13 October 2008

Economic News

CHANGES TO MACRO FORECASTS

At the start of a global recession

At their crisis summit in Paris, the heads of state and government of the 15 Euronations yesterday agreed upon common guidelines for national aid programmes to cope with the financial market crisis. Specifically, they agreed to state-backed guarantees for the interbank market. Furthermore, governments can invest directly in banks in the form of equity assistance. The size and the exact details of the planned measures to be adopted by individual countries are not yet available. Germany, France and Italy want to present their plans at the same time today (we will have a special report on this). We regard these measures as a necessary step in the right direction. They are comprehensive, uniform and should help to ensure that the crisis of confidence is gradually overcome and therefore mean that the fallout for the real economy is no greater than it is already expected to be. Despite the numerous rescue bids mounted around the globe, we assume that the financial market crisis will leave a deep impact on the economy. both in the USA, and beyond.

In a nutshell, our assessment of the prospects for 2009 is that there will be virtually no economic growth in the industrialised nations, a noticeable downturn in many emerging economies, cuts in key rates the world over and a slowdown in inflation. We are therefore accentuating our forecast of a global recession, which we published at the end of August - before the latest deterioration in the situation on the financial markets. The positive economic forces may well not recuperate before the end of next year.

- **USA – several quarters of declining economic activity.** Severe bank crises lengthen and deepen economic downturns and often lead to recessions. We have no evidence to suggest that the USA will be an exception to this rule. Following fairly strong growth in the first half of the year, economic activity has slowed considerably of late. The government's economic aid package is manifestly having ever less effect and the stimulus provided by foreign trade is weakening. Above all, however, there already appears to be a downturn in real household consumer spending for Q3, despite considerable relief from lower energy prices. Prospects for the labour market and incomes are likely to continue to deteriorate over the coming months. Given the high level of debt, stricter lending terms, negative wealth effects and limited savings, private households are likely to continue to rein in their spending. With financing terms difficult and the increasingly unfavourable situation in the real economy, it is reasonable to assume that companies will continue to limit their capital expenditure. Commercial building is now also showing signs of the long-expected weakness. At the same time, the growth stimulus stemming from foreign trade may well lessen. We think it is likely that overall economic output will not only be limited in the current half year, but also for the first half of next year. This would mean that the USA is already in the middle of a recession. Following moderate economic growth (1.4% in 2008), we expect the US economy to stagnate at best in 2009.

FORECASTS

Interest rates/ yields (as %)	Current	in 3 months	in 6 months	in 12 months
Main refi rate	3,75	3,25	2,75	2,00
3-month money	5,38	4,90	4,00	3,00
10-year Bunds	4,09	3,60	3,70	4,00
Fed funds target	1,50	1,00	1,00	1,00
3-month money	4,82	4,00	3,50	3,00
10-year US Tr.	3,88	3,50	4,00	4,30
EUR/USD	1,36	1,40	1,37	1,32

Bastian Hepperle
+49 211 826 3145
bastian.hepperle@westlb.de

Alexander Klein
+49 211 826 8457
alexander.klein@westlb.de

Jörg Lüschow
+49 211 826 2034
joerg.lueschow@westlb.de

Torge Middendorf
+49 211 826 71749
torge.middendorf@westlb.de

Holger Sandte
+49 211 826 7398
holger.sandte@westlb.de

- **Fed – further rate cuts.** We expect the US Federal Reserve to lower its Fed Funds Target Rate to 1% over the next three months. Although the monetary policy is only having a very limited effect because the Fed's stimulus initiatives are being largely swallowed by the ailing financial system, it will hardly want to abstain from using even this blunt instrument if the data emerging in the months to come reveal an "official" recession and/or it has to combat renewed panic on the financial markets. Depending on how the financial markets and the real economy develop, the prospect of even lower interest rates cannot be ruled out.

- **Germany – slight recession.** Our calculations suggest that German GDP has fallen in Q3 too. This would therefore fulfil the (technical) definition of a recession. In view of the numerous internal and external difficulties, we do not expect to see a rapid end to the economic slowdown, all the more so since the latest escalation of the financial market crisis makes it increasingly likely that corporates will find it ever more difficult and expensive to gain access to credit lines. In addition, the weak state of the global economy means that exports are unlikely to act as engines of growth for the time being. For this reason, the economic slowdown is likely to cause GDP to decline further and persist until well into next year. The situation is hardly likely to stabilise before the end of 2009. Following 1.8% growth in 2008, GDP is likely to shrink by 0.3% in 2009. Up to now, we had assumed there would be slight growth. Germany's average annual GDP was last in negative territory in 2003.

- **Eurozone – greater economic contraction.** The economic indicators suggest that eurozone GDP is contracting by more than we had hitherto forecast. Back in August, we predicted there would be a technical recession, but GDP is also likely to decline in Q4 2008 and the recovery at the start of next year will probably be extremely weak. There are indications that in particular private consumption and investment will be weaker. Furthermore, foreign trade will probably fail to provide an economic stimulus. We have lowered our forecast for GDP growth for this year to 1.0% and for next year to a meagre 0.1%. At the same time, we now expect the average inflation rate to fall back from its current 3.6% to 2.0% next year (previously 2.4%).

- **ECB – room for significant cuts in base rates to 2%.** By taking part in the concerted rate cut on 8 October, the ECB has more than made up for the rate hike at the start of July. The continuing weakness of the economy makes further rate cuts a natural option, and we feel the significant continued fall in the rate of inflation will probably give the ECB room to move in this direction. We expect the main refinancing rate to stand at 2% by autumn next year, which is also the level the ECB aimed for in 2003. The base rate may well even be lowered by a further 50 basis points to 3.25% within the next three months.

- **UK – dramatic slump on real estate market.** As we forecast previously, the UK economy will also slip into recession in the latter half of this year. However, this downturn will be more severe than initially thought. For all intents and purposes, the real estate market is collapsing; in August mortgage lending was 98% down y-o-y. The Bank of England will react to the recession by easing its monetary policy considerably. On a 12-month horizon, the Bank Rate may well be cut to 3.0%.

- **Emerging markets – the negative factors are mounting.** Many figures suggest (and the stock markets are rightly showing) that the emerging economies, regardless of their steeper growth trends, will not remain immune to the economic slowdown in the industrialised nations because globalisation is the opposite of decoupling. Weaker demand from the USA, the EU and Japan is likely to impact exports from the emerging markets of Latin America and Asia harder than previously expected. The decline in demand abroad will make overcapacities apparent in many places. This is likely to hit investment in machinery and equipment, the labour market and privateconsumption.

Western countries' direct investments in emerging markets that export raw materials will probably slacken off. Public budget surpluses and huge reserves of foreign currency in Emerging Asia can cushion this slowdown, but they cannot avert it. We have lowered our growth forecasts for Asia (ex Japan) for 2009 from 6.7% to 6.0% (China: 8.0%), while our estimate for the Latin American economies is down from 3.1% to 2.7% and for Central and Eastern Europe from 5% to 4.9%. Our estimates are already below the IMF's recently updated forecasts, but the downside risks continue to dominate the picture, in our view.

- **Global economy – slowest growth rate since 2001.** We have dropped our projection for global economic growth next year from 3.0% to 2.4%. (2008: 3.8%). The IMF defines rates of 3% and less as a global recession, which was last the case in 2001/02. Taking everything into consideration, we only expect 0.2% growth for the industrialised countries (previously 0.8%; 2008: 1.3%), and close to 5% growth for the emerging and developing economies (previously 5.5%). The balance of the global economy is therefore continuing to shift in favour of the up-and-coming economies, and in particular Asia.

- **Bond yields – still low.** In our view, easing inflation, gloomy growth prospects and further key rate cuts all contribute to an environment in which the yields of long-term bonds are well-anchored at their present low levels and might even continue to decline. However, continued high levels of volatility should be expected, because as soon as a solution to the banks' solvency and liquidity problems is in sight, it is likely that investors' risk appetite will increase again, thus leading to a turnaround in safe-haven inflows into government bonds. However, the subdued fundamental environment suggests that bond yields would then also be relatively low.

- **US dollar – firmer in the long term.** Banking crises do not necessarily coincide with weak currencies. That is why a softening of the dollar is in no way imperative, particularly as it is also European banks that have been sucked into the maelstrom. We expect the dollar to trend sideways amid fluctuations, possibly weakening somewhat, but firming towards USD/EUR 1.30 over the next 12 months, as the key rate differential between the US and the eurozone is likely to be reduced.

- **When and from where will the next upswing come?** There is no doubt that the economy largely paints a depressing picture. However, this has nothing to do with pessimism or even doomsaying. Imbalances or price bubbles such as those in the US real estate market, which were built up over a period of many years, cannot be adjusted simply in the space of one year. That is why the downswing – escalated by the credit/liquidity/banking crises – will simply take a while longer. The downswing will sow the seed for the next upswing, which in Germany as a rule is germinated by a jump in exports. A globally more expansive monetary and fiscal policy will play a significant role in this connection. Generally more powerful, however, are the market forces themselves, for example the sharply declining prices of many commodities. We have reduced our forecast for the average **oil price** next year by US$ 10 to US$ 80 – and it may well turn out to be lower than that. But when will the positive forces outweigh the negative forces? Our answer is probably not before the end of next year. This may not be much comfort, but we do feel it is realistic. The IMF's latest World Economic Outlook uses the words "recovery" or "upturn" on 35 occasions in 245 pages of text, but uses the word "recession" 142 times. We are confident that at least this imbalance will be largely redressed by the time the October 2009 issue of the World Economic Outlook is published.

Growth forecast summary

	2004	2005	2006	2007	2008	2009
EU	**2,7**	**2,2**	**3,4**	**3,0**	**1,6**	**0,4**
EMU	**1,9**	**1,7**	**2,9**	**2,6**	**1,0**	**0,1**
Germany	1,2	0,8	3,0	2,5	1,8	-0,3
France	2,2	1,9	2,4	2,1	0,8	0,1
Italy	1,4	0,7	1,9	1,4	0,0	0,0
United Kingdom	3,3	1,8	2,9	3,1	1,1	-0,2
Newly acceded EU members	5,8	4,9	6,7	6,4	5,1	3,2
Central/Eastern Europe ex EU	**8,2**	**6,6**	**7,4**	**7,4**	**6,8**	**4,9**
Russia	7,2	6,4	7,4	8,1	7,8	5,5
USA	**3,6**	**2,9**	**2,8**	**2,0**	**1,4**	**0,0**
Latin America	**6,1**	**4,6**	**5,4**	**5,5**	**4,7**	**2,7**
Brasil	5,7	3,1	3,7	5,4	5,3	3,0
Asia, Pacific	**6,5**	**6,5**	**7,3**	**7,6**	**5,9**	**4,6**
Japan	2,7	1,9	2,4	2,0	0,5	-0,2
China	10,1	10,4	11,6	11,9	9,5	8,0
India	7,2	9,1	9,8	9,3	8,0	7,0
Emerging Asia	6,1	5,4	5,8	6,0	4,8	3,0
World (PPP weighted)	**4,8**	**4,3**	**5,0**	**4,8**	**3,7**	**2,4**
World ex China	4,3	3,7	4,2	4,1	3,0	1,7
Industrial countries	3,0	2,4	2,8	2,3	1,2	0,1
Emerging Markets and dev. countr.	7,1	6,7	7,5	7,9	6,5	4,9
World (market exchange rate weighted)	**3,9**	**3,4**	**4,0**	**3,7**	**2,5**	**1,3**

Source: IMF, OECD; 2008-09: WestLB forecasts.

WestLB AG
Herzogstrasse 15
D-40217 Düsseldorf

T: +49 (0)211 826 71841
F: +49 (0)211 826 6154

WestLB AG
London Branch
Woolgate Exchange
25 Basinghall Street
London EC2V 5HA
United Kingdom

T: +44 (0)20 7020 2000
F: +44 (0)20 7020 4209