<u>Economic Outlook for 2007/08</u>

At the time of determining the Treasury Strategy Statement for 2007/08 in February 2007, the outlook for the economy and interest rates was as follows:

UK

- House prices were growing at 10%; rising demand was expected to keep the housing market buoyant. The economy was growing healthily and consumer spending had not, until then, showed signs of weakening.
- Oil prices had fallen to $55-$60/barrel from the highs in 2006, however utility prices were increasing.
- Consumer Price Inflation (CPI) had risen to 3% in December 2006, i.e. it was at the upper limit of the Bank of England's inflation remit, but fell back to 2.7% in the next month. The Bank of England had increased rates three times since the previous summer and the Bank Rate stood at 5.25% in January 2007. Concerns of a wage-price spiral were diminishing as wage settlements remained below the Bank's 4.5% comfort threshold. The view was that the Bank would gauge the full effect of the three rate rises before increasing them further, unless inflation continued to challenge the Bank's 3% upper limit.

International

- In the US inflation concerns and a strong labour market were expected to counter the slowdown in the housing market, allowing the Federal Reserve to maintain rates at 5.25%.
- The European Central Bank was expected to raise rates from the then level of 3.5% by 'a quarter per quarter' to 4.5%.

<u>Economic Outturn for the Bank Rate, short-dated gilt yields and longer-term yields/rates 2007/08</u>

UK Economic data and events

- CPI rose to 3.1% in March, resulting in the Bank of England's Governor writing an open letter to the Chancellor for the first time in the 10 years of the Bank's independence. As inflation pressures grew, the Bank Rate was increased by 0.25% in April and a further 0.25% in July. The markets thereafter increased the odds that the Bank Rate would be 6% by the end of 2007.
- What began as a financial market wobble, as losses in the US sub-prime housing markets started increasing, widened into a credit crunch in August. Initially central bankers took a relatively sanguine view of the tumult. The UK economy, with its reliance on the financial sector as its growth driver, was particularly vulnerable to the fallout from the credit crisis. Large write-downs in the value of debt and investment products dislocated money markets and soon escalated into an unprecedented global financial crisis.
- Higher wholesale funding costs drove a wedge into the funding and business model of Northern Rock, the UK's fifth largest lender, and for the first time in over 30 years the country saw a run on a major High Street bank. The Bank of

England ultimately provided emergency short-term funding in September and the government guaranteed all the bank's deposits. Northern Rock was subsequently taken into public ownership.

- The availability of credit shrank as, confidence evaporated, financial institutions mistrusted each others' balance sheets, preferring to hoard liquidity instead of using it for interbank and commercial lending. Lenders increased their margins driving up the cost of debt or made new lending available on more onerous terms. The lack of liquidity drove the 3-month rate to 6.60% in August and to 6.83% in mid September. 1-year LIBID rose to 6.62% in September. (The ability to transact at these levels however was not guaranteed due to the dearth of market counterparties.)
- Foreclosures in the US sub-prime housing market rose rapidly. The volumes of derivatives and complex debt instruments supporting the US mortgage market began to unravel and threatened to push the US economy into recession. The US Federal Reserve responded with unexpected and aggressive rate cuts in Q1 2008 totaling 2%. The Fed also publicly stepped in to support the investment bank Bear Stearns from collapse and stood willing to use its $900bn balance sheet to prevent other banking failures.
- The Bank of England cut rates by 0.25% in December and a further 0.25% in February 2008 but there was no sign by the financial year end that the credit crisis had abated. 3-month Libor was nearly 0.7% above the Bank Rate of 5.25% at 31st March 2008.
- Short-dated gilts benefited from the tumult as investors shunned complex debt instruments or exotic assets, preferring the safety of sovereign debt. The 5-year gilt yield dropped by nearly 1.9% from its high in July to a low of 3.88% in March. 50-year gilt yields oscillated between 4.20% and 4.60% during the year. The decrease in long-dated (30-50 year) gilt yields was less pronounced with yields falling on average 0.4%.