

APPENDIX 3

INTEREST RATE FORECASTS & ECONOMIC BACKGROUND

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. INDIVIDUAL FORECASTS

Sector interest rate forecast – 24 December 2007

	Q/E4 2007	Q/E1 2008	Q/E2 2008	Q/E3 2008	Q/E4 2008	Q/E1 2009	Q/E2 2009	Q/E3 2009	Q/E4 2009	Q/E1 2010	Q/E2 2010	Q/E3 2010	Q/E4 2010	Q/E1 2011
Bank Rate	5.50%	5.25%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
5yr PWLB rate	4.80%	4.70%	4.65%	4.55%	4.55%	4.60%	4.70%	4.75%	4.80%	4.80%	4.80%	4.85%	4.85%	4.85%
10yr PWLB rate	4.80%	4.70%	4.60%	4.55%	4.55%	4.55%	4.55%	4.60%	4.70%	4.75%	4.75%	4.80%	4.80%	4.80%
25yr PWLB rate	4.65%	4.60%	4.55%	4.55%	4.50%	4.55%	4.55%	4.60%	4.65%	4.70%	4.70%	4.70%	4.70%	4.75%
50yr PWLB rate	4.55%	4.50%	4.45%	4.45%	4.45%	4.45%	4.45%	4.50%	4.50%	4.55%	4.55%	4.55%	4.55%	4.60%

Capital Economics interest rate forecast – 12 December 2007

	Q/E4 2007	Q/E1 2008	Q/E2 2008	Q/E3 2008	Q/E4 2008	Q/E1 2009	Q/E2 2009	Q/E3 2009	Q/E4 2009
Bank rate	5.50%	5.25%	5.00%	4.75%	4.50%	4.25%	4.00%	4.00%	4.00%
5yr PWLB rate	4.65%	4.45%	4.35%	4.05%	3.95%	4.05%	4.25%	4.35%	4.75%
10yr PWLB rate	4.65%	4.45%	4.25%	4.15%	4.15%	4.25%	4.45%	4.65%	4.85%
25yr PWLB rate	4.65%	4.55%	4.45%	4.45%	4.35%	4.45%	4.55%	4.75%	4.95%
50yr PWLB rate	4.55%	4.55%	4.45%	4.35%	4.25%	4.35%	4.55%	4.65%	4.75%

UBS interest rate forecast (for quarter ends) – 7 January 2008

	Q/E1 2008	Q/E2 2008	Q/E3 2008	Q/E4 2008	Q/E1 2009	Q/E2 2009	Q/E3 2009	Q/E4 2009
Bank Rate	5.25%	5.00%	4.75%	4.50%	4.50%	4.50%	4.50%	4.50%
10yr PWLB rate	4.75%	4.70%	4.70%	4.65%	4.65%	4.65%	4.65%	4.70%
25yr PWLB rate	4.60%	4.60%	4.65%	4.55%	4.55%	4.55%	4.55%	4.60%
50yr PWLB rate	4.43%	4.50%	4.60%	4.55%	4.60%	4.65%	4.65%	4.70%

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury – November 2007 summary of forecasts of 24 City and 13 academic analysts for Q4 2007 and 2008. (2009 – 2011 are based on 21 forecasts)

BANK RATE FORECASTS	quarter ended			annual average Bank Rate		
	actual	Q4 2007	Q4 2008	ave. 2009	ave. 2010	ave. 2011
Median	5.75%	5.80%	5.30%	5.24%	5.22%	5.26%
Highest	5.75%	5.80%	6.30%	6.00%	6.00%	6.00%
Lowest	5.75%	5.30%	4.80%	4.50%	4.06%	4.00%

ECONOMIC BACKGROUND – Sector - December 2007

International

- The US, UK and EU economies have all been on the upswing of the economic cycle during 2005 and 2006 and so interest rates were successively raised in order to cool their economies and to counter the build up of inflationary pressures.
- The US is ahead of both the UK and EU in the business cycle and started on the downswing of the economic cycle during 2007. The Fed. rate peaked at 5.25% and was first cut in September by 0.5% to 4.75%. This was a response to the rapidly deteriorating prospects for the economy in the face of the downturn in the housing market, the sub prime mortgage crisis and the ensuing liquidity crisis which started in August 2007 and has subsequently resulted in banks making some major write offs of losses on debt instruments containing sub prime mortgages. Banks have also tightened their lending criteria which has hit hard those consumers with poor credit standing.
- The Fed has cut its rate again, to 4.5% in October 2007 and to 4.25% in December and is expected to cut by another 0.25% to 0.75% by April 2008 to try to stimulate the economy and to ameliorate the extent of the

downturn. However, the speed and extent of these cuts will be inhibited by inflationary pressures arising from oil prices, the falling dollar increasing the costs of imports, etc. The US could well be heading into stagflation in 2008 – a combination of inflation and a static economy (but the economy could even tip into recession if the housing downturn becomes severe enough).

- The major feature of the US economy is a steepening downturn in the housing market which is being undermined by an excess stock of unsold houses stoked by defaulting sub prime borrowers pushed into forced sales. Falling house prices will also undermine household wealth and so lead to an increase in savings (which fell while house prices were rising healthily) and so conversely will lead to a fall in consumer expenditure. Petrol prices have trebled since 2003 and, with similar increases in the price of home heating oil, this will also depress consumer spending with knock on effects on house building, employment etc.
- The downturn in economic growth in the US in 2008 will depress world growth, (especially in the western economies), which will also suffer directly under the impact of high oil prices. However strong growth in China and India will partially counteract some of this negative pressure.
- EU growth has been strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.

UK

- GDP: growth has been strong during 2007 and hit 3.3% year on year in Q3. Growth is expected to cool from 3.0% in 2007 as a whole to 2.0% in 2008.
- Higher than expected immigration from Eastern Europe has underpinned strong growth and dampened wage inflation.
- House prices started on the downswing in Q3 2007 and this is expected to continue into 2008.
- The combination of increases in Bank Rate and hence mortgage rates, short term mortgage fixes expiring and being renewed at higher rates, food prices rising at their fastest rate since 1993 and increases in petrol prices, have all put consumer spending power under major pressure.
- Banks have also tightened their lending criteria since the sub prime crisis started and that will also dampen consumer expenditure via credit cards and on buying houses through obtaining mortgages.
- Government expenditure will be held under a tight reign for the next few years, undermining one of the main props of strong growth during this decade.
- The MPC is very concerned at the build up of inflationary pressures especially the rise in the oil price to \$90 – 100 per barrel (was \$30 in 2003) and the consequent likely knock on effects on general prices. The prices of UK manufactured goods have risen at the fastest rate in 16 years in November 2007 – 4.5%. Food prices have also risen at their fastest rate for fourteen years (6.6% annual increase) driven by strong demand from China and India. Consequently, the MPC is going to be much more cautious about cutting rates compared to the Fed. in the face of these very visible inflationary pressures. In addition, UK growth was still exceptionally strong in Q3, as has also been the growth in the money

supply. The downward trend in Bank Rate is now expected to be faster than at first thought after the initial cut in December 2007 to 5.50% in view of the MPC minutes which showed a unanimous MPC vote for a cut and the consideration given to a half per cent cut. This demonstrated how concerned the MPC is at the potential impact of the credit crunch on the economies of the western world. However, the MPC's room for cutting rates is currently limited by concerns over inflationary pressures. However, if those pressures subside, then there is further downward risk to the Sector forecast which currently only allows for 0.25% cuts in Q1 and Q2 2008 before Bank Rate stabilises at 5.0% for the next two years.