

December 2008

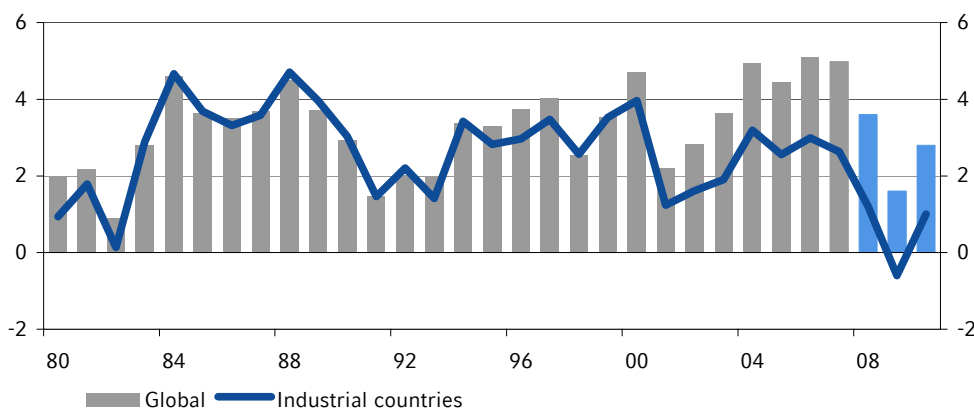
Economic Trends



- **USA: Looking for solutions**
- **Germany: The road to recovery will be a thorny one**
- **Fixed-income markets: Interest rates dictated by recession**

While 2009 will be a difficult year, the latter part may at least bring a slow recovery from the global recession. Initially the adverse effects of the financial market crisis on capital expenditure, consumption, labour markets and earnings will continue to feed through. We expect the rate of global growth in 2009 to be 1.6%, which is the lowest since 1991. For the first time in post-war history, economic output in industrialised countries is likely to shrink by around 0.6% next year.

Global growth (yoy in %)



Source EcoWin, WestLB Research

WestLB Research – Economists

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Editorial

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Outlook for 2009 – torn between hope and fear

An outlook for the following year can seldom have been clouded by so many concerns and such huge imponderables as at the end of 2008. The global economy is in a surprisingly sharp and synchronous downturn that has embraced all regions. In many countries, the state has had to protect the banking system from possible collapse, while lending is faltering and various segments of the financial markets are not working. Even if the financial crisis has probably peaked, the inevitable dampening effects on capital spending, consumption, earnings and labour markets are still unfolding to a large extent. For the time being, newsflow is likely to remain largely downbeat.

Stabilisation likely over the course of 2009

As of today, it is impossible to state how long the downturn will last and how deep it will be. However, forecasts are still necessary. In our opinion, the situation may stabilise over the course of the coming year and a recovery may set in, although it will probably be fairly hesitant. Our central scenario for 2009 and possible alternative scenarios on either side are set out in this outlook.

Election year, not only in Germany

2009 will also be a year of developments that nobody expected in advance. However, the calendar dictates the occurrence of certain events. For example, a new president will assume office on 20 January. He will be faced with trying to satisfy huge expectations despite his limited room for manoeuvre. In Germany, the general election will take place in September. A renewed grand coalition would not surprise us in the least. In the spring, India – the world's largest democracy – is due to go to the polls. One of the major emerging nations, it has just been shaken by terrorist attacks.

The lower expectations are, the easier they might be exceeded

There may also be a good side to the current deep sense of pessimism. After all, the lower expectations are, the more likely it is that they will be exceeded. As a profession, economists – including ourselves – underestimated the downturn this year. Perhaps we are underestimating the next upswing. And once all the negative aspects have been discussed, the positives will become interesting again and optimism will make a comeback.

Changes to our publication range

From the coming year, we will publish "Economic Trends" – one of WestLB's most enduring products – on a quarterly, rather than monthly, basis. At the same time, we will expand our weekly product. We welcome any suggestions on this.

Merry Christmas!

It only remains for us to wish our readers a joyful and relaxing Christmas and a great start to the New Year. We also wish you the best of luck and success in your decisions and hope we can continue to help you with our analyses and assessments.

Macro outlook 2009: summary of key points

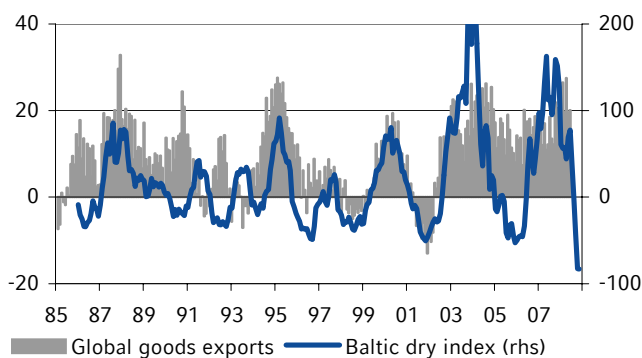
Extraordinary times, extraordinary forecasts

While 2009 will be a difficult year, the latter part may at least bring a slow recovery from the global recession. Initially the adverse effects of the financial market crisis on capital expenditure, consumption, labour markets and earnings will continue to feed through. It will be a year for banks and – by no means only in the US – households to sort out their balance sheets and finances. It will also be a year for very expansive monetary and fiscal policies. We expect commodity prices to remain low, leading to huge swings in current account balances to the detriment of commodity-exporting countries. We anticipate that Germany's economic output will fall by around 1%, with a sharp contraction in capital expenditure, but that private consumption will remain relatively robust.

Uncharted territory: financial market crisis significantly increases the uncertainty of forecasts

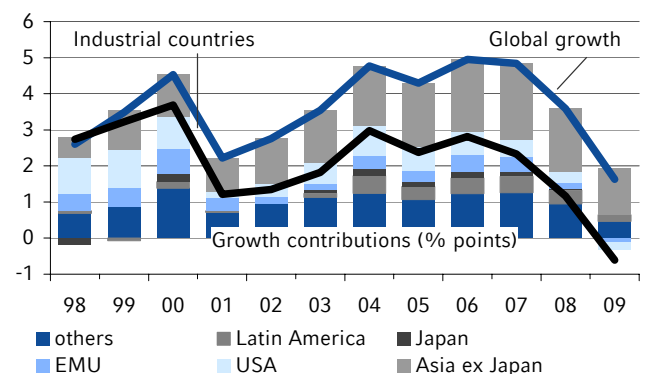
This year the subprime and credit market crisis turned into a general crisis of the banking and financial system that is having a serious adverse effect on growth in all regions of the global economy. The financial market crisis has triggered deep-seated uncertainty among consumers and companies, which is being reflected in various sentiment indicators and, increasingly, in hard economic data, both in industrialised nations and emerging markets. Given the lack of suitable benchmarks for comparison, the uncertainty of forecasts is unusually high at present. This applies both to the question of how severe the downturn will be and to predicting how long the slump will last, and what form the subsequent recovery will take. To some extent, we are into uncharted territory here. This is certainly no time for forecasters to engage in fine-tuning: it is not about adding or subtracting a few tenths of a percentage point to or from growth forecasts at the moment, but about looking at the overall trend and thinking in terms of alternative scenarios. Accordingly, we have included two risk scenarios at the end of this macro outlook report.

Global goods exports and freight rates index
(yoy in %)



Source EcoWin, WestLB Research

Global economic growth
(yoy in %)



Source EcoWin, WestLB Research forecast

Painful recession more likely than a fresh Great Depression

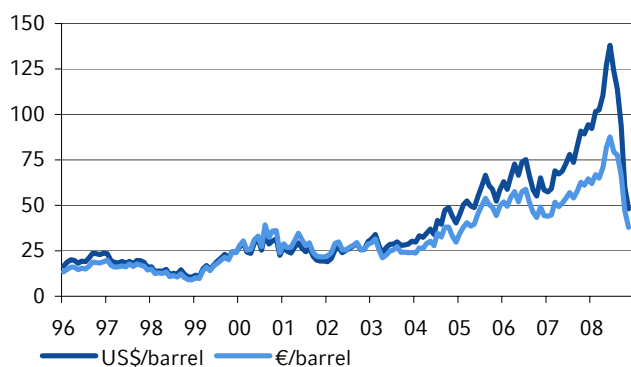
In the main scenario, the question is whether the global economy will slide into a lengthy depression – accompanied by actual deflation (see the separate report on this subject) and double-digit declines in economic output. We do not expect this to happen because ...

- ... in many countries, comprehensive rescue packages have been quickly agreed to assure the solvency and liquidity of the banks and therefore ensure that the financial sector can continue to function;
- ... unlike during the Great Depression, the central banks will act as lenders of last resort;
- ... the authorities in many countries will use not only monetary policy but also fiscal measures to fight the downturn;
- ... economic policy reaction to the crisis has been internationally coordinated, which suggests that there will be no slide into extreme protectionism.

Weakest global economic growth since 1991

That is the good news. On a more sobering note, there will inevitably be a sharp slowdown in global growth and a contraction in economic output across many industrialised countries. We expect the rate of global growth in 2009 to be 1.6%, the lowest since 1991. Economic output in industrialised countries is likely to shrink by around 0.6% next year (2008: +1.2%). That is unprecedented in post-war history. We put growth in the emerging and developing markets at around 4% (2008: 6.3%), although we think that the risk of that forecast being undershot is greater than the chance of it being exceeded. Once again, a lot depends on China, where we expect growth to slow to 7.8%. Stripping out China, global economic growth will not even reach 1%. Only a slight growth of global trade is likely next year.

Oil price (Brent)



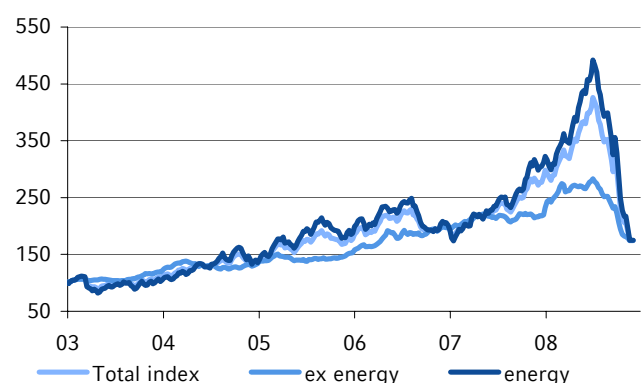
Source EcoWin, WestLB Research

Much lower oil prices than in 2008

In the economic downturn, and with commodity prices much lower, the inflation problem should continue to recede. We base this on the expectation of the oil price averaging US\$50 over the 12 months of 2009, and US\$60 in 2010. This would mean a 50% fall in the annual average price in 2009 compared with 2008 – delivering a hefty boost to the current account balances of oil-importing countries. The last time there was a decline in the annual average oil price was 2001.

Commodity prices

(in US\$, January 2003 = 100)



Source EcoWin, WestLB Research

Forecast risks

The main scenario outlined here of a painful global recession, limited to a few years with a subsequent gradual recovery, describes what we believe to be the most likely development. As mentioned above, the uncertainties of the forecast at this time are unusually high. We believe that the risk of weaker growth is greater than the prospect of improved growth.

Alternative scenarios:

downward spiral versus...

Negative scenario: downward spiral (likelihood: 20%). If the financial crisis should worsen, the counter measures taken by the central banks and governments to date could prove to be insufficient. The banks' liquidity and solvency problems would increase, lending would dry up, capital expenditure and consumption would slow more sharply, a deflationary gap would develop, and a lack of "ammunition" would mean that monetary policy could barely be tackled at all and financial policy only with huge efforts. In this event, it is conceivable that the global economy could even contract in terms of GDP adjusted for purchasing power parity, due to declining economic activity (instead of noticeably less expansion in the main scenario) even in the larger emerging markets. The process of repairing balance sheets could then take several years. Yields on government bonds would drop even more sharply and for a longer period in this scenario.

... v-shaped recovery

Positive scenario: v-shaped recovery (likelihood: 10%). Studies show that on average, economists not only underestimate the severity of downturns but – contaminated by general pessimism – also the rate of the subsequent recovery. A possible exaggeration of the actual situation by the latest slump in numerous sentiment indicators should not be ruled out, nor that the recent weak economic data in many countries may already be showing almost the lowest point in the downturn. Surprisingly positive reports from the economy and the financial sector could lead to an upturn in sentiment among consumers and companies. Driven by lower interest rates, drastically falling commodity prices and a more expansive fiscal policy, the economy could be pulled out of the downturn. In this scenario, instead of deflation, inflation would re-emerge as a risk, alongside significantly higher yields on government bonds.

USA

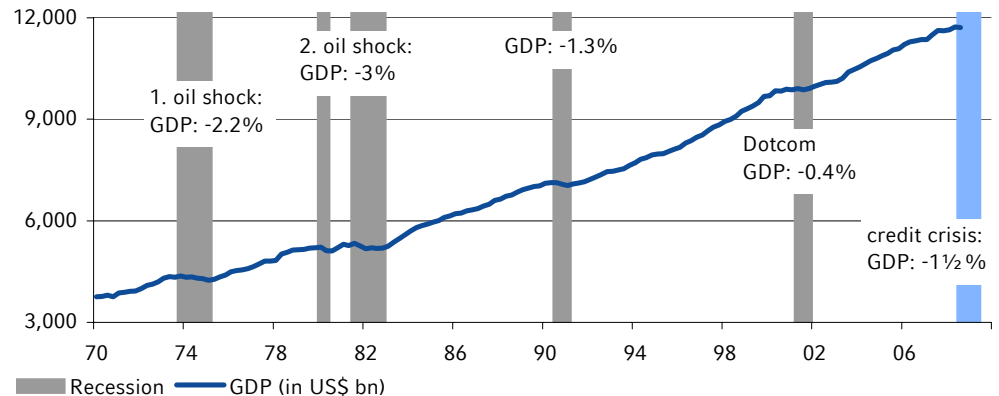
Looking for solutions

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Financial market crises
exacerbate economic slumps

Intervention and support measures on a massive scale by the US Federal Reserve and government have prevented the financial system there from collapsing. The money market situation has now stabilised to some extent, although it is still a long way from being business as usual on the market. However, the intervention has not been able to stave off a likely US economic recession. There is great concern that, given the financial market crisis and the impact it is still expected to have on the real economy, the recession will be deeper and longer-lasting than previous economic downturns. At least, this is what past experience tells us. In its World Economic Outlook from October 2008, the International Monetary Fund looked at the effects of various financial crises on economic performance and concluded that, in previous periods of economic weakness preceded by problems in the financial sector, economic output has been below its long-term potential for up to eight quarters and has contracted by up to 4½% overall. This is far more than during “normal” downturns or recessions, when the cumulative decline in GDP has been between 1½% and 2¼%.

Falls in US gross domestic product during recessions (cumulative, in %)



Source EcoWin, WestLB Research

Weakness likely to be
protracted

Only a sluggish recovery

In our forecasts we are assuming that things will not be so bad, as the economic policymakers have acted relatively quickly and the US government is to put together a further economic package. This, together with the considerable relief provided by lower energy prices, the very expansive monetary policy being pursued and the diminishing negative impact of the financial crisis and residential construction sector, ought to ensure that the economic slump is not too severe. Nevertheless, the current spell of weak growth is likely to drag on until well into next year. We think it is highly likely that there will be a contraction in aggregate economic output spanning three to four quarters. Even so, despite the credit crisis, the 2008/09 downturn, for which we are forecasting a cumulative fall of 1½% in GDP, is likely to be on a similar scale to the 1990/91 recession, and less severe than the recessions of the 70s and 80s. We expect the average contraction in GDP for 2009 as a whole to be 1.0%, which will include a sluggish recovery in the latter part of the year. For 2010 we forecast economic growth of just 1.0%. Growth will therefore be below potential for the foreseeable future, which,

given the country's huge macroeconomic imbalances (high debt and low savings of households, big public budget and current account deficits), is hardly surprising.

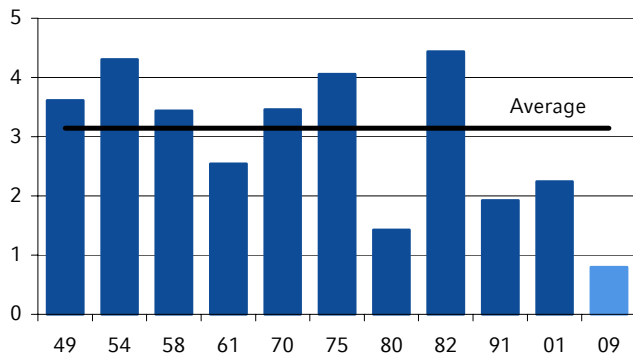
Considerable risks for the economy

The risks to US economic performance going forward are considerable. The financial sector rescue package that has now been put in motion and the massive liquidity injections and rate cuts by the Federal Reserve are starting to bear fruit and should help to mitigate the worst of the impact of the crisis on the real economy. However, it will be a while before we see a significant easing in the situation.

An unfavourable environment for private consumption

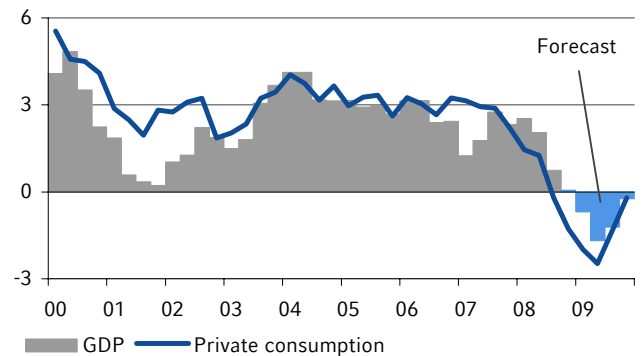
Leaving aside the financial market crisis, the current economic situation also differs from previous recessions in that conditions for private consumption are far less favourable. In the third quarter, consumer spending fell for the first time since 1991, and households are likely to be reining in their spending for some time to come. The accelerating decline in employment, deteriorating income prospects and shrinking assets of private households (continuing decline in property prices, huge share price losses), together with high levels of debt and low availability of credit are also having a detrimental effect. In addition, as saving through capital growth is not really an option at the moment, households are likely to return to saving by traditional means, i.e. putting money aside from their current income. The uncertain labour market situation will probably also lead to an increase in precautionary saving. Consequently, the savings ratio looks set to rise next year. Despite the considerable relief brought by the fall in oil and energy prices, we reckon that households will limit their real-term consumer spending until well into the first half of 2009.

Private consumption: cumulative contribution to growth
(in percentage points, four quarters after recession)



Source EcoWin, WestLB Research

US: real gross domestic product and private consumption (yoy in %)



Source EcoWin, WestLB Research

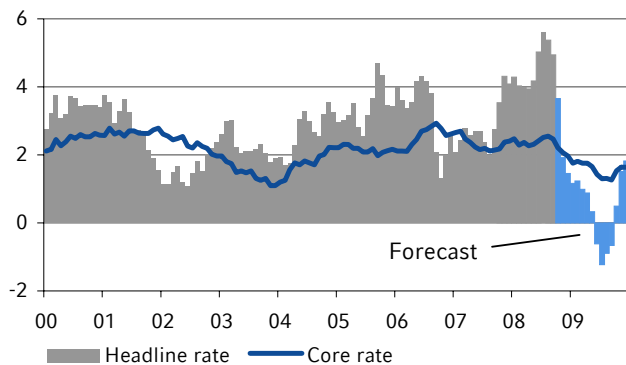
Private consumption will not provide a spark in the near term...

There has not been such a long bout of belt-tightening by consumers in the US since the Second World War. In previous recessions, private consumption has picked up again after two quarters at the latest, and has almost always been the biggest contributor to growth. For the reasons given above, a recovery in consumer spending is likely to take a little longer, and even when it happens, we only expect to see it growing again at a below-average pace. Barack Obama's landslide victory will do little to change this, with the euphoria among large sections of the US population unlikely to translate into a speedy revival in private consumption given the difficult economic situation. As a result, we cannot expect private consumption to provide the spark for a substantial recovery in the US economy.

...and nor will other major demand components

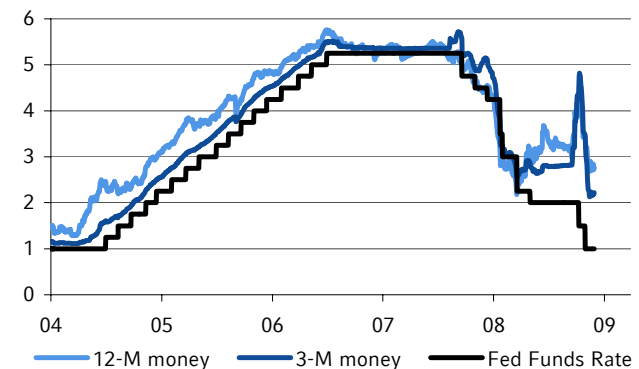
Nor can we really expect the other demand components to become the driving force for an upturn anytime soon. The downtrend in private residential construction is likely to continue for the time being. However, spending on residential construction has more than halved in the past three years so the potential for a further fall in 2009 is limited. The decline in residential construction investment will probably not have such a big negative impact and should start to contribute to growth once again in 2010. With the slump in growth and tighter financing conditions, willingness to invest in commercial construction projects will be severely limited. As there has not been a bubble here like the one in residential construction, we do not expect the contraction to be as severe; instead, it is likely to follow the same pattern as in previous downturns. Declining capacity utilisation, an uncertain sales outlook and difficult financing conditions also point to a fall in capital expenditure. In fact, the pace of the downturn here is even likely to accelerate over the next few quarters. We are assuming that there will be a very gradual recovery in 2010. Meanwhile exports, which have recently been propping up the economy, will not be able to come to the rescue either, given the severe slowdown in global growth, which has led to a reduction in demand for exported goods from the US.

US: consumer prices (yoy in %)



Source EcoWin, WestLB Research

US: money market rates (in %)



Source EcoWin, WestLB Research

Monetary policy means have been all but exhausted...

Now that a programme of measures to help the financial sector has been put in place, the political authorities and the Federal Reserve are switching their focus to the real economy. Given the lack of economic drivers, US economic policy will need to remain very expansive so as to lay the foundations for the next upturn. As inflation risks are receding faster than originally expected, the Fed is set to cut fed funds rate to 0.50% in December. This will leave the US on the brink of a zero-interest rate policy – naturally raising the spectre of a “Japan scenario”. However, we believe such a scenario is unlikely. In the current environment, the potential for monetary policy to affect the real economy has been all but exhausted. At the same time, this means that the way out of the crisis has to be via a more expansive fiscal policy, even if that means a further widening in the US budget deficit.

... so now it is down to fiscal policy

The expectations that voters have placed on the shoulders of their new president, Barack Obama, are enormous. He is expected to steer the economy out of the crisis, find a solution for Iraq and reform both the tax and the healthcare systems. One of the keys to the success of these measures is growth. The US administration will put together a further package of measures to help the ailing economy, homeowners and the middle class. It is still unclear exactly how this package will be structured, but our forecast is based on the assumption that fiscal policy will be very expansive.

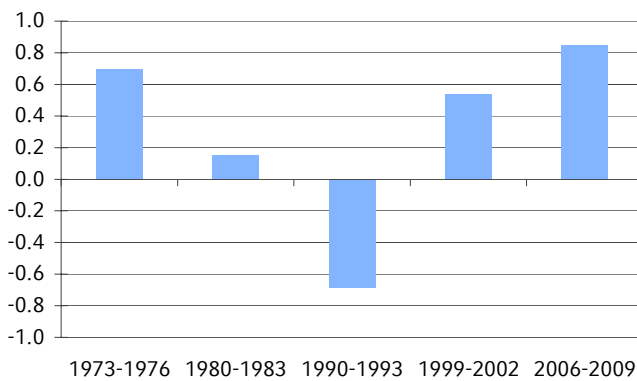
Eurozone

Worst downturn since the introduction of the single currency

Eurozone affected by the global nature of the financial market crisis and a lack of growth drivers

For the coming year, we expect only a very modest economic recovery in the eurozone. The single currency area slid into its first recession this year, and output is still likely to be falling as we go into 2009. There are two reasons for this severe recession. The first is that the financial market crisis is a global shock that has led to a remarkable synchronisation of industrialised countries' economies. The correlation between the GDP growth rates of the G3 is likely to be even greater than at the time of the first oil price shock in the 1970s. Home-made crises are the second reason. Spain, one of the eurozone's growth drivers in past years, is experiencing its own property crisis. Already, the country's contribution to eurozone growth is the lowest since 1996. We expect Spain, too, to slide into a recession and to continue dragging on eurozone growth for the foreseeable future.

US, eurozone, Japan: correlation of GDP growth rates
(average correlation coefficient)



Source EcoWin, WestLB Research

Eurozone: GDP and Spain's contribution to growth
(in % yoy and in percentage points)

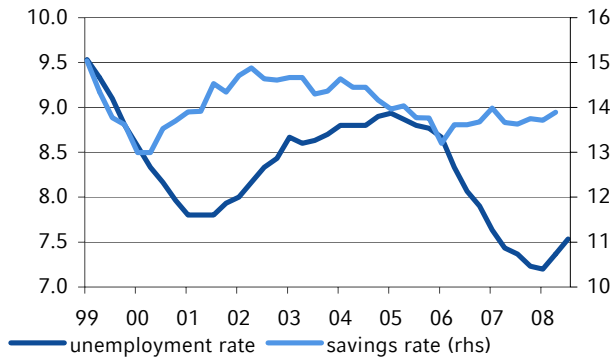


Source EcoWin, WestLB Research

Unprecedented weakness in private consumption – rise in unemployment to have adverse effect in 2009

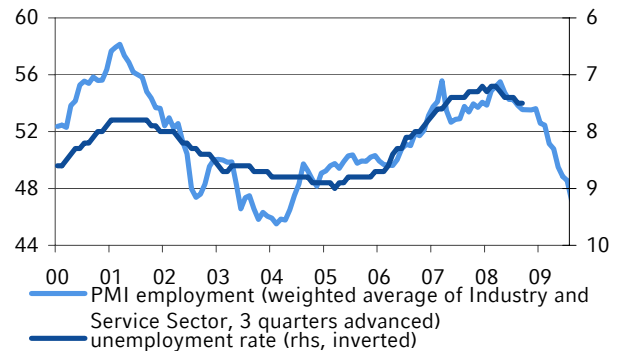
Eurozone growth is being adversely affected by factors on all sides. Private consumption has been heading downwards since the beginning of the year. This is a new situation for the eurozone: it is the first time the single currency area has experienced consecutive quarters of contraction in private consumption since the introduction of the euro. The reason is a small increase in the savings ratio, probably due to an erosion in assets (especially those invested in equities) and the rise in unemployment that we are now seeing. While the stock markets are likely to pick up again in the latter part of next year, unemployment will probably continue to grow at an accelerated pace, according to what companies are saying about the hiring outlook. The only positive impetus will come from the decline in oil prices, which should bolster disposable incomes. All in all, however, we expect private consumption to decline over the year.

Eurozone: unemployment rate and savings ratio (in %)



Source EcoWin, WestLB Research

Eurozone: unemployment rate and PMI Employment (in % and in points)

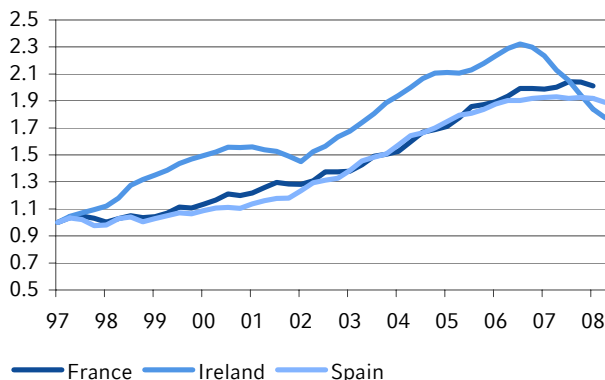


Source EcoWin, WestLB Research

Different factors weighing on capex

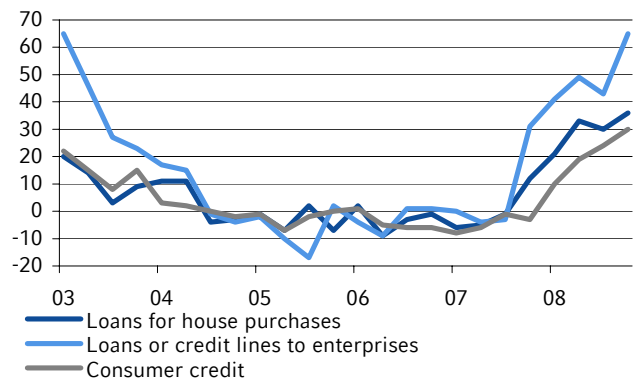
There are a couple of factors weighing on fixed investment in the eurozone. Firstly, in some member states such as Spain and Ireland, property bubbles have burst and the corrections are likely to last for some time. Compared with rent levels, new buildings in the countries concerned are still significantly overvalued. Meanwhile, the downturn in the office property segment has just got underway and is likely to last until 2010. We expect eurozone construction activity to shrink until the end of next year. Weak private consumption figures and the drastic fall in demand from abroad are both having an adverse effect on investment in equipment. Meanwhile, the corporate earnings situation, although still extremely good by historical standards, has recently deteriorated slightly. In addition, the ECB's survey indicates that borrowing conditions for companies have got much worse as a result of the financial market crisis. Consequently, equipment investment is likely to fall about as sharply as it did in 2001, when a period of overinvestment was followed by a steep decline.

Eurozone countries: property prices relative to rents (1997 = 100)



Source EcoWin, WestLB Research

Eurozone: tightening/loosening of credit lines (net balances in %)



Source EcoWin, WestLB Research

Weak exports damaging growth

Meanwhile, global trade is likely to be flat next year, so the eurozone will be lacking yet another of its growth drivers, albeit only a small one: over the past three years, exports have contributed a mere 0.3 percentage points on average. This is about the same as the negative impact that exports will have on eurozone growth next year, and less than was the case in the global recession of 2001. The reason is that emerging markets now account for a higher percentage of (extra-)eurozone exports than they did in 2001, and we expect the economic performance of emerging markets to be more robust during the

No significant economic programmes on the cards

forecast period than that of industrialised countries. For instance, since the 2001 recession, China's share of extra-eurozone exports has doubled from 2% to 4%.

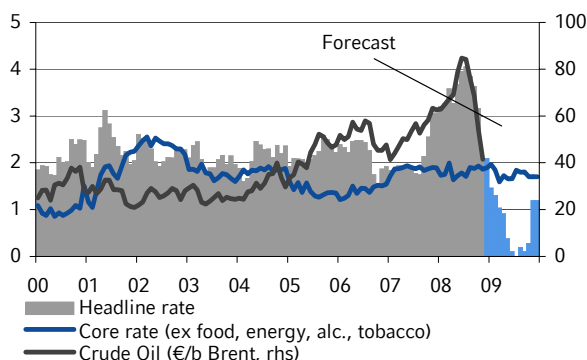
The only remaining option open to the eurozone in the short-term is for governments to spend their way out of the crisis by significantly increasing public consumption. The member states have already made funds available to the financial sector on a large scale with government rescue packages. However, these are not primarily intended as a means of stimulating the economy, but take the form of guarantees and will only drive up member states' deficits if institutions have recourse to them. The size of the true economic packages that have been put together up until now is disappointingly small. For instance, the German programme aimed at stimulating economic activity amounts to just €12bn, or 0.5% of GDP, which is actually spread over two years. The plan for an EU-wide economic stimulus package the EU commission recently unveiled is intended to have a volume of €200bn, which would correspond to about 1.5% of the member states' GDP. The programme is supposed to be largely funded by the member states and would have a significant economic impact. Member states' deficits will therefore to rise in the next few years, and, taking account of the exceptional circumstances, the European Commission is not expected to take any sanctions against countries that fail to meet the Maastricht criteria.

Inflation falling sharply

Next year occasionally even declining prices

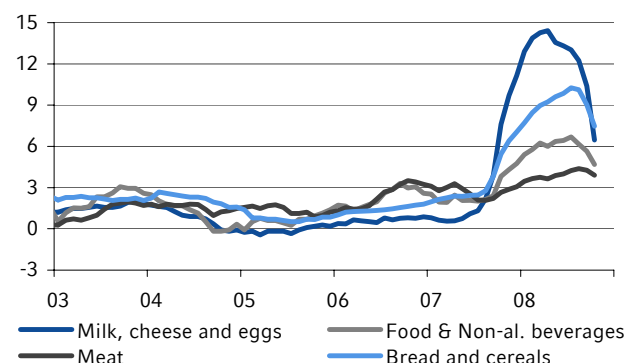
Inflation in the eurozone reached unprecedented levels this summer, driven by the continued rise in the price of oil and steep rises in food prices as a result of crop failures. The ECB responded in June with a hike in the refi rate, citing the risk of second-round effects. However, the inflation picture has since changed considerably. The economic slump has likewise led to a slump in the oil price, which is now down by around 35% year-on-year in euro terms. We expect the drop in demand for oil to ensure that its price does not rise above its current level next year. This, combined with an easing in food prices following record harvests, will lead to much slower inflation rates. Eurozone prices are even expected to drop next summer.

Eurozone: consumer prices and the oil price
(in % yoy and in € per barrel)



Source EcoWin, WestLB Research

Eurozone: food prices
(yoy in %)



Source EcoWin, WestLB Research

ECB to meet target for the first time since 1999

Although core inflation is expected to only slightly decrease next year, the ECB will meet its own target – 2% inflation or less – clearly next year on the basis of the headline rate. That would be the first time it had done so since 1999. We expect inflation over the year to average 1.2%. This would give the ECB greater scope for cutting interest rates.

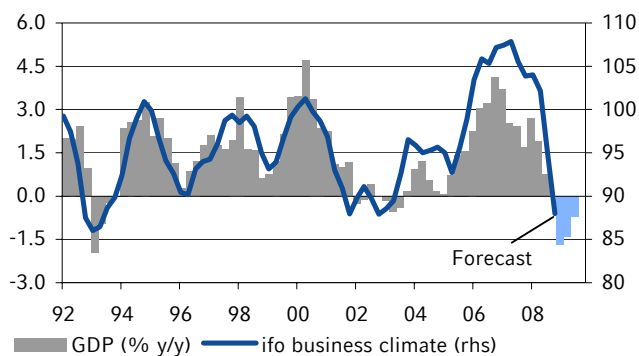
Germany

The road to recovery will be a thorny one

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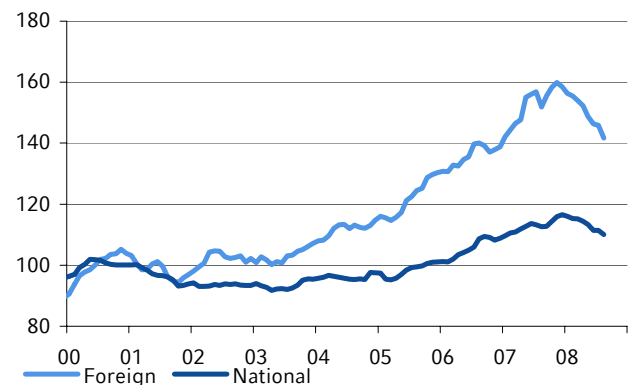
After three good years, the German economy is in a recession as 2008 draws to an end. The plummeting of several sentiment indicators and hard economic data suggest that the weak phase will continue for a while to come.

Gross domestic product and ifo-business climate (% y-o-y change, 2000 = 100)



Source EcoWin, WestLB Research

Manufacturing Orders (2000 = 100)



Source EcoWin, WestLB Research

Two guarantees of success seem to be turning into risks

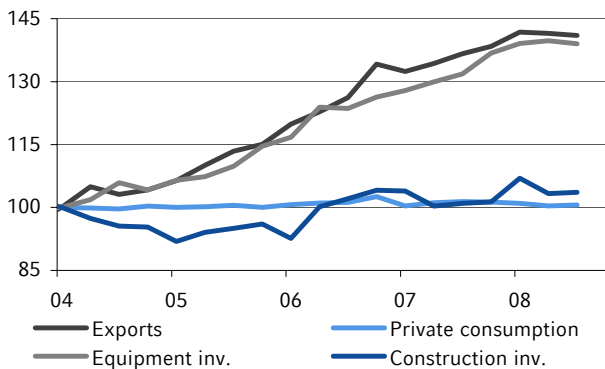
Two former guarantees of success for the preceding upturn now seem to be turning into downside factors, and thus to harbour a substantial risk for the future economic trend:

- **Germany's close integration in international trade.** An export ratio (exports relative to gross domestic product) of over 50% is unusually high for such a large economy as Germany's. The corresponding ratio in the USA is only 13%; it is also far lower in Japan (17%) and France (20%) than in Germany.
- **The high proportion of capital goods.** Almost 40% of goods produced by German industry are capital goods; these also account for a large part of exports. Slightly more than half of all foreign sales of the industry come from the capital goods sector (including automobiles). Manufacturers of capital goods have even benefited from the high oil price, as many oil-producing countries have used their revenues for additional purchases of capital goods from Germany.

Are exports and capital expenditure facing a collapse?

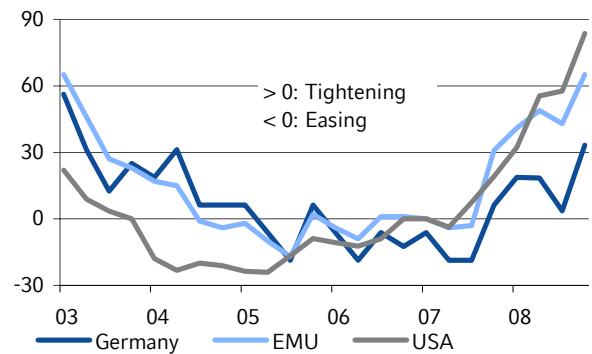
But exports and investments have been suffering a severe setback since the end of the global economic upswing, the global investment boom and the oil price's bull run. In industry as a whole, the producers of capital goods have so far suffered the severest decline in demand, both from abroad and domestic. Since exports and investments were almost the sole growth drivers in the previous upturn, there is clearly a risk that Germany could be heading for a hard landing.

Components to GDP
Q 1 2004 = 100



Source EcoWin, WestLB Research

An international comparison of credit standards
(balance)



Source EcoWin, WestLB Research

Momentum of exports is slackening appreciably...

The volume of German exports is likely to decline appreciably, given the global growth rates we forecast for 2009. Another problem is likely to be the economic downturn in other EMU states, which are among Germany's most important trading partners.

... but exports have not declined in absolute terms

There are, however, some aspects that argue against an absolute decline in exports: Germany's international competitiveness remains very high. Among the major industrialised countries, only Germany has been able to defend its competitive position in the global markets during the past few years. Extensive rationalisation measures are likely in many countries, and the plant and machinery needed for this in many cases come from Germany. The German export sector is also likely to benefit from the fact that a large number of countries have launched economic stimulus programmes; many of these are aimed at improving public infrastructure and increasing energy efficiency. Germany's mechanical engineering and plant construction sectors are likely to benefit particularly from this.

Investment activity likely to be curtailed

A gloomy earnings outlook in the export business, continuing doldrums in domestic business, rising costs, pressure on margins and gradually falling capacity utilisation will squeeze capital expenditure, which will probably be reduced in the next few quarters.

Tightening of credit standards is a drag on investment

Investment activity is likely to slacken off because it has become harder to raise funds as a result of the crisis in the financial markets. Corporate spreads in the bond market have widened significantly, and banks have recently tightened their credit standards significantly – especially for large enterprises. However, the latest findings of the ECB's Bank Lending Survey indicate that lending standards are less restrictive in Germany than in other countries.

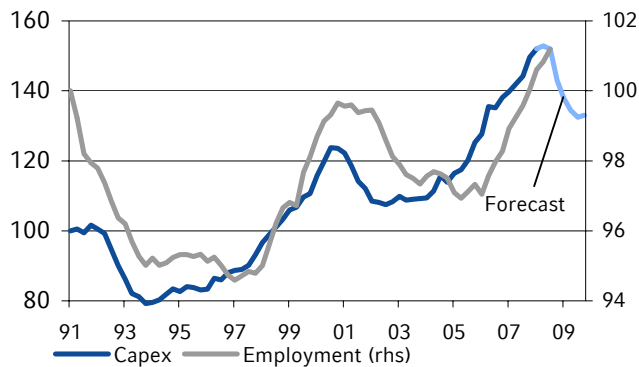
We do not therefore expect a credit crunch, as the support measures for the financial sector are likely to have the desired impact. The fact that companies are able to finance the bulk of their capex out of equity due to significant increases in their profits during the past few years also eases the pressure on them.

Accumulated decline in capital expenditure of around 15%

Experience of previous economic cycles shows that investment contracts during a downswing by 10-25% in cumulative terms over a period of five to eight quarters. The extent of the decline depends essentially on how much capacity was increased previously, but also on how quickly the economy is expected to recover. In the last upturn, capital expenditure on plant and equipment was increased by around 40%

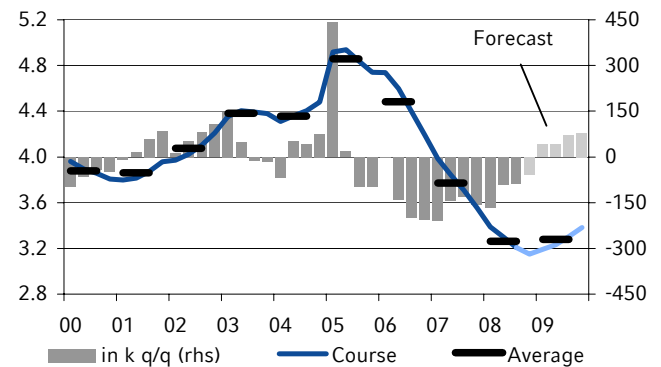
overall, which is not an excessive amount compared with previous cycles. We assume that the cumulative decline will be around 15%, which is towards the lower end of the above-mentioned range, and will continue until roughly the middle of next year. The worst of the adjustment is, however, still ahead of us.

Capital expenditure and employment (1991 = 100)



Source EcoWin, WestLB Research

Numbers of unemployed (millions and '000s)



Source EcoWin, WestLB Research

Increase in unemployment is already inevitable

As a result, employment will probably decline and unemployment will rise, at the latest at the beginning of next year. Experience has taught us that the decline in employment is initially limited as companies first make use of productivity and labour reserves before laying off employees. We do not expect to see a wave of redundancies similar to that seen at the beginning of this decade, but companies are nevertheless likely to react to falling capacity utilisation and the initially continuing wage pressure by cutting jobs. Unlike in 2007 and at some times during 2008, companies may no longer be able to offset large increases in collectively negotiated pay, most of which will still be having an impact next year, with corresponding gains in productivity. We assume that the number of unemployed will increase in 2009 by around 250,000. We forecast that the average level of unemployment in 2009 will not be significantly higher than this year because of the low level at the beginning of the year 2009.

Consumer spending remains weak so far

How deep the downturn turns out to be will probably depend largely on the behaviour of consumers. So far, consumption has remained weak, mainly because inflation, which increased steeply up to mid-year, has eroded the considerable nominal increases in incomes.

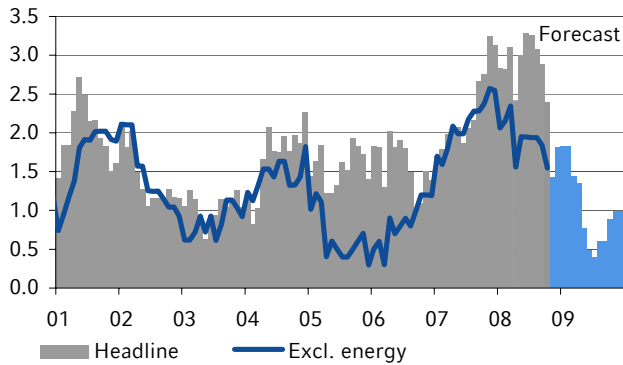
Inflation has eased off appreciably

However, inflation has slowed significantly in the wake of the dramatic decline in oil prices, and will in all likelihood continue to pull back over the coming months. Although the growth in disposable income will probably not be quite as great as in 2008, it should still be more than in recent years. Our calculations therefore suggest that real incomes will increase by almost 1¼% in 2009.

Moderate increase in private consumption, and a rising savings rate

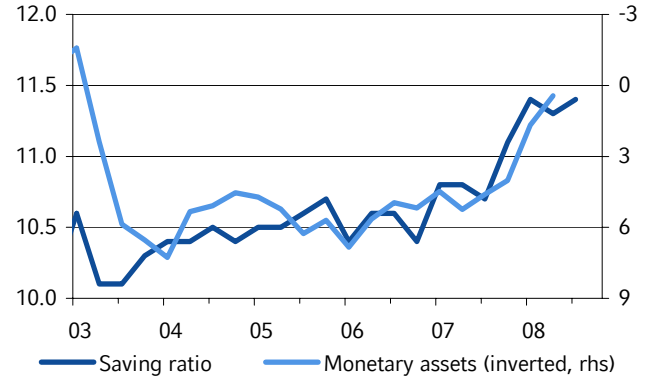
To what extent this could boost consumption depends on the pattern of household savings. The current economic setting, the ongoing trend towards private pension provision, and the asset losses suffered in connection with the crisis in the financial markets suggest that savings will increase and that part of the growth in incomes will go into savings. Nevertheless, there is still leeway for an increase – albeit moderate – in consumer spending, which we estimate at 0.5%.

Consumer prices
(% y-o-y change)



Source EcoWin, WestLB Research

Saving rate and monetary assets of private households
(in % and % y-o-y change)



Source EcoWin, WestLB Research

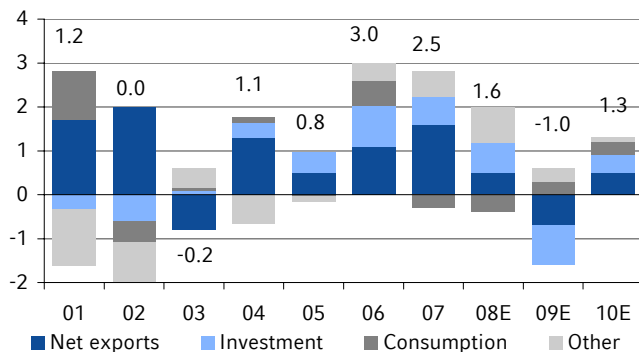
Economic downturn may extend well into the coming year

But this would not prevent the forces of recession from retaining the upper hand for the time being; nor would it prevent the downturn from going on until well into the coming year. It is likely to be similar in extent to that seen during the 1992-93 recession. We believe the slight increase in private consumption will prevent an even steeper economic downturn. Gross domestic product is likely to contract by around 1% in 2009, after growth of 1.6% this year. Average annual economic output last fell in Germany in 2003. Nor will the measures taken by the German government to support the economy do anything to stop the trend we forecast.

Reasons for economic stabilisation at the end of 2009

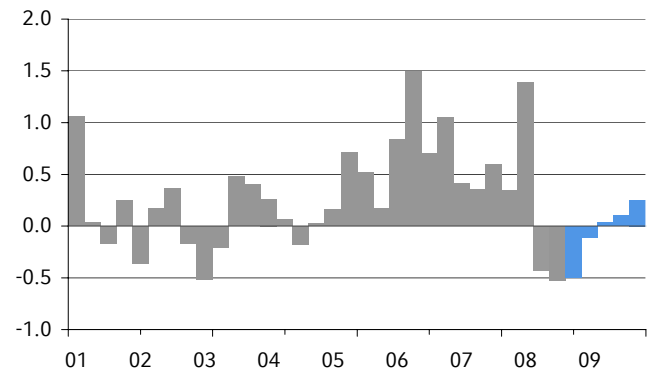
The economic outlook may gradually brighten towards the end of 2009, though fiscal policy may make only a modest contribution to this. Stabilisation can be expected due to the easing of the reins of monetary policy, normalisation in the financial markets, and falling crude oil and commodity prices. There is, therefore, a prospect of an economic recovery in 2010; we assume annual average growth of 1.3% in that year.

Contributions to gross domestic product growth
(percentage points)



Source EcoWin, WestLB Research

Gross domestic product
(% change q-o-q)



Source EcoWin, WestLB Research

Central and eastern Europe

Downwards alongside the eurozone

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Poor economic policy is being punished

The international financial market crisis has also left its mark in central and Eastern Europe. The countries most affected are those whose economic performance was characterised by significant imbalances such as for example high current account deficits. Among these countries are Hungary and Romania who also suffer from high levels of foreign debt. Due to high interest rates, foreign currency debt – in euro or Swiss francs – is particularly attractive. What makes the situation more difficult is that Hungary and Romania have flexible exchange rate systems, and a depreciation of the local currency during the financial crisis has increased the debt levels of private households and companies.

By contrast, the Baltic states and Bulgaria have tied their currency to the euro. Interest rates in these countries are therefore significantly lower than in Hungary or Romania, thus making foreign currency debt less attractive.

Western European banks dominate

The banking sector in the new EU states is firmly in western European hands. Many banks were bought up by western European institutions in the course of privatisation. This was long considered as an advantage for the stability of the banking system as knowledge transfer would also mean the transfer of modern management methods and risk assessment systems. However, it could now turn out to be a disadvantage as the banks in the industrialised nations are more heavily affected by the subprime crisis. The parent company's poor image could impact on its subsidiary's refinancing possibilities and the supply of liquidity from the parent company is also likely to fall significantly. In addition, credit default risks increase during economic downturns, which is particularly impacting banks that had previously benefited from the strong credit expansion in central and eastern Europe.

Instability in central Europe: where are the weaknesses? (data for 2007)

	Hungary	Romania	Bulgaria	Latvia	Estonia	Lithuania	Poland	Czech Republic
Current account balance ¹⁾	-5.0	-14.0	-21.4	-22.9	-18.1	-14.6	-3.8	-1.8
covered by direct investment ²⁾	40.5	22.2	62.2	30.6	29.4	24.5	98.6	175.6
Budget balance ¹⁾	-5.0	-2.6	0.1	0.1	2.7	-1.2	-2.0	-1.0
Gross government debt ¹⁾	65.8	12.9	18.2	9.5	3.5	17.0	44.9	28.9
External debt ³⁾	111.4	86.5	41.3	36.6	23.5	28.1	204.0	74.6
% of forex earnings	100.3	168.1	166.0	308.9	152.0	125.8	115.4	53.6
Exchange rate vs. EUR ⁴⁾	-3.3	-7.1	0.0	-1.2	0.0	0.0	1.3	7.4
Long-term interest rates ²⁾	6.7	7.1	4.5	5.3	6.1	4.5	5.5	4.3

1) in % of GDP, 2) in %, 3) in \$bn, 4) yoy in %, as at Nov. 2008, negative = depreciation, 5) Estonia: term up to 1 year, reference value Germany: 4.2%.

Sources EU, ECB, Global Insight, IMF, WestLB Research

EU membership has proven to be an advantage over other emerging markets for transition countries. In addition to the IMF, the EU and the ECB can come to the aid of these countries if they fall into financial difficulties.

Close trade relations with the eurozone spell gloomier growth prospects

Central Europe's main vulnerability is its close trade relations with western Europe and the high dependence on exports of some individual countries. Although intra-regional trade is also high, Germany is the biggest trading partner for many countries. A recession in Germany and the eurozone would therefore significantly dampen growth in the new EU states. The situation is made more difficult as internal demand is barely able to compensate for this. Tougher lending conditions from the banks are having a dampening effect on consumption and capital expenditure. We therefore believe that growth in the region will fall from 5.4% this year to 2.5% next year. The Russian economy and neighbouring economies which are heavily dependent on oil and gas exports are facing a sharper slowdown.

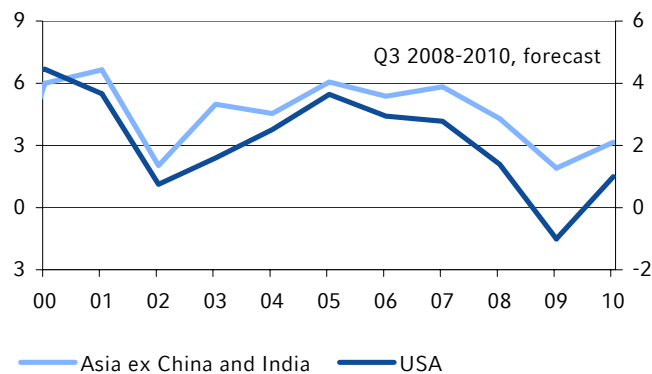
Asia

Fiscal and monetary policy prevent worse to come

Overall fall in demand

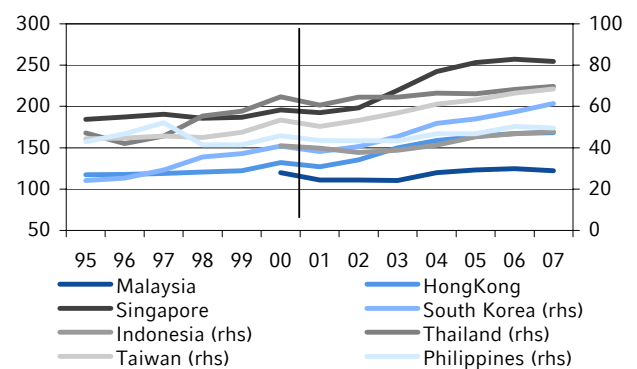
Rapidly falling demand in the G3 (US, EU, Japan) states is not only affecting the countries in Asia simultaneously, but is also clearly reflected across the board in the consumer and capital goods markets and in commodities. In addition, the integrated value chain in Asia is now more dependent than ever on external demand from the West. Hong Kong and Singapore in particular but also Taiwan have a greater degree of openness than during the 2001 crisis.

Asia and the US: GDP growth
(yoy in %)



Source EcoWin, WestLB Research

Asia: Export to GDP Ratio
(nom. exports in % of nom. GDP)



Source EcoWin, WestLB Research

Impact visible everywhere

The impact of falling foreign demand is visible everywhere. Exports from Taiwan are falling, as is industrial output in Malaysia, and even industrial production in China is part of the negative picture, dropping from around 17% at the start of the year to 8% according to the latest figures. The picture is also bleak for growth in Asian commodities. Prices for agricultural products saw a sharp increase at the start of the year but have since dropped like a stone. The losers include rubber, for which Indonesia, Malaysia and Thailand account for around 80% of global production. These countries are directly affected by weak sales on the international automobile market, for example, because they produce car tyres. The outlook is equally poor for other agricultural commodities and for energy.

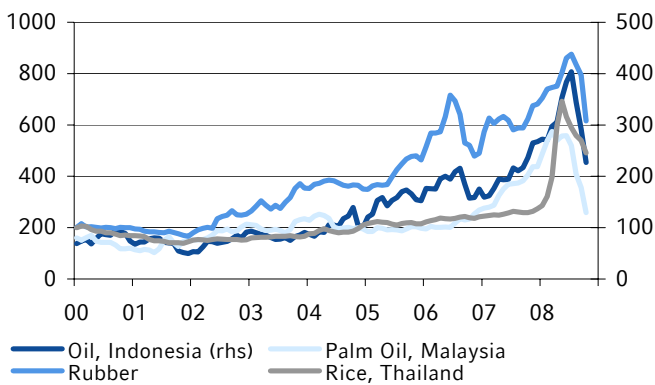
Following exports, investments will weaken

In addition to falling demand for goods, private investments are also likely to decline. For example, the first signs can be seen in the production centres of coastal China, where a growing number of company insolvencies due to decreasing exports are accompanied by lower direct investments. China will not be an isolated case. In the face of falling prices on the energy market, Indonesia's extractive industry is dealing with increasing caution on the part of foreign investors who were still extremely active until recently; the story is the same in India, where increasingly risk-averse investors are backing out of infrastructure projects. This means that falling exports, weaker industrial output and declining investment will also leave their mark on the labour market and private consumption.

Counter measures across the board

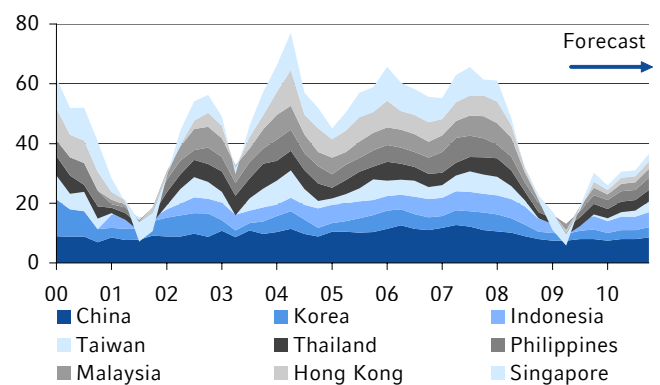
But there are also positive developments. In most countries, falling inflation is easing the burden both on consumers and national budgets – through lower price subsidies for energy, for example. The budget situation, which is far better than that in 2001, means that many countries are in a position to take fiscal counter measures. China recently announced a comprehensive economic package that accounts for almost 14% of nominal GDP. The Korean central bank can draw on US dollars from the Fed, and the IMF is providing liquidity to ailing but essentially stable countries that are not overindebted. Both the World Bank and the Asian Development Bank are supporting infrastructure projects, in India and Vietnam, for example. The central banks are also cutting interest rates across the board.

Asia: commodities
(Price index, 1999 = 100)



Source EcoWin, WestLB Research

Asia: economic growth
(cumulative growth rates, in percentage points)



Source EcoWin, WestLB Research

But as positive as this sounds, the effect of many measures is limited. China's economic package includes infrastructure projects such as new hydro-electric power plants, improvement of road and rail links to the West and an increase in welfare expenditure. However, many of these projects were already planned or have already been started (please find more details in the following chapter).

Economic programmes have limits...

Many Asian countries partly lack national institutions equivalent to those of the Western industrial nations which make a targeted injection of fiscal stimulus. Considering the still very small middle class in Asia, a short-term and in particular a significant increase in discretionary spending is unlikely for private households. No compensating boost to growth is therefore expected from private consumption.

... but prevent worse to come

What is far more likely is that the measures implemented will only act as a cushion overall due to the considerable burdens. The factors depressing growth are too great to be offset by economic packages and interest rate cuts. Following 6% growth in Asia (excluding China and India) in 2007, we expect growth of 4% this year and 2% in 2009. Growth in China and India is likely to slow from 11.9% and 9.3% respectively to around 8% and 6.5% in 2009 and 2010. As in other Asian countries, the economic programmes and interest rate cuts in China and India will not lift growth above the rates seen in 2006 and 2007. However, at the same time, they should prevent the economy from weakening further as a result of the heavier burdens compared to 2001. Overall, we anticipate that the Asian economy will only pick up again when there is a clear recovery in G3 demand.

China

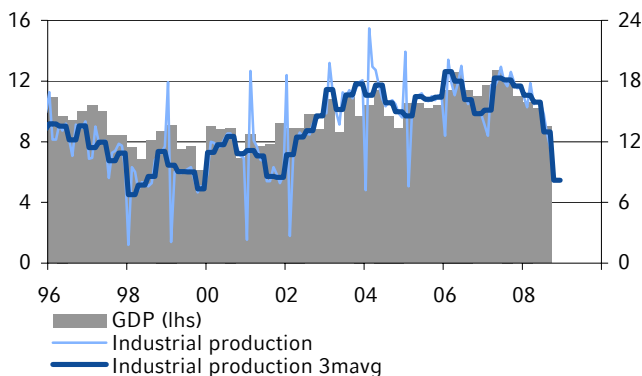
Battle to stem the downturn

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Stormy weather ahead

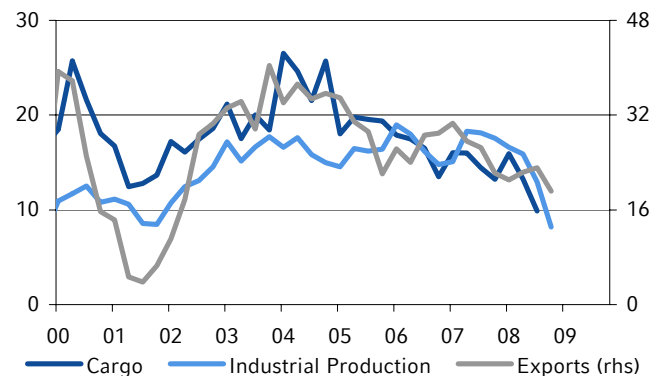
At least since Q3, when the psychologically key GDP growth level of 10% was broken, China's economy has clearly been sailing into stormy waters. The latest developments in Q4 underline just how critical the situation is. Exports are slowing, port freight turnover is falling and the production of steel and electricity is continuing to drop. The recent rioting of laid off workers rounds off the worrying picture in China. Against this backdrop, the government on 9 November 2008 – a Sunday – hastily announced a very comprehensive economic stimulus package of some four trillion yuan, which is equivalent to nearly 15% of GDP. However, since then further details have been emerging that indicate the impact of the package will be considerably lower.

China: GPO and industrial production
%, y/y



Source EcoWin, WestLB Research

China: freight turnover, industrial production and exports
%, y/y



Source EcoWin, WestLB Research

Increasing social spending and ...

The stimulus package includes, among other things, infrastructure projects such as new hydro-electric power plants, extending the rail and road networks westwards and boosting social spending to stimulate consumption. However, a near-term expansion of the social security network and a targeted increase in social spending appear unlikely, simply because of the fragmented structure of the social welfare funds – a left-over from the communist collectives, communes and state-owned enterprises.

China's structural adjustment to the growth pattern of developed industrialised states, i.e. a significantly higher weighting of private consumption in GDP, is likely to take several years. We therefore do not believe that a near-term, or significant, rise in discretionary spending and boost to consumption is very likely.

... extension of rail network cannot prevent slowdown

On closer inspection, the prominent measure aimed at extending the transport networks (especially rail) appears in a different light. China's overall rail network embraces some 75,000 km, which is equivalent roughly to Chinese rail steel output over the last three years. However, the share of rail steel in China's aggregate steel product is less than 1%.

This means that even a doubling of the current network – and only a few thousand kilometres are planned – would have only a marginal impact given this small share. The situation is similar in the case of other infrastructure measures. The construction of the famous three gorges dam required fewer than 300,000 tonnes of steel – representing not even 0.1% of total steel output.

Even if these examples are considered only on a net basis (i.e. the remaining value added of such projects was not included), they still serve as examples to underline that such high-profile projects always have to be part of a broader range of measures in order to produce really far-reaching positive effects. The negative factors from the parallel recession in the G3 (US, EU, Japan) are so great that the stimulus package and rate cuts in China cannot offset them. In the near term, the slowdown in economic growth in the wake of weak export performance and probable further falls in capital spending will not be halted by an increase in consumption expenditure.

Further restraining factor – institutional conditions

However, there is another restraining factor – the institutional conditions in China. Efficient administrative institutions as found in western industrialised states that enable stimulating fiscal measures to be injected in a targeted manner are only partially in place in China. If one therefore assumes that a considerable portion of the fiscal impetus will be dissipated and probably used less efficiently than originally planned, the four trillion yuan appear in a different light. In addition, planning and a certain lead time are required to put the measures into effect. Accordingly, no impact of any note can be expected from the stimulus package before the spring of 2009.

Considerable downside risks

Despite the extensive efforts on the part of the Chinese government, it will hardly be possible to prevent a slowdown in economic growth. However, the overall effect of the economic stimulus programme should be to stop Chinese growth from collapsing. China does not have institutional economic tools that are as fine as those available in the G3 industrialised states although the watering-can principle does nevertheless have a generally positive impact on the economy. Yet, as long as China has sufficient money at its disposal, this is likely to be the least of its problems. After the decline in growth from some 12% in 2007 to 9.5% this year, we expect it to slow further to about 8% next year. The downside risks to this projection are however considerable. Overall, the situation should start to brighten gradually as the G3 regions recover during the course of 2010.

Fixed-income markets

Interest rates dictated by recession

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Those that can do so will cut
interest rates further

ECB monetary policy rapidly
becoming expansive

The central banks of the industrial countries whose key rates are not already close to zero are expected to further loosen monetary policy over the next few months. This applies to the ECB, the Bank of England, the Scandinavian central banks and the Swiss National Bank. In view of the rapid decline of many economic indicators and the threat of an acute credit crunch, there are many signs that this cycle of rate cuts will take place comparatively quickly.

ECB to cut key rates significantly again

After the failure of the interest rate hike at the start of July from an economic point of view, the ECB switched to an expansive strategy in the autumn. We believe that the two cuts of half a percent in October and November will be followed quickly by another, probably at the start of December. With a nominal key rate then of 2.75% and an actual rate – after deducting the core inflation rate – of below 1%, a rate would be reached within a few weeks that at least aims to be expansive. Whether its impact is also expansive depends largely on whether the situation on the interbank market continues to improve and whether the banks pass on the interest rate cuts in their lending terms. Given the significant need for repair on a lot of banks' balance sheets, there are many indications that the effectiveness of this monetary policy will initially be limited.

FORECASTS

in %	current	in 3 in 6 in 12		
		months		
Main refi rate	2.75	1.75	1.50	1.50
3M funds	3.85	2.60	2.10	2.00
10Y Bunds	3.25	3.40	3.20	3.80
Fed funds rate	1.00	0.50	0.50	0.50
10Y Treasuries	2.92	3.10	3.00	3.80

Central bank outlook

	Inflation target	CPI		Next rate decision	Current		Comment
		Current	2009**		rate	Forecast	
EMU	1.9% HICP*	2.1	1.2	04-Dec	3.25	-50 bp	Recession fighting
USA	1.8% core PCE	3.7	0.5	16-Dec	0.50	-50 bp	Growth risks are rising
Canada	1-3% CPI	2.6	1.5	09-Dec	2.25	-25 bp	Growth risks are rising
Australia	2-3% over the cycle	3.9	2.5	03-Feb	4.25	-50 bp	Growth risks are rising
Japan	0-2% CPI*	1.7	0.8	19-Dec	0.30	unchanged	No changes ahead
UK	2% CPI	4.5	0.9	04-Dec	3.00	-50 bp	Economic slump, risk of deflation
Sweden	2% CPI	4.0	1.6	04-Dec	3.75	-50 bp	More cuts expected
Norway	2.5% CPI-ATE	5.5	3.0	17-Dec	4.75	-25 bp	Growth risk prevail
Switzerland	<2% CPI*	2.6	1.2	11-Dec	1.00	no change	Further cuts next year
Poland	2.5% (+/- 1%age pt) CPI	4.2	3.0	23-Dec	5.75	-25 bp	Easing cycle has begun
Czech Rep.	3% (+/- 1%age pt) CPI	5.9	2.8	17-Dec	2.75	-25 bp	More cuts expected
Hungary	3% CPI	5.1	3.0	22-Dec	11.00	-50 bp	Base rate expected to fall significantly

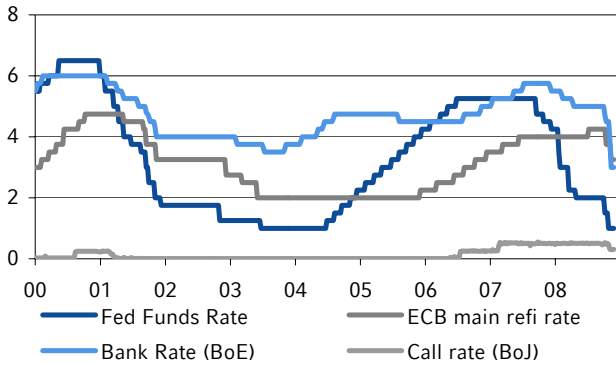
* unofficial ** WestLB forecast (annual average)

Source WestLB Research

ECB could cut interest rates to
1.5%

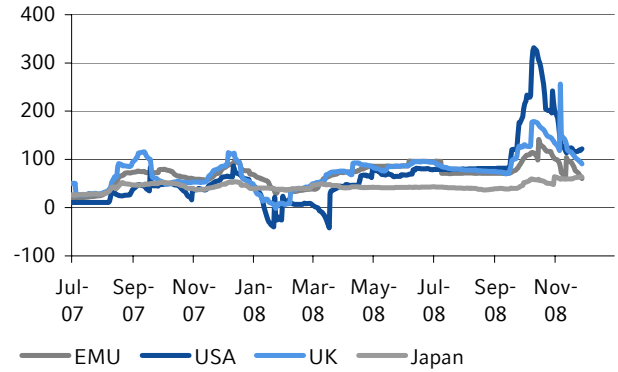
During the downturn at the start of the decade, the ECB lowered the key rate from 4.75% to 2% within two years. The current cycle of rate cuts has begun more rapidly. The far-reaching problems in the banking sector and the downturn indicate that the current cycle of rate cuts will occur more quickly with a lower end result. We anticipate that the ECB key rate will reach a low of 1.5% in summer next year. However, in our main scenario, we do not expect that the ECB will lower the key rate to close to zero, unlike the Fed and the Bank of Japan. We also believe that it will be early 2010 rather than the latter part of next year before the ECB raises interest rates.

Key rates
(in %)



Source EcoWin, WestLB Research forecast

Spread between three-month interbank lending and key rate
(in basis points)



Source EcoWin, WestLB Research forecast

Yields on government bonds not yet at cyclical low

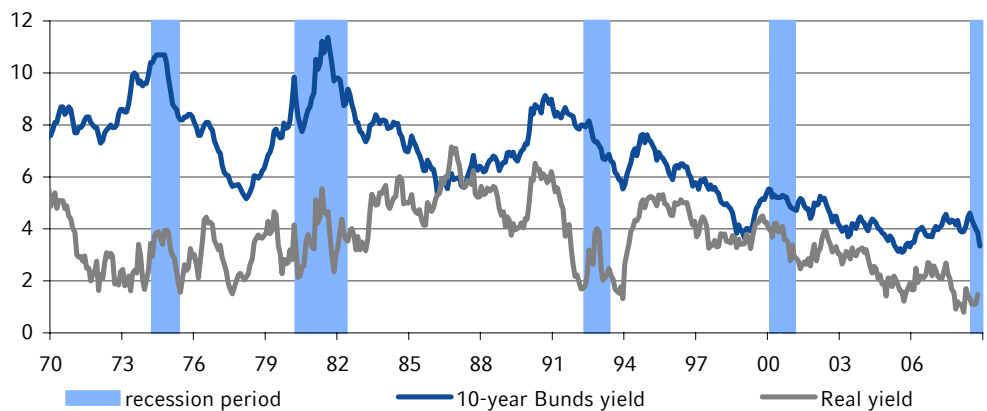
Safe haven

Government bonds have benefited in recent months from the recessionary environment, with German government bonds (Bunds) in particular gaining from the flight of investors to safe havens. At 3.15%, 10-year Bund yields are low but not excessively low, rather at an appropriate level in the recessionary environment. We do not expect any headwind from the US for bond prices in the next few months. The US recession is still only in its early stages. The Fed has almost no more scope to cut rates, but will not opt to raise them rapidly either. Due to the low proportion of tax in fuel prices, the drop in the inflation rate caused by falling oil prices in the US will have a more marked impact and may also provoke a debate on deflation.

Historically low yield on the 10-year Bund could be in sight

In our view, yields on 10-year Bunds have yet to reach their cyclical low. If the next few months see significantly lower inflation and the economy remains weak, as we expect, yields on 10-year Bunds are likely to sink below 3.5%. In the course of the resulting intensifying debate on deflation, the existing historic low of 3.0% from 2005 could be in sight. However, we do not think that such a low yield is sustainable. In the past, real interest rates of below 2% have usually only lasted for a short period.

Yields on 10-year Bunds (in%)



Source EcoWin, WestLB Research forecast

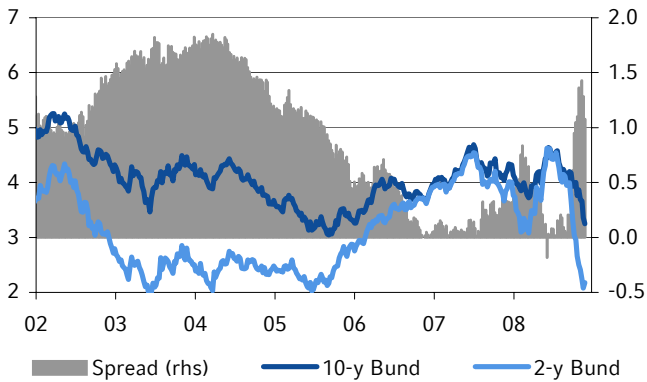
Arguments for increasing yields in the long term...

There are three arguments against a sharp fall in yields on government bonds and in favour of a renewed increase in the second half: the considerable financing requirements of economic programmes and bank rescue packages, the prospect of a gradually more robust economy and the possibility of investors recovering their appetite for risk.

... and an even steeper yield curve

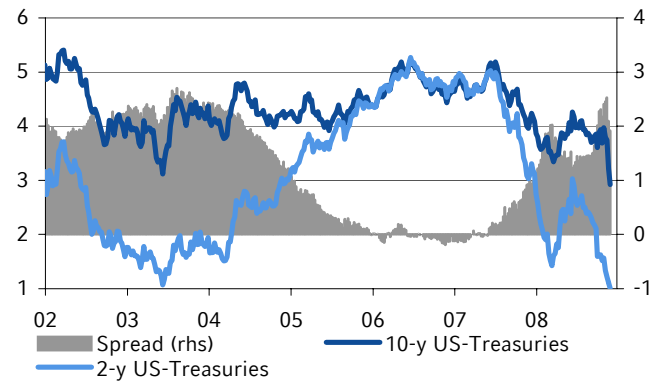
In the past few weeks, a downward movement at the short end has made the yield curve considerably steeper. If our view that the ECB will cut interest rates to 1.5% is correct, yields on two-year Bunds will fall significantly below 2%. The current historical low of 1.88% from June 2003 could be undershot. The spread between yields on ten and two-year paper is likely to increase again in the next six months from its current level of around 130 basis points.

Yields on Bunds
(in %)



Source EcoWin, WestLB Research

Yields on Bunds (in %) and DAX



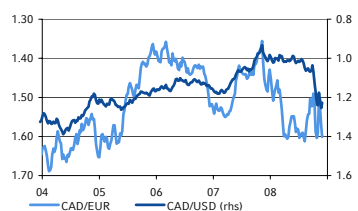
Source EcoWin, WestLB Research

Currencies

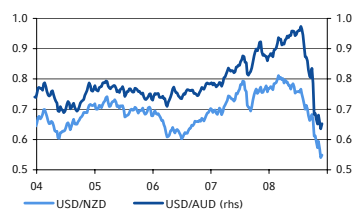
- The exceptionally **high forecasting uncertainty** in the current situation referred to previously holds particularly true when it comes to foreign exchange rates. Each currency pair depends on the expected fundamental factors in their respective economic regions, and these factors are currently difficult to foresee. Besides this, there is the question as to whether investors will recover any appetite for risk next year - and if so when. This could boost high interest rate currencies like the Hungarian forint, and make safe havens like the Swiss franc less attractive.



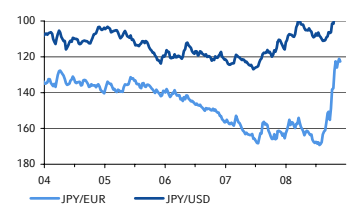
Source EcoWin, WestLB Research



Source EcoWin, WestLB Research



Source EcoWin, WestLB Research

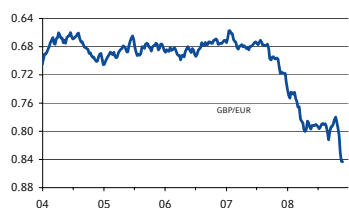


Source EcoWin, WestLB Research

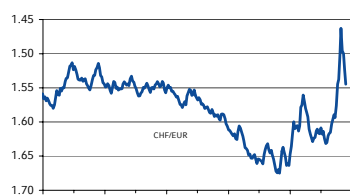
- **USD/EUR:** In our view, the dollar will stay attractive for the time being because the demand for dollar liquidity is likely to remain strong for now while investors are averse to taking on risk. Another supporting factor is the expectation that the US government will soon put together another comprehensive economic package and that the US economy will emerge from the doldrums more quickly than other regions. In addition, the declining interest rate spread between the USA and the Eurozone suggests the dollar will be firmer. However, in the medium-to-long term we expect the dollar to weaken again, as the financial market crisis gradually blows over, risk aversion recedes and demand for dollar liquidity falls. In addition, if the market takes the view from the middle of next year that the economic recovery will probably be sluggish and that US economic growth will remain well below potential, so that the gap is therefore much greater than in the Eurozone, the twin deficits in the US (i.e. public budget and current account) will become more of an issue again. On a 12-month view, we therefore expect much lower spot rates of around USD/EUR 1.40.

- **CAD, AUD and NZD:** As a result of investors' high risk aversion, the rapidly deteriorating prospects for global growth and the softening of commodity prices, the currencies of the so-called dollar satellites have come under considerable pressure since the middle of July. Following massive losses, the nosedive experienced jointly by the Aussie, the Loonie and the Kiwi slowed somewhat. However, we see little chance over the next few months of these currencies making a complete recuperation. In all three countries, the domestic economy will slow markedly. As a result of the global recession and falling commodity prices, foreign trade will also fail to provide an economic stimulus. With inflationary pressure easing, central banks will in all likelihood lower their key rates significantly. Even if risk aversion were to diminish, we still feel this suggests that all three currencies will tend to lose ground against the US dollar, and even more so against the euro over the months to come.

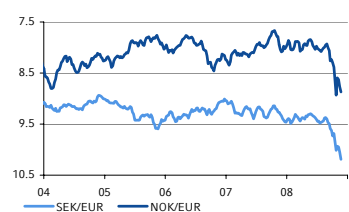
- **JPY/USD:** The ongoing uncertainty on the global financial markets and the high degree of volatility is supporting the yen across the board. At the end of October, the yen briefly climbed to its 1995 highpoint of JPY/USD 92.8. Following a short breather it recently rose back to about JPY/USD 95. The disappearing interest rate advantages enjoyed by the USA and the EU means that the yen is likely to remain below the 100 mark for the time being. Once the turmoil on the financial markets abates, attention may well shift back to the weakness of the Japanese economy over the next 6-12 months and weaken the yen. For this time horizon, we assume the yen will trade at about JPY/USD 110.



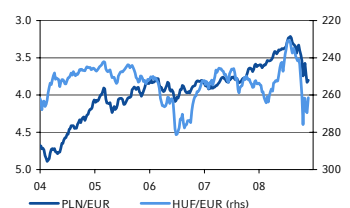
Source EcoWin, WestLB Research



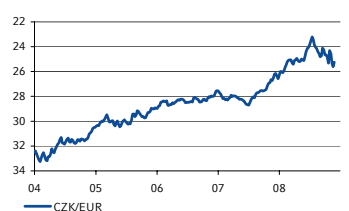
Source EcoWin, WestLB Research



Source EcoWin, WestLB Research



Source EcoWin, WestLB Research



Source EcoWin, WestLB Research

■ **GBP/EUR:** In the space of one month, Sterling lost almost seven percent against the euro after having merely oscillated slightly about the GBP/EUR 0.80 mark in the preceding weeks. This was due to the surprisingly sharp rate cut by the Bank of England, which brought the Bank Rate down by 150 bp to counter the economic slump and mounting risks of deflation. In the meantime, fiscal policy is now also being used to combat the imminent deep recession. For example, VAT is scheduled to be cut by 2.5 percentage points by as soon as December. Since we feel these measures will be able to cushion the impact of the economic slump in Britain, we even see slight upside for the UK pound against the euro over the next three months.

■ **CHF/EUR:** The rate cut by the SNB on 20 November, surprising both in terms of its timing and its scope (100bp), contributed to the franc recently weakening to CHF/EUR 1.53. The SNB now has less leeway for rate cuts than the ECB. In the short term, the Eurozone's key interest rate advantage, which is expected to decline in the months ahead, argues in favour of a firmer franc, which we expect to see at CHF 1.52 on a 3-month horizon. Provided the situation on the financial markets stabilises and investors' appetite for risk recovers – which we assume – we expect the franc to weaken slightly in the medium term. On a one-year horizon we see fair value for the franc at CHF/EUR 1.55. The currency's short-term volatility will probably be strongly determined by investors' risk perception in the coming year as well.

■ **NOK and SEK:** The Scandinavian currencies have also come slightly under pressure as a result of the financial crisis and have each depreciated by ca. 10% against the euro. Both the Swedish krona at an exchange rate of above SEK/EUR 10 and the Norwegian krone at just under NOK/EUR 9 have reached new historical lows against the euro. In the next few months, Norges Bank and the Riksbank will probably follow the ECB's trend in rate cuts. As the interest rate differential will in all likelihood increase, on a 12-month horizon we expect the Scandinavian currencies to make up lost ground against the euro.

■ **PLN, CZK and HUF:** The escalation of the financial market crisis has caused the currencies in Central Europe to come under considerable pressure and led to strong exchange rate fluctuations. The consequences of the financial market crisis are becoming gradually evident in the real economy too: Nearly all indicators clearly suggest an economic slowdown over the next few months. Hungary is already on the verge of a sharp recession, but growth in Poland and the Czech Republic, too, is likely to weaken to rates next year that are clearly below their potential growth rates. Against this backdrop, the central banks in Poland, the Czech Republic and Hungary will probably cut their key rates (further). At the end of 2009 we expect key rate levels of 2% in the Czech Republic, 3.50% in Poland and 7.50% in Hungary. The continuing risk aversion, lower interest rates and an increasing current account deficit are likely to weigh upon these currencies for the next six months. The Hungarian forint, which has had to cope with the greatest losses up to now, will in all likelihood be helped back to an exchange rate of HUF/EUR 260 by the international financial aid packages within the next three months. The currencies will probably only return to a moderate strengthening trend once the economic prospects have brightened again by about the end of 2009, the dislocations brought about by the financial market crisis have ebbed away, and investors have less aversion to risk.

Oil market

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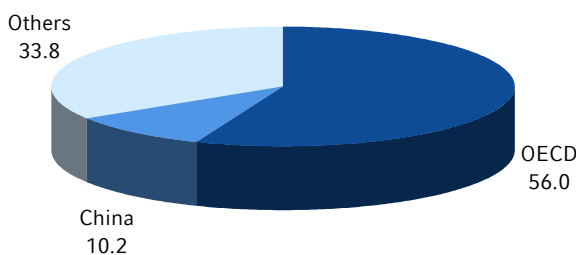
OECD states account for over half of oil demand

Demand for oil to fall for the first time since 1992

Over the past decade, global demand for crude oil has risen by an average of 1.6% p.a. The emerging markets were the main growth driver. China's share of global oil consumption alone has almost doubled since 1995 to 10.2% currently. Over the same period, the share of the industrial states – and specifically the OECD states – fell noticeably, although they still account for over half of total demand. The main reason for this, aside from the thirst for energy from the emerging economies, is the ongoing efficiency improvements in crude oil consumption in the developed economies. For example, Germany currently uses less crude oil in total per year than it did at the beginning of the 70s.

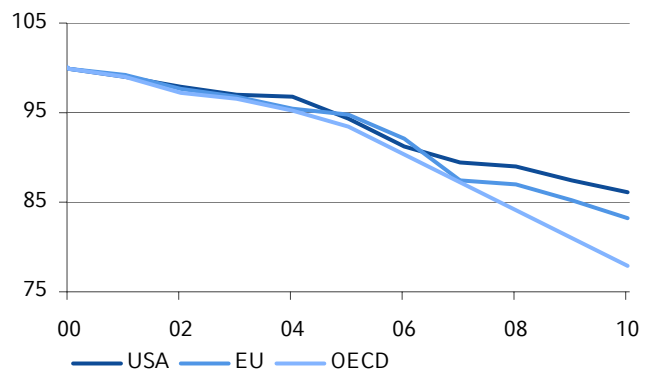
Share in global oil consumption

(in %, forecast 2008)



Consumption of crude oil per share of GDP

(2000 = 100, forecasts from 2008)



Source EcoWin, WestLB Research

Source EcoWin, WestLB Research

Demand for oil to fall for the first time since 1992

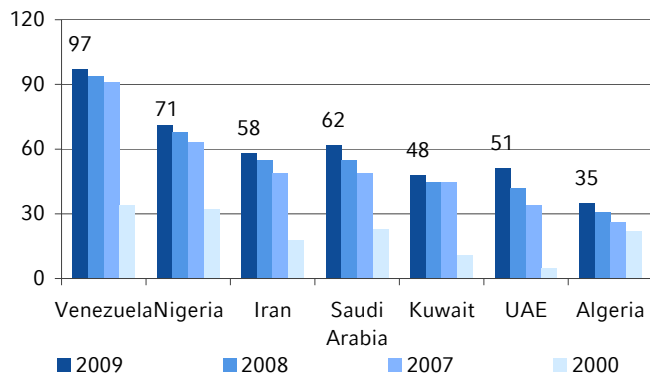
Given these circumstances, the global recession we have forecast should significantly weaken demand for crude oil. There are two factors behind this in the OECD countries: firstly, growing energy efficiency, and secondly, the declining economic performance of 0.3% in 2009. Crude oil consumption in the OECD states looks set to fall by 2.2% this year compared to 2007. We expect an even greater decline of 4% in 2009. The US Department of Energy expects a 5.4% fall in demand in the US this year. Crude oil demand in China is likely to continue to rise, but we forecast such a big decline in oil consumption in the industrialised countries over the next two years that in all probability, global consumption will fall for the first time since 1992. We expect global oil consumption to decrease by around 1.4% in 2009 and by 0.3% in 2010. This would be the biggest drop since the start of the 80s, and is likely to further impact oil prices.

OPEC is facing a dilemma

This raises the question of whether the oil producers will adjust production to the same degree to avoid a surplus that would further weaken the oil price. At its most recent meeting, OPEC decided to cut production by 1.5 million barrels from 1 November. However, in similar market situations in the past, OPEC has not proven particularly able to implement such cuts, with the result that not all member states stuck to their negotiated quotas. Individual states produced more oil, in breach of agreements, to secure their income. The incentive to exceed quotas has increased further in recent years. According to estimates from the consultancy PFC Energy, the dependence of

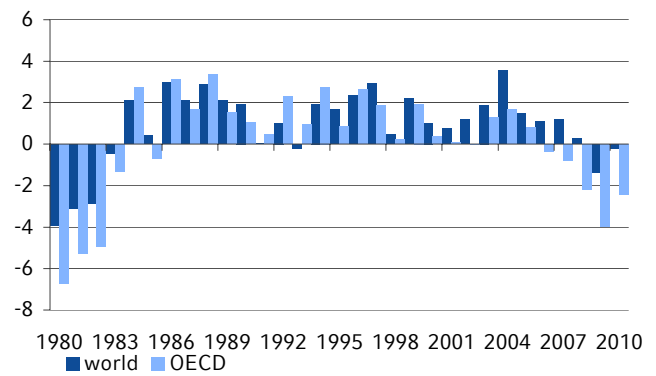
some OPEC states on their oil income has grown further. While the oil prices were rising steadily, they significantly increased their state spending. The price at which the national budget would be balanced can be calculated based on an assumed constant level of oil production. For Algeria, this is \$35 per barrel. If revenues fall below this level, the Algerian budget slides into deficit. This clearly shows that Algeria is still in a very good position based on current prices. By contrast, countries such as Venezuela and Nigeria are facing a massive increase in their deficit, meaning that there will be a considerable effort to pump as much crude oil as possible, despite the agreement. However, this damages both OPEC’s credibility and its ability to implement cuts on the market.

Price required to cover national budget
(in \$ per barrel)



Source PFC Energy, WestLB Research

Change in oil consumption
(yoy in %; forecast from 2008)



Source EcoWin, WestLB Research

Forecasts

2009: \$50 per barrel
2010: \$60 per barrel

We anticipate falling and lower oil prices in the next two years due to declining demand. However, prices are unlikely to go into freefall as they did in the 90s, as production costs have risen sharply in recent years. We anticipate that Brent will be priced at \$50 per barrel in 2009 and \$60 per barrel in 2010.

However, this does not alter our assessment that commodities and crude oil in particular are still in a long-term uptrend. The efforts by the emerging economies to industrialise will continue to increase demand for oil in the long term, although supply can only be increased to a limited degree. Formerly productive sources, for example in Mexico and the North Sea, are gradually running dry. New resources are more difficult to reach (deep sea, polar region) or very cost-intensive to develop (oil sands). Spare capacity has almost completely disappeared in recent years. As long as the global economy continues to gather momentum, oil prices are likely to continue to rise.

Forecast tables

Growth and inflation

	GDP ¹⁾ Annual change (%)				Consumer prices ²⁾ Annual change (%)			
	2007	2008*	2009*	2010*	2007	2008*	2009*	2010*
Industrialised countries	2.3	1.2	-0.6	1.1	2.1	3.5	1.1	1.8
USA	2.0	1.4	-1.0	1.0	2.9	4.0	0.5	2.0
Canada	2.7	0.6	0.2	1.3	2.1	2.0	1.5	2.0
Australia	4.2	2.4	1.6	2.0	2.3	4.3	2.5	2.3
New Zealand	3.2	0.5	0.0	1.5	2.4	4.0	2.5	2.3
Japan	2.0	0.5	-0.2	0.6	0.1	1.6	0.8	0.8
Switzerland	3.3	2.0	-0.2	0.8	0.7	2.5	1.2	1.3
Norway	3.7	2.5	1.0	1.5	0.7	3.9	3.0	2.0
EU	3.0	1.5	-0.3	1.4	2.2	3.8	1.9	1.8
EMU	2.6	1.0	-0.5	1.0	2.1	3.4	1.2	1.7
Germany	2.5	1.6	-1.0	1.3	2.3	2.7	0.9	1.3
France	2.1	0.9	-0.3	1.2	1.6	3.3	1.0	1.4
Italy	1.4	-0.4	-0.7	0.8	2.0	3.6	1.7	2.0
Spain	3.7	1.3	-1.0	0.8	2.8	4.3	2.1	2.4
Netherlands	3.5	2.0	-0.3	1.3	1.6	2.3	1.4	2.3
Belgium	2.8	1.4	-0.2	1.2	1.8	4.6	1.5	2.5
Austria	3.1	1.8	0.3	1.2	2.2	3.3	0.7	1.6
Greece	4.0	3.2	1.2	2.4	3.0	4.3	2.2	3.0
Portugal	1.9	0.7	0.2	1.3	2.4	2.8	1.4	2.0
Finland	4.4	2.0	0.5	2.0	1.6	4.0	1.5	2.0
Ireland	6.0	-1.5	-1.0	1.8	2.9	3.2	1.0	1.7
UK	3.1	0.9	-0.9	1.1	2.3	3.7	0.9	1.3
Denmark	1.8	1.0	-0.5	0.8	1.7	3.7	2.5	2.2
Sweden	2.9	0.8	-0.5	1.7	2.2	3.6	1.6	1.7
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
New EU members	6.4	5.0	2.0	3.1	3.8	5.9	3.7	3.1
Poland	6.7	5.5	2.2	3.0	2.6	4.2	3.0	2.3
Czech Republic	6.6	4.3	2.3	3.3	2.9	6.5	2.8	3.0
Romania	6.0	8.6	4.0	5.0	4.9	7.8	5.5	4.0
Hungary	1.3	1.0	-1.5	1.0	8.0	6.2	3.0	3.0
Slovak Republic	10.4	7.0	4.0	5.0	1.9	4.0	3.0	3.3
Bulgaria	6.2	6.3	4.0	4.3	7.6	12.5	8.0	7.0
South/Eastern Europe excl. EU members	7.4	5.6	2.7	3.9				
Russia	8.1	6.0	3.0	4.0				
Turkey	4.6	3.7	3.0	4.0				
Asia excl. Japan	9.2	7.3	5.4	6.5				
China	11.9	9.5	7.8	8.0				
India	9.3	7.8	6.3	6.5				
Asian emerging countries ³⁾	6.0	4.3	1.9	3.2				
Latin America	5.5	4.7	2.2	3.0				
Brazil	5.4	5.3	2.5	3.0				
World	4.8	3.6	1.6	2.9				

¹⁾ Working day-adjusted data except for Germany.

²⁾ EU (except for Germany): Harmonised consumer price index.

³⁾ ASEAN, plus Hong Kong, South Korea and Taiwan.

Source National Statistics; OECD. - * 2008-09: WestLB forecast

Key figures

Germany

	2008	2009	2010	2008		2009			
				Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (% y/y)**	1.6	-1.0	1.3	0.8	0.0	-1.7	-1.4	-0.7	0.0
Real GDP (% q/q)				-0.5	-0.4	-0.3	-0.1	0.1	0.3
Domestic demand (% y/y)	1.1	-0.3	0.8	1.5					
Private consumption (% y/y)	-0.4	0.5	0.5	-0.8					
Public consumption (% y/y)	1.8	2.3	0.6	2.9					
Gross fixed invest. (% y/y)	3.5	-4.0	3.0	4.2					
Plant & equipment (% y/y)	3.5	-9.0	5.0	5.4					
Construction (% y/y)	3.0	0.0	1.0	2.7					
Other (% y/y)	5.3	3.5	4.3	6.4					
Inventories (% points)	0.2	-0.1	-0.1	0.6					
Net exports (% points)	0.5	-0.7	0.5	-0.7					
Exports (% y/y)	4.5	1.0	6.0	3.2					
Imports (% y/y)	4.2	3.0	6.0	5.2					
Consumer prices (% y/y)	2.7	0.9	1.3	3.1	1.8	1.3	0.5	0.1	0.7
Budget balance (% of GDP)	0.2	-1.0	-1.2						
Unemployment rate (%)	7.8	7.9	8.1						

** quarterly data are working-day adjusted, annual data not adjusted.

Eurozone

	2008	2009	2010	2008		2009			
				Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (% y/y)	1.0	-0.5	1.0	0.7	-0.1	-1.0	-0.8	-0.3	0.3
Real GDP (% q/q)				-0.2	-0.4	-0.3	0.0	0.3	0.3
Consumer prices (% y/y)	3.4	1.2	1.7	3.8	2.5	1.3	0.5	0.1	0.9
Budget balance (% of GDP)	-1.1	-2.0	-2.6						
Unemployment rate (%)	0.0	8.3	9.1						
Current account balance (% of GDP)	-0.8	-0.4	-0.1						

USA

	2008	2009	2010	2008		2009			
				Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (% y/y)	1.4	-1.0	1.0	0.7	0.1	-0.7	-1.7	-1.2	0.3
Real GDP (% q/q)				-0.1	-0.7	-0.5	-0.3	0.3	0.3
Real GDP (% q/q ann.)				-0.5	-2.9	-2.1	-1.2	1.4	1.0
Consumer prices (% y/y)	4.0	0.5	2.0	5.3	2.3	1.1	0.2	-0.9	0.4
Budget balance (% of GDP)	-5.3	-7.5	-6.5						
Unemployment rate (%)	5.7	7.5	7.0						
Current account balance (% of GDP)	-5.0	-4.5	-4.2						

Source EcoWin, WestLB Research; 2008-10: WestLB forecast

Interest rates and yields (%)

		current 01.12.08	in 3 months	in 6 months	in 12 months
EMU	Main Refinancing Rate	3.25	1.75	1.50	1.50
	3-Month Deposits	3.82	2.60	2.10	2.00
	10-Year Bund	3.16	3.40	3.20	3.80
USA	Fed Funds Target	1.00	0.50	0.50	0.50
	3-Month Deposits	2.22	1.50	1.30	1.20
	10-Year US-Treasury	2.73	3.10	3.00	3.80
Canada	Overnight Rate	2.25	1.75	1.75	1.75
	3-Month Deposits	2.54	2.60	2.30	2.10
	10-Year Government Bonds	3.16	3.40	3.20	3.90
Australia	Cash Rate	5.25	4.25	3.75	3.75
	3-Month Deposits	5.13	4.30	3.90	4.00
	10-Year Government Bonds	4.53	4.60	4.30	4.80
New Zealand	Cash Rate	6.50	5.50	5.00	4.75
	3-Month Deposits	6.31	5.60	5.10	4.80
	10-Year Government Bonds	5.03	5.50	5.00	5.40
Japan	Call Rate	0.30	0.30	0.30	0.30
	3-Month Deposits	0.95	0.80	0.75	0.75
	10-Year Government Bonds	1.35	1.40	1.40	1.50
UK	Bank Rate	3.00	2.00	1.50	1.50
	3-Month Deposits	3.88	2.70	2.10	2.00
	10-Year Government Bonds	3.67	3.70	3.70	3.90
Sweden	Repo Rate	3.75	2.75	2.00	2.00
	3-Month Deposits	4.35	3.60	2.60	2.50
	10-Year Government Bonds	2.83	3.20	3.00	3.60
Norway	Overnight Deposits	4.75	3.75	3.00	3.00
	3-Month Deposits	6.17	4.60	3.60	3.50
	10-Year Government Bonds	3.87	4.00	3.90	4.60
Switzerland	Repo Rate	0.05	0.30	0.30	0.40
	3-Month Deposits	1.24	0.80	0.50	0.50
	10-Year Government Bonds	2.20	2.30	2.10	2.60
Poland	2w Repo Rate	5.75	4.75	4.00	3.50
	3-Month Deposits	6.55	5.50	4.70	4.20
	10-Year Government Bonds	5.93	6.00	5.80	6.50
Czech Rep.	2w Repo Rate	2.75	2.25	2.00	2.00
	3-Month Deposits	4.09	3.30	2.80	2.50
	10-Year Government Bonds	4.45	4.40	4.20	4.70
Hungary	Base Rate	11.00	9.50	8.25	7.25
	3-Month Deposits	11.08	9.70	8.50	7.40
	10-Year Government Bonds	9.02	9.00	8.00	7.50

Source EcoWin, WestLB Research

Foreign exchange

		current 01.12.08	in 3 months	in 6 months	in 12 Months
vs. Euro	USD/EUR	1.26	1.20	1.30	1.40
	CAD/EUR	1.57	1.54	1.69	1.89
	AUD/EUR	1.96	2.00	2.24	2.55
	NZD/EUR	2.36	2.31	2.60	2.92
	JPY/EUR	118.42	118.00	137.00	154.00
	GBP/EUR	0.84	0.82	0.80	0.78
	SEK/EUR	10.36	10.00	9.90	9.50
	NOK/EUR	8.89	8.70	8.50	8.20
	CHF/EUR	1.53	1.52	1.55	1.56
	PLN/EUR	3.84	3.90	4.00	4.00
	CZK/EUR	25.61	25.70	26.00	25.80
	HUF/EUR	262.20	260.00	260.00	250.00
	vs. US Dollar	CAD/USD	1.25	1.28	1.30
USD/AUD		0.64	0.60	0.58	0.55
USD/NZD		0.53	0.52	0.50	0.48
JPY/USD		93.92	98.00	105.00	110.00
USD/GBP		1.50	1.46	1.63	1.79
SEK/USD		8.22	8.33	7.62	6.79
NOK/USD		7.05	7.25	6.54	5.86
CHF/USD		1.21	1.27	1.19	1.11
PLN/USD		3.05	3.25	3.08	2.86
CZK/USD		20.31	21.42	20.00	18.43
HUF/USD		207.96	216.67	200.00	178.57

Source EcoWin, WestLB Research

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