

November 2009

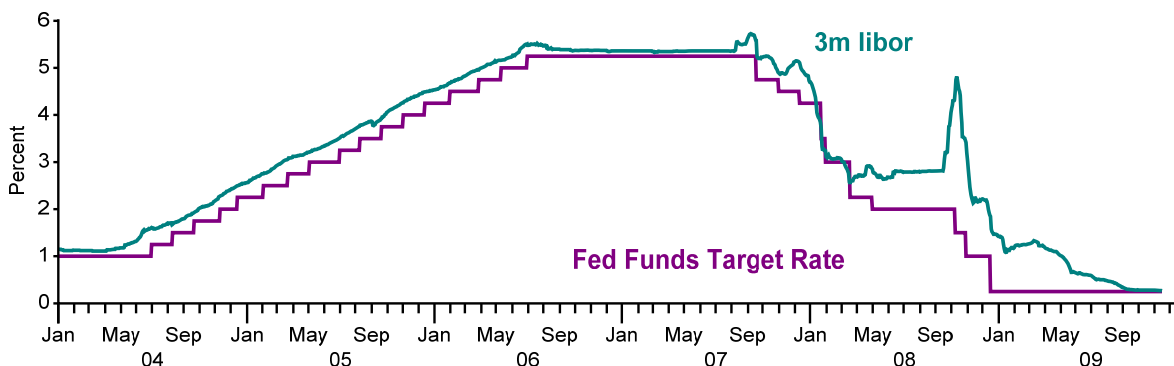
## Is the Policy Working?

One year ago we were in the midst of a huge financial crisis and there were genuine fears that the world was about to fall into an economic depression, similar to the 1930s. In response, policy makers introduced support on a scale, and with a speed, never seen before. Total support on offer to the UK banking sector amounts to almost £1 trillion, fiscal support across the G20 nations totals more than \$2 trillion, policy rates of interest have been cut to record lows and quantitative easing has been introduced on a large scale. But is all this policy support actually working?

### Recovery in Money Markets

The large scale support offered to the financial sector has clearly been successful in improving levels of trust and confidence. The smoothness with which the money market is operating can be assessed by looking at the spread between the 3 month libor rate and the policy rate of interest, as illustrated for the US in the chart below. Last autumn, when financial markets were close to collapse, the spread between these lines moved above 320 basis points, whereas a more 'normal' spread would be closer to 10 basis points. This increase in the spread highlighted the extent to which banks were distrustful of each other and were unwilling to lend.

#### US Interbank Rate v Policy Rate of Interest



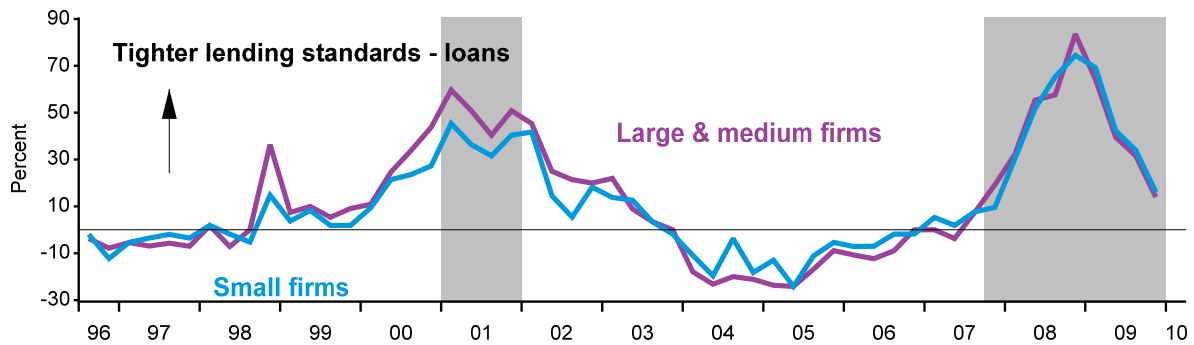
Source: Reuters EcoWin

Since that time, the large scale injections of liquidity and offers of support have helped to ease the situation and the spread between these two lines has come all the way back close to zero. This is clearly a much welcomed improvement as it shows that banks trust each other again and are willing to do business with each other, without punitive rates of interest. However, while it is encouraging to see the banks starting to lend to each other, the big question for the economy is – are they willing to lend to anyone else?

### US – companies and households still facing tough credit conditions

Unfortunately, the evidence to date remains disappointing. The following chart illustrates the Senior Loan Officer Opinion Survey, which gives a good indication of lending conditions to the corporate sector in the US, with any reading above zero indicating that lending standards are being tightened. Clearly, standards have improved since the peak of the crisis at the end of 2008, but this survey is telling us that, even at this relatively late stage, a net 15% of banks are still tightening their lending standards. And, while standards appear to be similar for small, medium and large scale firms, the impact falls more heavily on the small and medium firms who may not have any other options for raising capital.

## Senior Loan Officer Opinion Survey



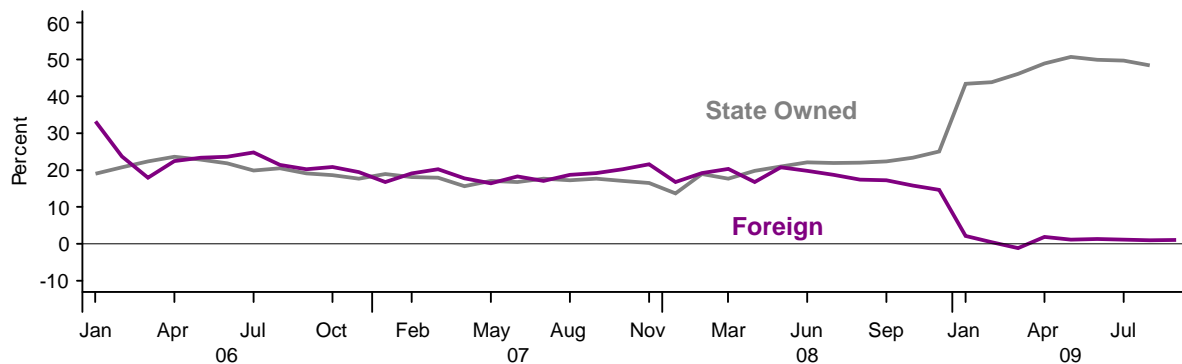
Source: Reuters EcoWin

This is bad news for the economy. Large firms may be much better known, possibly being quoted on the stock exchange, but these account for only 17% of employment in the US. It is the small and medium sized firms which account for the remaining 83%. And, given that these firms are struggling against relatively weak economic conditions and problems securing credit, they are still being forced to reduce employment. The other alternative for companies who have better access to finance is to retain workers on shorter working times and lower wages, but this is also damaging, to some extent, for consumer confidence and spending. Given that the consumer accounts for close to 70% of all activity in the US economy, we cannot be sure that a sustainable economic recovery will be achieved until we see some recovery in the labour market.

## China – fiscal spending compensates for weak external demand

The relative weakness in consumer confidence and spending in the US continues to hit exports right across Asia, including China. But, while export demand is weak, policy makers have responded with large scale fiscal policy and the encouragement of bank lending which has helped to fund large scale infrastructure spending by state owned enterprises. This has increased by almost 50% over the last year and has more than compensated for the sharp decline in foreign investment.

### Investment in Fixed Assets



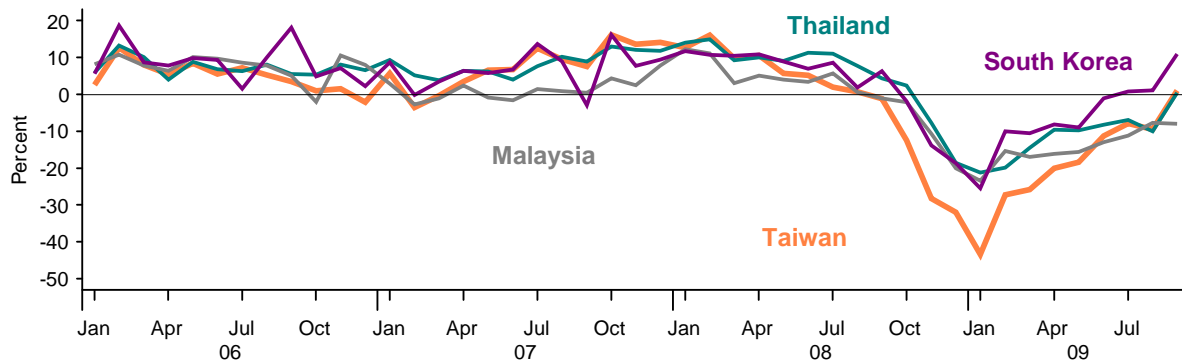
Source: Reuters EcoWin

This money has been spent very quickly – only time will tell whether it has been spent wisely – and there is some concern that policy makers are fuelling an asset price bubble. However, despite these concerns, there is no doubt that the policy has helped to generate a level of activity which is compensating for the lack of global demand. China's GDP grew by almost 9% over the year to Q3, and is widely expected to climb even further as we move into 2010, boosted by the high level of infrastructure spending.

## Rest of Asia - benefiting from increase in Chinese activity

The success of China's stimulatory policy is having positive knock-on effects in its Asian neighbours too. All Asian economies have been hit hard by the decline in global demand, which caused export sales to fall by up to 30-40% over the year, at the trough of the cycle. Because Asian economies rely so heavily on exports, the downturn in global demand had a similar impact on industrial production, as can be seen in the chart below. Production levels fell by up to 20-30% on average, but by more than 40% in the case of Taiwan.

### Industrial Production



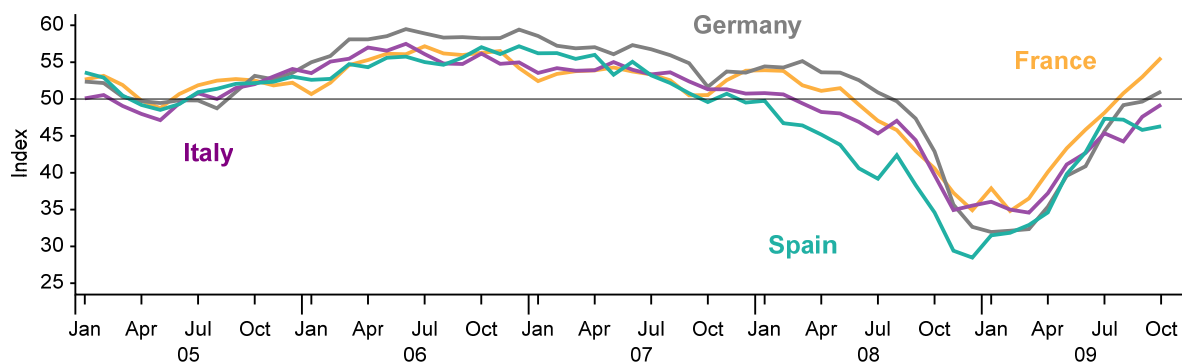
Source: Reuters EcoWin

However, as global demand has shown signs of improvement, and Chinese activity has been boosted, output levels across Asia have begun to increase. Recent reports show that production growth has turned sharply positive in South Korea, and has moved into positive territory in both Thailand and Taiwan. We expect this encouraging trend to continue and Asia to outperform its western peers. Most Asian economies have the advantage of not being hampered by high levels of household and financial sector debt and not suffering the same high levels of government deficits and public debt levels. This fact should allow Asia, and some other emerging economies, to emerge from this downturn in a relatively strong position.

## Europe – divergences between countries expected to build

Whereas Asian economies are following similar patterns of recovery, there is much more divergence across Europe. In the chart below, which records the views of purchasing managers in the four main European economies, only France and Germany have moved back above the critical level of 50, indicating that output is expanding. Italy and Spain continue to record readings below 50, indicating that output is still contracting.

### Manufacturing Sector Survey



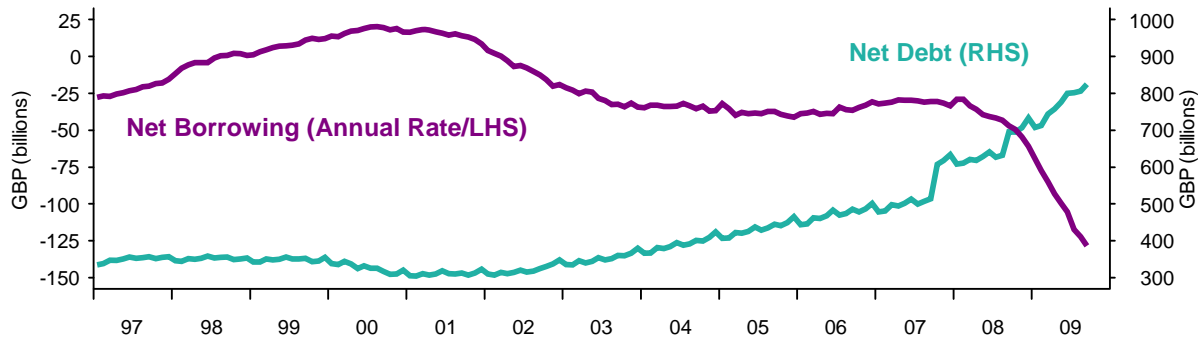
Source: Reuters EcoWin

This divergence between the winners and losers in Europe could be key to economic trends in 2010. Countries such as France and Germany appear to have been better able to cope with the global downturn and stand to gain in the upturn too, largely because they can remain relatively competitive. But countries such as Italy and Spain are likely to struggle for longer, with the recent appreciation of the Euro adding a further obstacle by threatening to further reduce competitiveness. This divergence between economies in Europe could prove to be a huge challenge for policy makers.

## UK – deterioration in public finances could weigh on the economy for some time

The UK economy continues to disappoint as it has not yet moved out of recession. This recession is the deepest since the Second World War, and could yet turn out to be the longest too. Banks remain reluctant to lend to businesses, in particular small and medium sized firms, keeping activity levels low. And while activity is low the fiscal position will probably continue to deteriorate. Net borrowing has reached an annual rate of £125bn and appears to be well on course to reach the level of £175bn predicted in the last Budget for the end of this fiscal year. That would be equivalent to more than 12% of current GDP.

### Public Sector Net Borrowing and Debt



Source: Reuters EcoWin

Net debt also continues to rise. This is currently at a level of more than £800bn and, even on the basis of the Treasury's relatively optimistic forecasts, is expected to almost double to £1.4trn within the next five years. This is equivalent to 100% of current GDP and would equate to £56,000 for each and every household in the UK. Clearly the UK's public finances have to be brought back under control, but this will not be painless. Here in the UK we probably face either some fairly sizeable tax increases, or significant cuts in public sector spending and employment, neither of which will be good for economic activity. For this reason, we expect the recovery in the UK economy to be more sluggish than we see elsewhere.

## Conclusion

At the end of a turbulent year we see clear signs that confidence has returned to financial markets, but the impact of this on the real economy is still far from clear. Lending remains relatively restrictive and this continues to hurt the small and medium sized companies who are the lifeblood of the economy. Household consumption is therefore expected to remain muted, particularly in western economies, until there are clear signs that labour markets are starting to improve. But Chinese policy makers have been successful in boosting activity and this is having beneficial effects not just in China itself, but in its Asian neighbours too. We expect Asian economies, and some other emerging markets, to emerge from this downturn in a relatively strong position compared to their western peers.

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