

17 July 2008

Spotlight

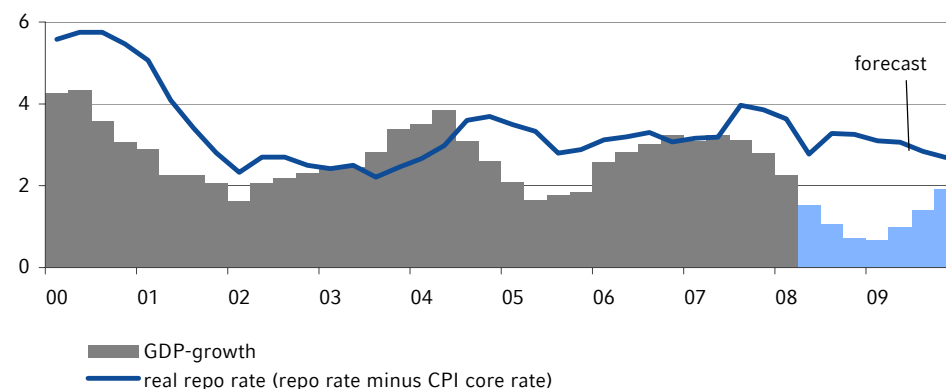
THE UK ECONOMY

On the brink of recession

- The UK is facing a major economic downturn that could lead it into its first recession since 1991. The economy has been hit by several shocks at the same time. First, there is the crisis in the UK property market. Second, the crisis in the financial markets is having more of an impact in the UK than in other countries because of the large relative size of its financial sector. Third and finally, the economy is suffering from the high oil price: the UK has been a net oil importer since 2005.
- The financial situation of UK households is far worse than it was at the time of the last recession in 1990-91. The savings rate is very low, which suggests that private consumption will be extremely weak.

UK: Gross domestic product and real repo rate

in % y/y and in %



Source EcoWin, WestLB Research estimates

- The high inflation rate may prevent the Bank of England from cutting interest rates any time soon. We do not expect cuts before the beginning of next year.
- We have revised down our economic forecasts slightly. We now expect GDP growth of only 1.4% this year and 1.3% next year. This year we would not rule out a recession in the technical sense of the term – two consecutive quarters of declining economic activity compared to the previous quarter.

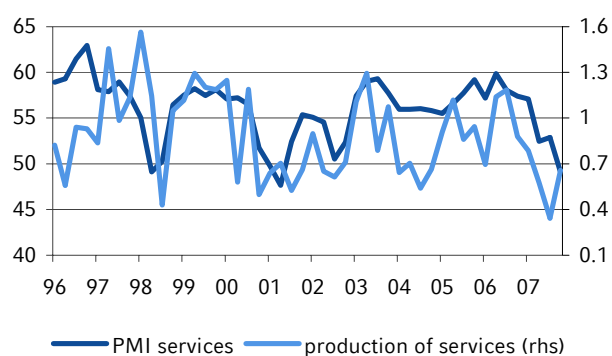
16 years of expansion come to an end

The economy has slowed significantly since spring last year

The UK economy has slowed significantly since spring last year. Real gross domestic product grew by 0.9% q/q in the second quarter of 2007, but at the beginning of this year it grew only 0.3% q/q, less than half that rate. The 16 years of expansion in the UK are thus drawing to a close. Nor do the indicators augur that well for the rest of the year. Purchasing managers in the manufacturing sector are more bearish than at any time since the terrorist attacks of 11 September 2001. Sentiment is also at recession level in the service sector, which accounts for around three-quarters of UK GDP. The purchasing managers' index here is significantly below the expansion threshold of 50 points. Thus, as in the period of recession in the early 1980s, there is a danger that the service sector could exacerbate the downswing. Therefore we can no longer rule out a contraction of aggregate economic output in the course of the year. The sluggish economic growth seen so far this year has already had a clear impact on the job market: the number of those seeking jobs has increased by 45,000 since January.

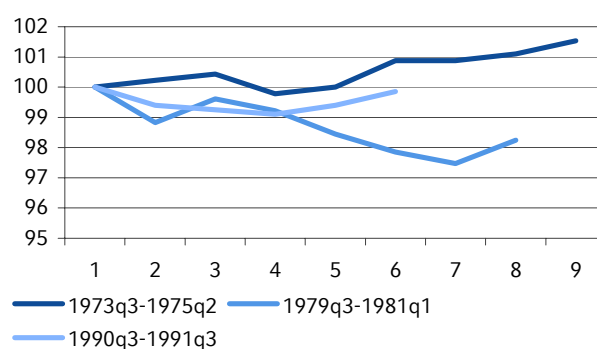
UK: Purchasing Managers' Index and output

In points and as % year-on-year change



UK: Service sector output during recessions

Index (quarter ahead of the recession=100)



Source EcoWin, WestLB Research

Source EcoWin, WestLB Research

Possibly the first recession since 1991

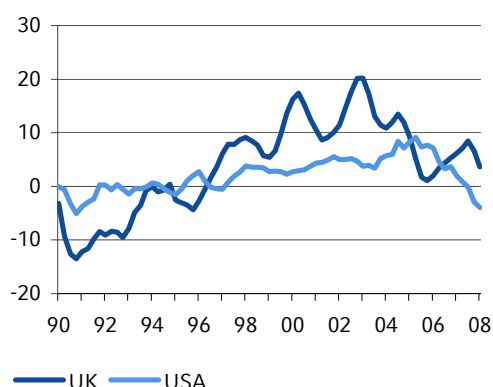
There are several reasons for the downswing and for what may be the first recession since 1991. First, the UK depends heavily on its financial sector. Financial services account for 8% of total value added compared to just 3% in Germany. The crisis in the financial markets, accordingly, has a greater direct negative impact on the UK economy. In addition, judging by the surveys, the crisis has led to tighter lending standards. Second, the UK is suffering – like other oil-importing countries – from significant increases in the oil price; this problem is currently exacerbated by the depreciation of the pound. As a result, inflation as measured by the consumer price index rose to an all-time high of 3.8% in June. Finally, the UK is suffering from a crisis in the property market.

The property market floored

Parallels with the USA

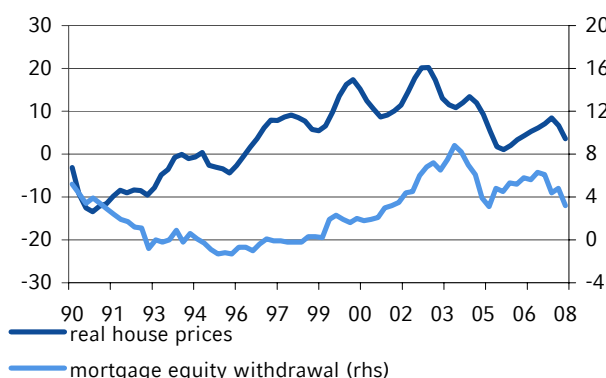
The UK's property market seems to be suffering the same fate as the US market: after exorbitant past increases, property prices are now rising more slowly or – according to some data – have already fallen significantly. The future economic trend may depend very much on whether the situation in the UK property market is comparable to that in the USA, and on whether it entails similar consequences for the economy.

UK and USA: real house prices
in % y/y



Source Acadametrics, EcoWin, WestLB Research

UK: house prices and mortgage equity withdrawals
% year-on-year change and as % of income



Source Acadametrics, EcoWin, WestLB Research

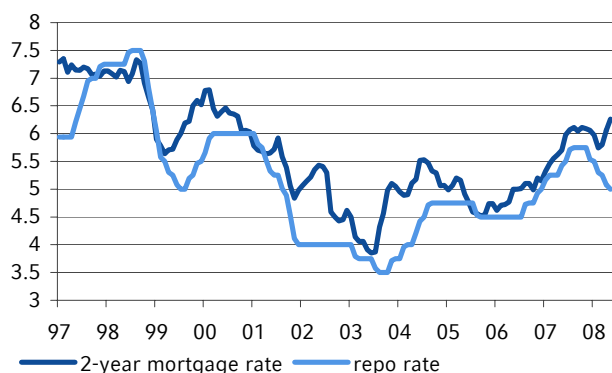
Property prices have risen more steeply in the UK than in the USA

The rate of property price inflation accelerated in both countries from the mid-1990s onwards, but far more so in the UK than in the USA. While property prices rose by 52% in real terms in the USA between 1996 and 2006, they increased by 160% in the UK. Key rate cuts lead to lower interest expenses for mortgage borrowers to the variable-rate mortgages in both countries. On the other hand, the value of properties increases due to price increases, and this makes it possible to take out larger mortgages. Both these factors have bolstered private consumption in the past.

Property prices are already falling in real terms

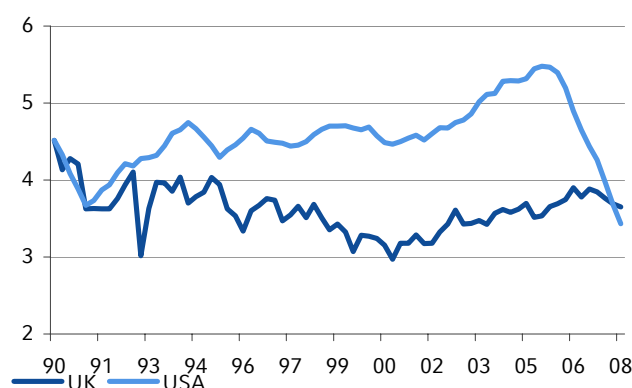
UK property prices took a short breather in 2005. This had a correspondingly negative impact on private consumption, which increased only very sluggishly in that year. However, property prices then went on to rise steeply, making it far harder for first-time buyers to finance a property due to the relatively sluggish growth of disposable incomes. As a result, demand has slackened significantly since autumn last year and prices have been rising far less steeply. In real terms, prices are already falling.

UK: mortgage rate and repo rate
in %



Source Bank of England, WestLB Research

UK and USA: housing investment
in % of GDP



Source EcoWin, WestLB Research

Predominantly a rise in prices – rather than an increase in construction activity

However, there are some clear differences between the USA and the UK that bear on any assessment of the future trend of the property market. OECD calculations indicate that UK households are on average more heavily indebted than their US counterparts. However, problems with delinquent debtors – measured in terms of the number of foreclosures or the level of mortgage arrears – do not seem to be so severe (although the latter has risen recently). The biggest contrast with the USA, however, is that the UK market

has reacted to demand in the past few years almost entirely in terms of prices rather than volume. Investment in residential building as a percentage of GDP has remained virtually unchanged in the past 17 years. The reason for this is the relatively tight allocation of building land. As a result, corrections may well be expected in some segments or regions. For example, housing completions as a percentage of total building completions have risen in the past seven years from 20% to around 50%. Regionally, property prices have risen far more in Northern Ireland than in the rest of the UK.

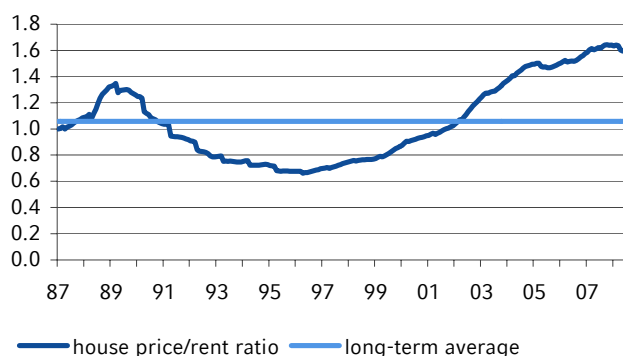
Initially, property prices are likely to chart further significant corrections

Initially, property prices are still likely to chart a steeper correction. This is suggested by a comparison of property prices and rents. In the long term, this relationship should be fairly stable. If homes are relatively expensive to buy, it is possible to rent a property, and vice versa. The ratio of purchase prices to rents has been above its long-term average in the UK since 2002; at the moment, it is roughly 50% above it. This suggests that property prices are still likely to fall significantly while rents rise at the same time.

Stricter lending hurts property market

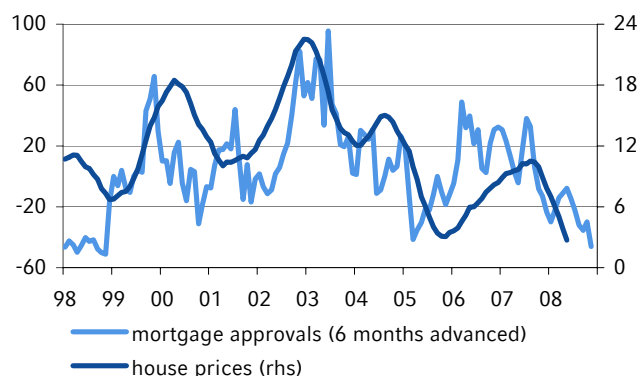
In addition, UK banks have significantly tightened their lending standards as a result of the crisis in the financial markets. The Bank of England's *Credit Conditions Survey* shows that the credit supply has contracted significantly since the survey was launched at the beginning of last year. The reasons cited for this include the poorer economic outlook, a changed risk assessment and funding problems. The survey indicates the credit crunch will continue for the rest of the year. At the same time, mortgage rates have risen – while base rates have fallen – and are now at the highest level since 2000. Hence investments, but also property prices, are likely to fall further during the forecast period. Mortgage approvals at the moment are 46% down on the year-earlier level. We assume nominal price declines in the UK real estate market of 3.7% this year and 6.2% next year. Price declines are unlikely to come to a standstill before 2010; we expect a cumulative fall amounting to 11% by then, which would be only slightly below the price erosion seen during the real estate crisis at the beginning of the 1990s (-16%).

UK: house-price/rent ratio
Index



Source Acadametrics, EcoWin, WestLB Research

UK: mortgage approvals and house prices
% year-on-year change



Source Acadametrics, EcoWin, WestLB Research

Consumer price inflation reached an all-time high of 3.8% in June

High inflation prevents early interest rate cut

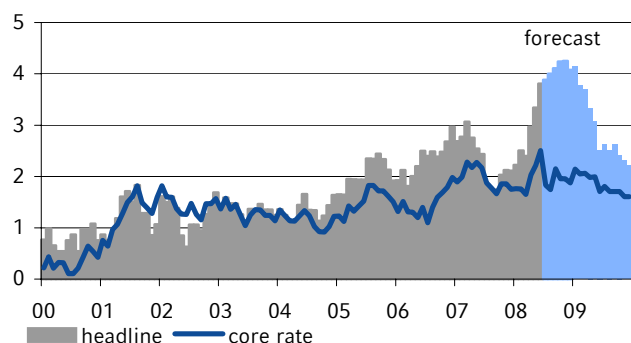
High inflation too has become an issue in the UK. In June the inflation rate rose to 3.8%, the highest level since the introduction of the Consumer Price Index. Last month, the governor of the Bank of England had to write an open letter to the Chancellor of the Exchequer setting out the reasons for missing the 2% inflation target by more than 1 percentage point. In his letter, Mervyn King ruled out any measures that would get the inflation rate back to the BoE's 2% target within a year, since these would entail an unneces-

sarily steep decline in production and employment. The markets have become increasingly aware of inflation risk in the past few weeks, and have priced in at most three rate hikes by the end of the year. In our view, however, rate hikes remain extremely unlikely given the extremely fragile state of the economy. The Bank of England is already reacting comparatively restrictively to the economic downswing. In 2001 it was quick to react to such deterioration in the economic indicators by cutting key rates.

Higher oil prices imply further rise in inflation so the BoE's hands are tied

Although inflation expectations have increased recently, these are very much oriented to the current inflation trend. In addition, wages are still rising at a less than average rate and the core inflation rate is exceptionally low. There are, therefore, no signs of genuine second-round effects at the moment. Nevertheless, inflation is likely to continue rising in the short term due to past oil price increases. We estimate that a £1/barrel increase in the oil price leads to a contemporaneous 0.2 percentage point increase in the energy component of the CPI, but that the bulk of the impact takes up to one year to take effect. In June the oil price was £67/barrel, which was £31 or 86% above the year-earlier level. We therefore expect inflation will not peak until H2 at slightly above 4%. In the short term, therefore, the Bank of England's hands remain tied as far as bolstering the economy with a looser monetary policy is concerned. We do not expect interest rate cuts before next year. The repo rate is likely to fall from the first quarter onwards, to 4% before the end of the year.

UK: consumer prices
% year-on-year change

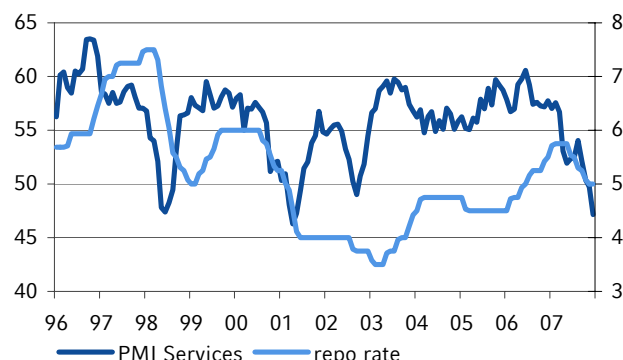


Source EcoWin, WestLB Research

Input prices rise significantly, profit margins fall

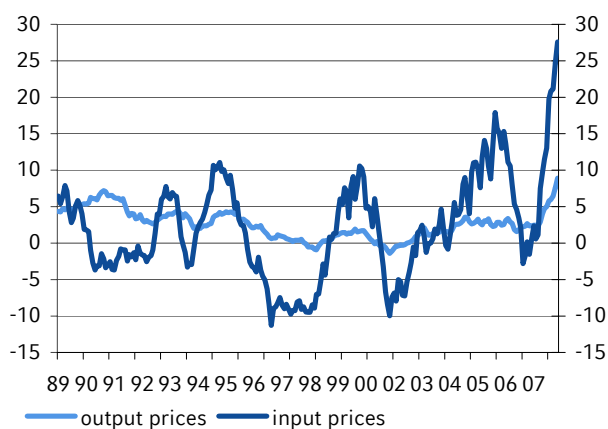
However, it is not just for the Bank of England that high inflation creates a dilemma, even if it is mostly caused by oil prices; it has a negative impact on the entire economy. The UK has been a net importer of oil since 2005, and so higher oil prices divert consumer purchasing power and corporate profits to oil-producing countries. High price increases for raw materials have already significantly increased input prices for UK companies. In May they were up by 27% on the previous year, which is the highest rate recorded since these price data have been collected. On the output side, however, the sluggish economy makes it impossible to pass on these increases completely into prices, and output prices have risen to a far lesser extent. Profits are being squeezed, especially in manufacturing industry, where the net margin fell to 4.9% in the first quarter, the lowest level since 1992. In the service industry, by contrast, profits are still very good. This may be due to less foreign competition in this segment.

UK: Purchasing Managers' Index and base rate
in points and %



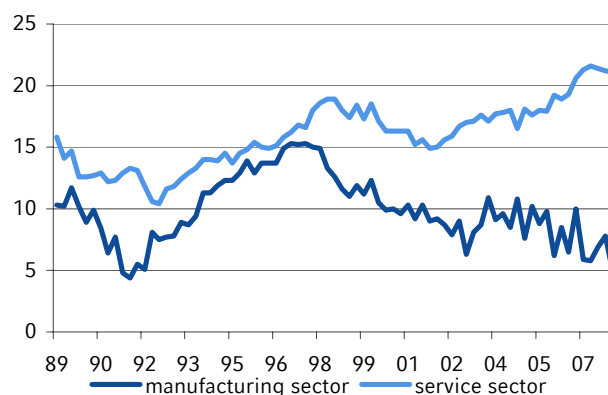
Source EcoWin, WestLB Research

UK: Input and output prices
% year-on-year change



Source EcoWin, WestLB Research

UK: net profits
as % of capital employed



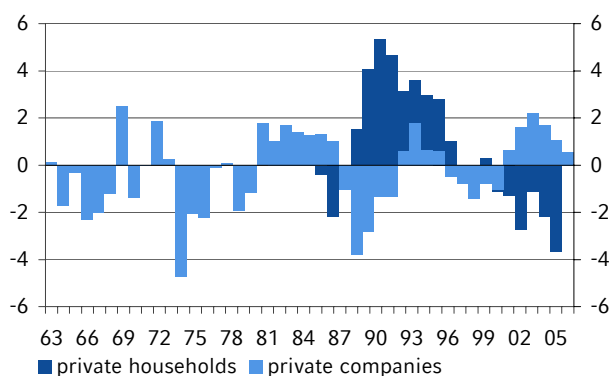
Source UK Statistics Authority, WestLB Research

Companies' financial situation is still good – unlike that of the state and households

Private companies are currently net lenders

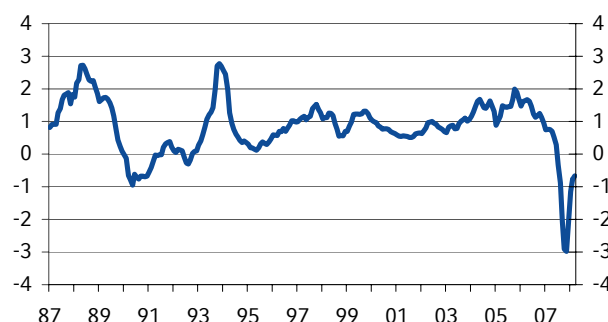
Overall, the current financial situation of UK companies is still very much better than during past recessions. Each of the three recessions in the mid-1970s, the late 1970s and early 1990s was accompanied by net borrowing by private companies, but these are now net lenders. This fuels hopes that companies will not scale back their investments in capital assets and inventories by as much as they did during past recessions. However, the collapse in prices in the property market also affects the commercial segment, so investment is initially likely to be weaker here.

UK: net lending positions
as % of GDP



Source UK Statistics Authority, WestLB Research

UK: commercial property yield
in %



Source EcoWin, WestLB Research

Private households are significantly more indebted than in the past

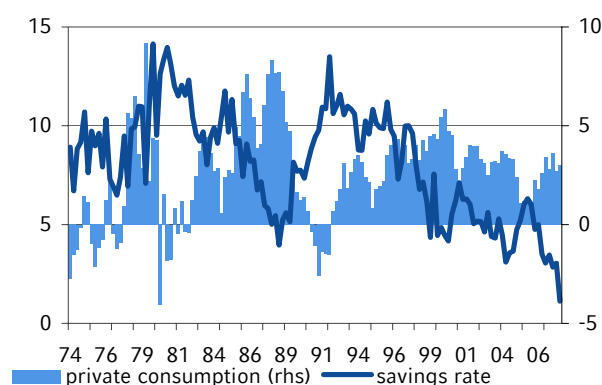
The financial situation of households, unlike that of companies, is significantly worse than during the past recession. Net borrowing, measured in terms of GDP, is at an all-time high. The OECD estimates that UK household debt is even higher than that in the USA. As things stand, household debt is likely to increase even further. Borrowers' interest payments are continuing to rise due to adjustable-rate mortgages. This means they will have to save far more from their current incomes in the future than the 1.1% recorded in the first quarter. For this reason, we expect consumer spending will be very weak during the forecast period. However, it rose relatively steeply recently – real retail sales in May increased by 3.4% m/m – even though published sentiment indicators have been showing a

significant souring of consumer sentiment for some time now. The European Commission's indicator, for example, is at its lowest point since 1994. The massive collapse in consumer sentiment is a typical indicator of a phase of recession.

Public sector is short of money The public sector has failed to make use of the economically strong years to reduce the national debt during the past few years. The national debt has actually increased since 2002. In 2003 and 2004 the budget deficit was above the Maastricht ceiling of 3% of GDP, and will probably be above it again this year too. In the past three years debt has exceeded the government's own ceiling of 40% of GDP (the so-called *sustainable investment rule*).

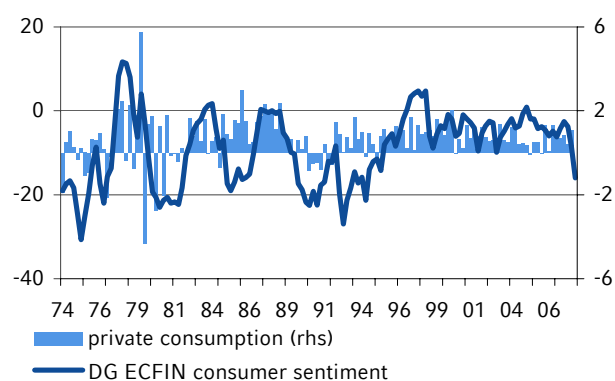
Little leeway for fiscal policy This leaves little leeway for fiscal policy to support the economy with tax cuts. The recent decision to increase the tax free allowance, which takes retroactive effect in September, will probably deprive the budget of an estimated £2.7bn. However, given the record level of household debt it is unlikely to have much effect on the economy. Public expenditure remained resilient during the past three recessions, and was even able to support the economy in the recession in the 1970s and the downturns at the beginning of the 1990s. However, given the tight budget situation we believe it will increase only moderately during the forecast period.

UK: private consumption and saving rate
% year-on-year change and as % of income



Source EcoWin, WestLB Research

UK: consumption and consumer climate
% year-on-year change and in points



Source EcoWin, WestLB Research

Support from foreign trade?

Exporters have used sterling depreciation to increase their margins

Sterling has depreciated significantly in the past few months. In real terms, it fell by around 12% in June compared to July of last year. This has stoked hopes that foreign trade will be able to lend the UK economy some support in the present situation. So far, however, there is no sign of this. Exports increased in May by only 1.6% year-on-year. Exporters have apparently used sterling's depreciation to raise prices. Export prices have risen by around 15% compared to the previous year, as a result of which the terms of trade have actually improved. However, the trade deficit could not be reduced significantly.

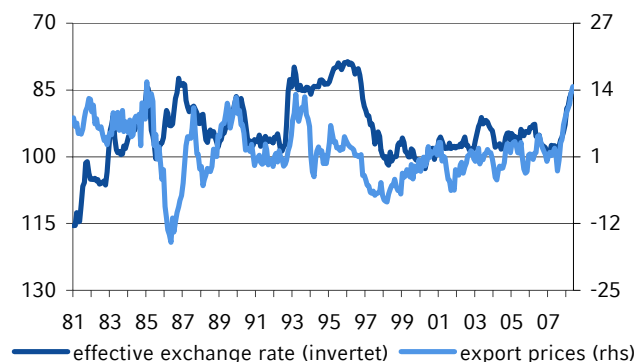
Foreign trade less dependent on the eurozone

Yet the structure of UK foreign trade has improved in the past few years. The percentage of exports going to the USA has not fallen – contrary to the global trend – but remains at around 9%. However, the percentage of exports to the eurozone has fallen by around 10 percentage points since 1993 to 33%. Thus the downturn in the USA affects the UK roughly as much as in the past, but the UK has become less dependent on the eurozone,

whose economy has slowed with something of a time lag. The emerging markets have become more important to the UK. Provided these continue to grow dynamically, net exports of goods and services are likely to support growth in the forecast period.

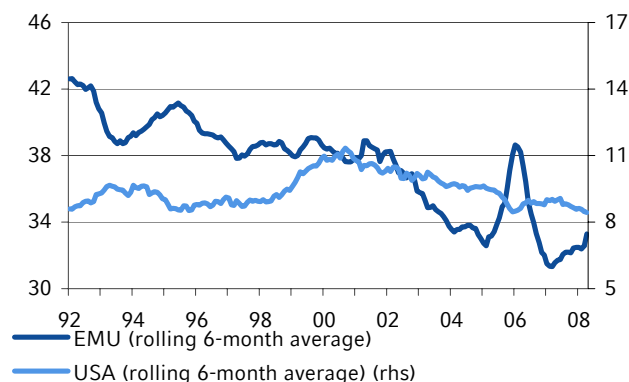
UK: exchange rate and export prices

Index (inverted) and % year-on-year change



UK: export shares

in %



Source EcoWin, WestLB Research

Source EcoWin, WestLB Research

Depreciation will continue in the longer term

We expect UK exporters will pass on more of the pound's depreciation into their export prices later in the year. Empirical studies show that the 'pass-through' of exchange rate movements into export prices in UK is near zero in the short term, as is also the case in the eurozone and the USA, but in the longer term (1.0-1.5 years) it climbs to around 50%. This means that there is a good chance that foreign trade will support the economy later in the year. Nevertheless, we cannot rule out a technical recession in the sense of two consecutive quarters of falling GDP.

UK key data (% year-on-year change)

	2004	2005	2006	2007	2008	2009
Gross Domestic Product	in % y/y					
1995 prices, calendar-adjusted	3.3	1.8	2.9	3.1	1.4	1.3
Domestic demand	3.9	1.8	3.0	3.8	1.2	0.9
Private consumption	3.5	1.5	1.9	3.1	2.2	0.7
Public consumption	3.2	2.7	1.7	1.9	1.8	1.1
Capital expenditure	5.9	1.5	7.6	6.0	-1.4	0.0
Inventories*	0.1	0.0	0.0	0.3	-0.4	0.1
Exports	4.9	8.2	10.7	-5.1	1.7	4.2
Imports	6.6	7.1	9.8	-2.4	0.8	2.5
Net export of goods and services*	-0.6	0.0	0.0	-0.7	0.2	0.4
* contribution to GDP growth						
Consumer prices (HICP)	1.3	2.0	2.3	2.3	3.5	2.9
Current account balance (as % of GDP)	-1.6	-2.5	-3.9	-4.3	-3.3	-2.8
Budget deficit (as % of GDP)**	-3.4	-3.0	-2.5	-2.8	-3.1	-3.0
ILO unemployment rate (in %)	4.9	5.0	5.6	5.5	5.6	6.2

**Fiscal year (April-March), according to Maastricht criteria

Source EcoWin, WestLB Research estimates

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