

ITEM NO: 9(v) Appendix 1

Economic Outlook for 2008/09

At the time of determining the Treasury Strategy Statement for 2008/09 in February 2008, the outlook for the economy and interest rates was as follows:

Inflation and the outlook for inflation gave cause for concern with the price of oil having reached \$100/barrel. Elevated food prices, fuel and transportation costs were expected to put upward pressure on Consumer Price Inflation. The effects of the credit crunch and the ensuing market turmoil experienced in the second half of 2007 were however expected to weaken UK business activity and growth. Tighter credit terms and availability was expected to weigh negatively on the UK housing market and on consumer spending.

The Bank of England had cut rates to 5.25% in January 2008. Further cuts were expected taking the Bank Rate to 4.75% in 2008 as stresses in financial markets and a deteriorating economic outlook increased the risks to growth.

The elevated short-dated Libor and Libid rates witnessed in Q4 2007 were expected to revert to more normal levels and reflect the outlook for the direction of interest rates. Gilt yields were expected to fall as the economy slowed. The risk to lower yields was that an increased gilt supply would be required to address the government's funding shortfall.

The economy and events in 2008-09

Inflation / GDP : Inflation rose higher than anticipated; CPI for May breached the Monetary Policy Committee's 3% outer boundary; CPI for August reached a high of 4.7%. The price of oil reached nearly \$145/barrel and food and commodity prices remained elevated. Higher levels of inflation did not however result in higher wage settlements as the spectre of slowing growth and deflation trumped concerns over inflation.

Economic conditions in the UK, Eurozone and US economies deteriorated rapidly into the worst post-war recession. In the UK the HBOS measure of house prices slumped by 17.5% in FY 2008-09. The dearth of availability of secured and unsecured finance posed a significant risk to consumer and corporate spending. Unemployment rose to 6.7%. The tightening in credit conditions and the economic malaise became entrenched; this rapidly impacted on growth which fell nearly 3.8% over the 12-month period. The UK was headed for a long and deep recession.

2008 saw the worst upheaval in credit and financial markets for some decades. The stresses in the financial markets threatened to quickly turn the liquidity crisis into a solvency crisis. In August and September several banking and financial stocks fell victim to intense negative investor sentiment and even the prices of high-grade credit took on the characteristics of distressed debt.

The financial crisis reached boiling point following the collapse of Lehman Brothers in September. It ultimately prompted governments and central banks to act unilaterally to shore up their financial systems. These included bank bailouts and direct capital injections into banks and financial institutions. Lloyds TSB agreed to acquire HBOS; Cheshire and Derbyshire building societies individually approached Nationwide BS to be acquired by the latter. The government injected significant capital into Royal Bank of Scotland Group (it now owns over 70%) and the Lloyds Banking Group. Financial bailouts and support for banks were replicated in much of Europe and in the US, with increasing pressure from the regulatory authorities for banks to raise their capital ratios to survive the worst of the economic downturn.

Policy rates in the UK and US were rapidly cut to near zero. In the UK the Bank of England cut rates from 5% in April to 0.5% by March 2009. As interest rates had reached terminal levels but were not having much effect in reflating the economy, the Bank of England initiated its Quantitative Easing (QE) programme in March 2009 under which the Bank would buy back an initial £75bn of gilts over a 3-month period with the purpose of lowering gilt yields and ultimately borrowing costs for the UK corporate sector.

The government's projections for growth in the November Pre Budget Report were overly optimistic; it was soon apparent the shortfall in public finances would have to be made good through hefty gilt issuance, estimated in January to rise in excess of £120 bn in 2009-10. (The borrowing requirement is likely to be revised significantly higher in the Chancellor's Budget on 22 April 2009.)

It was not surprising that money market rates and gilts yields exhibited extreme volatility during the financial year. Money market rates spiked as the banking crisis intensified and confidence crumbled. 3-month Libor, a proxy for the direction of policy rates, climbed to a high of 6.4% in October; this despite markets' forecast that the Bank Rate was set to fall below 3%. Due to the distressed state of the markets, short-term money market rates remained elevated despite the large cuts in the Bank Rate and only began to move down towards the Bank Rate in early 2009 when, following efforts to recapitalise banks, some stability seemed to have returned to the banking and financial sector.

Short-dated gilt yields benefited most from negative sentiment. The 5-year gilt yield dropped by nearly 3.2% from its high of 5.3% in June 2008 to a low of 2.1% in March 2009. 10-year yields fell from 4.85% in October to a low of 2.95% in March 2009. Longer dated yields (30-50 year maturities) exhibited relatively less volatility; ranging between 3.60% and 4.70%.

Money Market rates, gilt yields, PWLB borrowing rates during the year was :

PWLB Borrowing rates %

	1yr	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01-Apr-08	4.03	4.11	4.51	4.71	4.53	4.47	4.43
30-Apr-08	4.56	4.62	4.86	4.89	4.66	4.56	4.48
30-May-08	5.19	5.15	5.20	5.10	4.79	4.64	4.56
30-Jun-08	5.19	5.24	5.24	5.09	4.79	4.63	4.52
31-Jul-08	5.01	4.95	5.04	4.97	4.69	4.55	4.46
29-Aug-08	4.80	4.58	4.70	4.77	4.57	4.48	4.42
30-Sep-08	3.98	4.33	4.60	4.76	4.65	4.64	4.60
31-Oct-08	3.00	4.02	4.69	4.92	4.69	4.57	4.48
28-Nov-08	2.13	3.55	4.11	4.53	4.30	4.18	4.12
31-Dec-08	1.00	2.89	3.55	4.10	4.00	3.96	3.91
30-Jan-09	0.94	2.95	4.09	4.65	4.63	4.62	4.56
27-Feb-09	0.97	2.73	3.83	4.54	4.51	4.50	4.48
31-Mar-09	0.83	2.56	3.38	4.14	4.38	4.54	4.58
Minimum	0.65	2.31	3.11	3.85	3.94	3.90	3.86
Average	3.17	3.97	4.44	4.71	4.56	4.49	4.43
Maximum	5.61	5.59	5.48	5.26	4.97	4.87	4.84
Spread	4.96	3.28	2.37	1.41	1.03	0.97	0.98

PWLB Repayment rates %

	1yr	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01-Apr-08	3.78	3.83	4.22	4.45	4.27	4.09	3.97
30-Apr-08	4.31	4.35	4.58	4.63	4.40	4.18	4.02
30-May-08	4.94	4.90	4.95	4.84	4.52	4.26	4.11
30-Jun-08	4.94	4.99	4.99	4.83	4.53	4.25	4.06
31-Jul-08	4.76	4.69	4.78	4.70	4.43	4.17	4.00
29-Aug-08	4.55	4.33	4.43	4.51	4.31	4.11	3.97
30-Sep-08	3.73	4.05	4.33	4.51	4.39	4.26	4.15
31-Oct-08	2.75	3.66	4.40	4.66	4.43	4.19	4.02
28-Nov-08	1.88	3.20	3.82	4.28	4.04	3.80	3.67
31-Dec-08	0.75	2.51	3.26	3.84	3.74	3.58	3.46
30-Jan-09	0.69	2.51	3.78	4.39	4.38	4.25	4.11
27-Feb-09	0.72	2.31	3.51	4.28	4.25	4.12	4.02
31-Mar-09	0.58	2.17	3.06	3.87	4.12	4.16	4.12
Minimum	0.40	1.94	2.79	3.58	3.69	3.53	3.40
Average	2.92	3.64	4.16	4.45	4.30	4.11	3.98
Maximum	5.36	5.33	5.22	4.99	4.71	4.50	4.39
Spread	4.96	3.39	2.43	1.41	1.02	0.97	0.99

Bank Rate, Money Market rates

Date	Bank Rate %	7-day LIBID %	1-month LIBID %	3-month LIBID %	6-month LIBID %	12-month LIBID %	2yr Swap Bid %	3-yr Swap Bid %	5-yr Swap Bid %
01-Apr-08	5.250	5.3500	5.7000	5.9400	5.9000	5.7500	5.1210	5.0540	5.0401
30-Apr-08	5.000	5.1000	5.4000	5.7600	5.7600	5.7400	5.3940	5.3610	5.2850
30-May-08	5.000	5.0700	5.3800	5.7900	5.9100	6.0800	5.9670	5.9140	5.7550
30-Jun-08	5.000	5.1000	5.3000	5.8000	6.0800	6.3700	6.2440	6.2190	6.0620
31-Jul-08	5.000	5.0500	5.3000	5.7000	5.8500	6.1000	5.5910	5.5760	5.5010
29-Aug-08	5.000	5.0800	5.3000	5.6900	5.8400	5.9500	5.3380	5.3150	5.2370
30-Sep-08	5.000	5.5000	5.8500	6.1000	6.2000	6.3000	5.3140	5.2540	5.1870
31-Oct-08	4.500	4.2500	5.4500	5.8000	5.7000	5.9400	4.2470	4.3850	4.5970
28-Nov-08	3.000	2.3500	2.8000	3.8500	4.0000	3.5500	3.1310	3.3270	3.6350
31-Dec-08	2.000	1.5000	2.0500	2.0000	2.7100	2.8300	2.5898	2.8610	3.1351
30-Jan-09	1.500	1.1500	1.4500	2.0000	2.1500	2.0500	2.0310	2.3680	2.9490
27-Feb-09	1.000	0.6000	1.2500	1.9000	2.0500	2.2000	2.2670	2.5890	3.1125
31-Mar-09	0.500	0.5500	0.8000	1.4500	1.6200	1.8200	2.0490	2.4550	3.0000
Minimum	0.500	0.3500	0.7000	1.4500	1.6200	1.8200	1.9480	2.2660	2.8220
Average	3.626	3.5320	4.0121	4.4879	4.6069	4.6858	4.2798	4.3783	4.5055
Maximum	5.250	5.5000	6.1000	6.2500	6.2500	6.5000	6.5040	6.4970	6.2700
spread	4.750	5.1500	5.4000	4.8000	4.6300	4.6800	4.5560	4.2310	3.4480

Source : Bloomberg

Gilt Yields %

	5 year	10 year	15 year	20 year	30 year	50 year
31/03/2008	3.89	4.35	4.59	4.57	4.38	4.21
30/06/2008	5.17	5.13	5.12	5.05	4.68	4.38
30/09/2008	4.19	4.44	4.71	4.68	4.50	4.40
31/12/2008	2.44	3.02	3.86	3.96	3.66	3.64
31/03/2009	2.35	3.16	3.89	4.03	4.16	4.32

Source : Bloomberg

Please note that the minimum, maximum and average rates/yields are those daily rates/yields during the year