is less spare capacity than previously assumed, then they may conclude that the output-gap may close sooner than expected as the economic recovery gathers pace. More importantly for the Bank of England, it means that economic conditions may not be as deflationary as currently feared – or at least being described by Mervyn King.

To illustrate our point, take the Bank of England's annual CPI inflation target of 2%, and combine this with an aim of maintaining price stability. In order to do this, the bank aims to keep a neutral output gap, or keep real growth close to trend growth of 2.7%. When growth looks like it may exceed 2.7%, then in the Bank's judgement, underlying inflationary pressures will build in the economy, and so interest rates have to rise. Conversely, if growth appears to be about to fall below trend growth, then a reduction in interest rates are called for. This of course assumes a starting position where growth is close to trend.

Taking the above and thinking about the BoE's implied objective in terms of nominal growth (real growth plus inflation), then the Bank targets nominal growth of 4.7% (2.7% real trend growth plus 2% inflation). The bank has a 1% symmetrical upper and lower limit around the 2% target, and so we also add this to our implied nominal GDP target. The results are shown in chart 15 along with rate cutting and hiking periods. As chart 15 shows (on next page), the BoE tends to raise interest rates as annual nominal GDP heads towards the upper limit. Similarly, it reduces policy rates as it heads towards the lower limit. We have also included the Bank's February 2010 inflation report modal forecasts for real GDP plus CPI inflation (to imply nominal GDP growth).

Chart 15: Nominal GDP with BoE growth and inflation targets



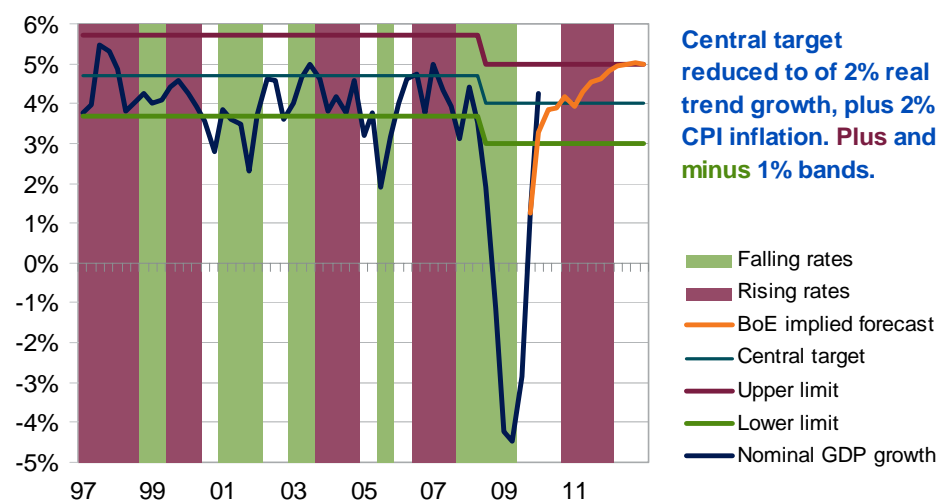
Source: Thomson Datastream, Bank of England forecast taken from February 2010 Inflation report. Nominal GDP is constructed using the Bank's real GDP forecast, plus its CPI inflation forecast

As we mentioned earlier, we are forecasting the Bank of England to raise interest rates in November 2010. However, based on the Bank's implied forecast above, November may be too soon, particularly as nominal growth would barely rise above the Bank's central target in 2011 (though Q1 nominal GDP growth was higher than expected). But what if the Bank of England reduced its trend growth assumption?

This may mean reducing trend growth assumptions for the UK economy

Chart 16 shows the same analysis as above, but reduces the implied central, upper and lower targets to factor in a fall in real trend growth from 2.7% to 2% from mid-2008. Though this is merely illustrative, the assumed fall in trend growth is similar to that estimated by Barclays Capital in their research for the Institute for Fiscal Studies' Green Book 2010.

Chart 16: Nominal GDP with lowered BoE growth and inflation targets



Source: Thomson Datastream, Bank of England forecast taken from February 2010 Inflation report. Nominal GDP is constructed using the Bank's real GDP forecast, plus its CPI inflation forecast.

Concluding that there is less spare capacity than previously assumed could lead to the MPC raising rates sooner than expected

When we examine the chart, an increase in interest rates in November now appears more likely if the Bank concludes that trend growth is lower than previously estimated. In fact, the latest estimate of first quarter nominal GDP growth is already above this target. Moreover, if the Chancellor's emergency budget increases VAT as we expect, then the Bank of England will be raising its inflation forecast further, making the case for raising rates even more compelling.

In addition, members of the MPC have also commented on the danger of persistently above target inflation becoming ingrained into the public's perception of medium term price developments, leading to de-anchored inflation expectations. The concern is should this happen, then employees may begin to successfully negotiate higher wage settlements, which in turn could lead to what economists call second-round inflation effects – the potential beginning of a wage-inflation spiral.

To be clear, we do not expect inflation to spiral out of control. In our view, should inflation surprise on the upside, then the Bank of England will raise interest rates in order to manage inflation expectations. However, the risk to our forecast is that rates remain lower for longer, especially if inflation falls back faster than both the Bank and we expect. Also, if the Chancellor does not raise VAT, but instead choose to raise additional tax revenues by a more deflationary means (such as raising income tax), then we would be inclined to push out our first rate increase.

Forecast update

We have reviewed our forecasts this month and are upgrading our expectation for global growth in 2010 to 3.6%, an increase of 0.5%. The main upgrades have been in the US, Japan and the emerging markets where activity has generally been stronger than expected and forward-looking indicators remain robust. Not surprisingly, given the debt problems in the peripheral economies, the smallest upgrades are in Europe. Nonetheless, the region has avoided downgrades as the benefits of a weaker Euro offset the increase in fiscal tightening. Our forecasts for 2011 are little changed with a moderation in growth expected as fiscal stimulus fades and the de-leveraging process holds back consumer spending.

On the price front, we have edged our global inflation forecast down to 2.7% for 2010, a move which reflects a lower forecast for the US. Whilst we have been optimistic that US inflation would fall, we did not anticipate the recent very subdued performance of core prices. In contrast, we have increased our forecast for UK inflation for this year following a run of higher than expected outcomes which indicate there is less slack in the economy than widely believed (see UK section for more detail). We continue to forecast a further rise in inflation in China, before a slowdown in growth helps moderate price pressures later in the forecast. For 2011, we expect global inflation to decline to 2.3% primarily led by the US and Europe.

Although we have raised our forecast for global growth, we have pushed out the first increase in interest rates in the US, Euro area and Japan. Monetary tightening is delayed as a result of low inflation and concern that the fiscal tightening may derail the recovery. We now expect the Federal Reserve to raise rates in March next year with the ECB following in June. Rate rises are also delayed in the UK, but the need to contain inflation expectations results in the Bank of England raising rates in November this year. The forecast has a stronger assumption for the US dollar at the expense of the Euro and pound sterling.

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-2.4	3.3	3.3	2.7	3.1
UK	5.1	-4.9	1.3	1.3	2.4	2.3
Eurozone	25.8	-3.6	1.2	1.2	1.5	1.5
Japan	9.3	-5.2	2.5	2.4	1.6	1.7
Australia	1.9	1.3	3.6	3.2	3.2	3.4
OECD	69.5	-3.3	2.3	2.2	2.1	2.3
China	8.2	8.5	10.5	10.3	9.0	9.2
Emerging*	30.5	0.6	6.7	6.3	5.7	5.8
World	100.0	-2.1	3.6	3.5	3.2	3.3

Inflation CPI

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-0.3	1.5	2.0	0.9	1.9
UK	5.1	2.2	2.9	2.9	2.5	1.8
Eurozone	25.8	0.3	1.7	1.3	1.0	1.4
Japan	9.3	-1.4	-1.0	-1.0	-0.3	-0.2
Australia	1.9	1.8	2.6	2.8	3.0	2.9
OECD	69.5	0.0	1.4	1.4	1.0	1.5
China	8.2	-0.7	4.5	3.3	4.0	3.4
Emerging*	30.5	4.3	5.8	5.4	5.3	4.9
World	100.0	1.3	2.7	2.6	2.3	2.5

* Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-09	Dec-10	Market	Dec-11	Market
US	27.3	0.25	0.25	0.92	2.00	1.62
UK	5.1	0.50	0.75	1.03	1.75	1.70
Eurozone	25.8	1.00	1.00	0.97	1.75	1.30
Japan	9.3	0.10	0.10	0.35	0.10	0.39
OECD	67.5	0.53	0.55	0.87	1.62	1.33

Market data as at

20/05/2010

Key variables

FX	Current	Dec-09	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.44	1.62	1.40	-13.7	1.45	3.6
USD/ EUR	1.23	1.46	1.20	-17.7	1.18	-1.7
JPY/ USD	89.6	90.0	95.0	5.5	97.5	2.6
GBP/ EUR	0.86	0.90	0.86	-4.6	0.81	-5.1
Brent crude	69.5	74.9	78.1	4.4	79.5	1.8
US output gap %GDP	-7.4	-8.0	-5.9		-3.5	
Unemploy. %	9.7	10.0	9.1		7.9	

Source: Schroders, Datastream, IMF, Consensus Economics (May 10)

II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

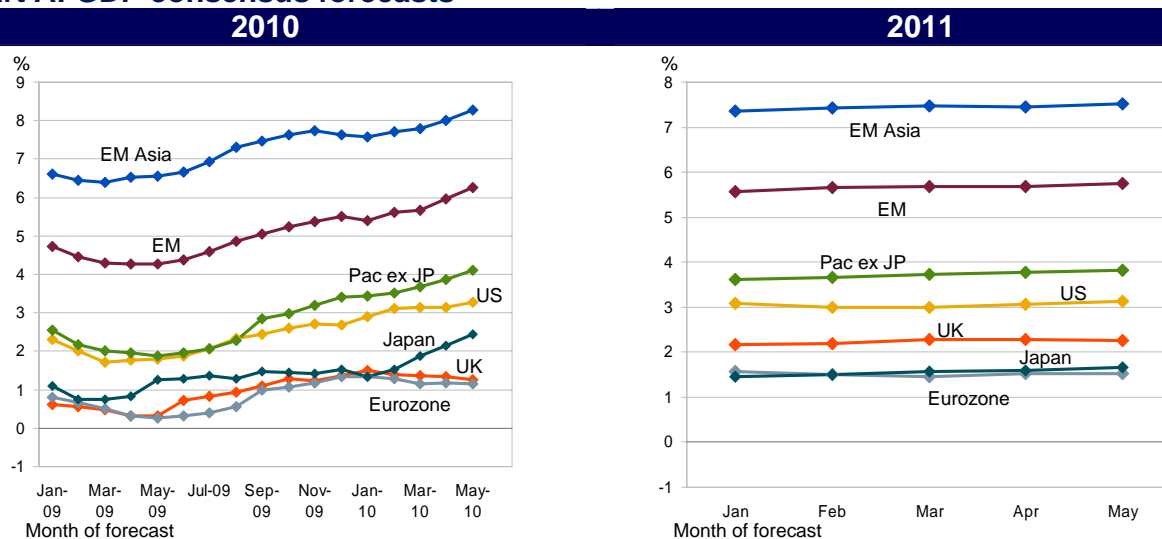
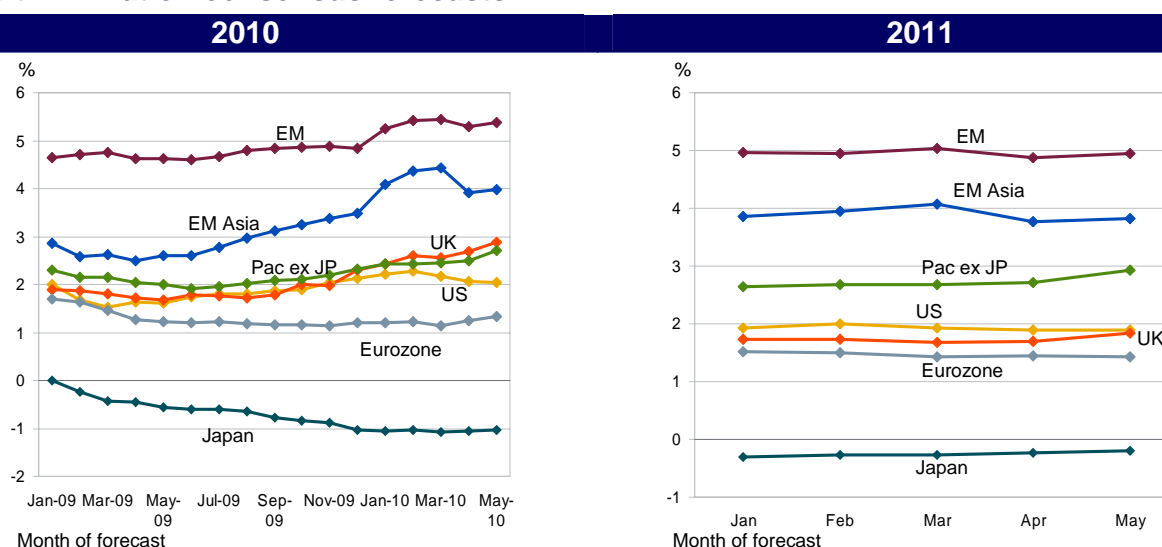


Chart B: Inflation consensus forecasts



Source: Consensus Economics (May 2010), Schroders

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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