

Global recession still continuing

The world economy is at an unusual juncture: after rapid adjustment to lower global demand, there is anticipation that rebuilding of inventories will lift industrial output. This in turn is lifting confidence and financial markets. Yet in the main, leading economies' consumers are rebuilding savings, firms have little appetite for investment in the face of excess capacity, and credit conditions remain tight. This mixture will weaken any prospective rebound in economic activity, which is likely to be slower and longer to come than normal.

UK Assessment:

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The UK economy contracted at the sharpest pace for thirty years in Q1 2009, but this is likely to mark the worst point of the current cycle. Recent surveys suggest weaker declines in activity can be expected in Q2, as the trend in inventories stabilises and the massive monetary stimulus in place gains traction. However, evidence that bank lending remains sluggish, combined with ongoing concerns that inflation will undershoot the 2% target over the medium term, may see the Bank of England further expand its quantitative easing programme in the months ahead.

CBI Economic Forecast:

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The UK economy now looks to be stabilising and it is likely that we will see an end to the recession (i.e. GDP no longer falling) before the year is out. However, we still believe that the economic recovery will not fully get off the ground until well into next year, and that it will be fairly slow and gradual. For 2010 as a whole we predict modest GDP growth of 0.7%, following a GDP fall of 3.9% in 2009.

International Economy:

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US non financial company profits and investment are still falling, as is output and employment, though there are signs that the rate of GDP decline will slow. This is also true of Europe, where inventories were reduced in the first quarter, and Japan, whose high value exports of capital and durable goods were clattered by the credit crunch in the West, but appear to be stabilising.

Current Focus:

UK: World leader in fiscal profligacy

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It is well known that the UK's public finances are dire. But how does the UK compare with other countries? The answer is: not well. With the highest fiscal deficit in the G20, the UK has some significant challenges ahead if it wants to reclaim its reputation for fiscal prudence.

CBI Business Survey Results:

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April's Industrial Trends Survey showed trends in manufacturing output and orders worsening further, although weaker declines were expected for the next quarter. Retailers in May reported a much weaker annual decline in sales than earlier in the year (p20), while financial services firms expect a slower rate of fall in business (p24). The rate of decline in services, particularly business services, is also expected to ease significantly (p22).

UK Economic Statistics:

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Latest key statistics on the UK economy.

UK Economic Assessment

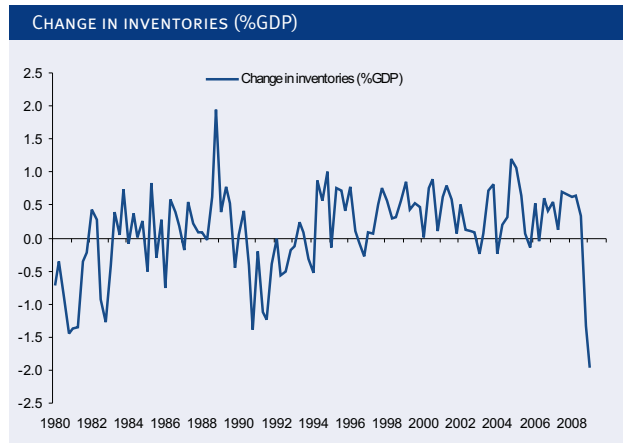
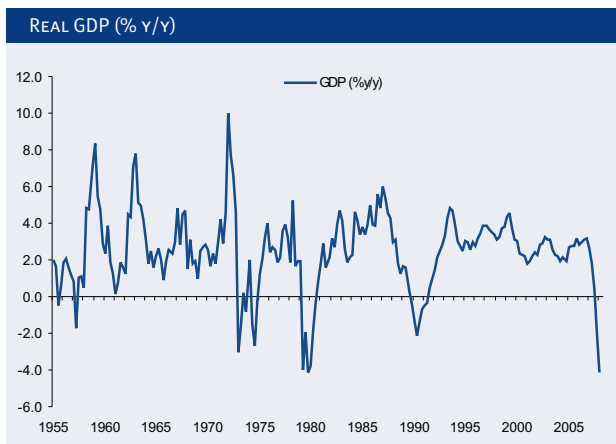
- The UK economy is experiencing its sharpest recession since that of the early 1980's, although the 1.9% decline in Q1 2009 is likely to mark the worst point in the current cycle.
- The Bank of England's Quantitative Easing programme is into its fourth month and has been extended by £50bn to £125bn. Further extension of the scheme may be announced given limited evidence that bank lending is loosening and expectations that inflation will undershoot the 2% target in the medium term.
- Unemployment continues to rise sharply and the loosening of labour market conditions is now placing severe downward pressure on wages.

Growth

UK Gross Domestic Product (GDP) fell by 1.9% in the first quarter of 2009, the sharpest decline since 1979. Overall, GDP has now fallen by 4.1%, much more than the 2.5% decline seen during the early 1990's, but still some way off the nearly 6.0% contraction of the 1980's.

There was a further massive fall in inventory during the latest quarter (£6.0bn after £4.2bn in Q4), as firms continued to run down stocks. This contributed to a record (5.5%) fall in manufacturing output, and sharp declines in trade and transport services. Transport & communications services contracted 2.3%, with other notable falls in the service sector a 2.2% decline in business & finance and 5.1% drop for hotels & restaurants.

The direct contribution of inventory to GDP, however, eased from -1.6pp to -0.6pp, as the second difference of



inventory was not as negative. In Q4 the trend in inventory changed from mildly positive to extremely negative over one quarter.

There is a high probability that Q1's GDP number will be revised down, to the range of -2.1 to -2.2%. This is due to a massive downward revision to construction output – now showing a 9% decline compared with the 2.4% contraction indicated in the most release GDP release.

The decline seen in Q1 is, however, likely to be the worst of the current recession, as inventory disposal eases and the decline in trade moderates. Although many of our surveys are still at or near their recent lows, the expectations components suggest less pronounced declines in activity during future months. The two exceptions are the Financial Services and Distributive Trades Surveys, which appear to have troughed in late 2008 and are already on an improving trend.

Household sector

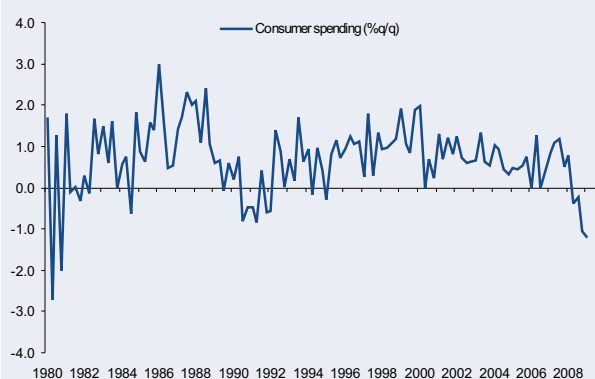
Households have reigned in their spending and increased savings as the outlook for employment and earnings becomes more uncertain. The savings ratio has risen from a low of -1.2% in Q1 2008 to 4.8% during the final quarter of last year. And it could well rise further during 2009, despite heavy cuts in interest rates since the start of the year. Faced with the prospect of job losses and/or lower earnings, consumers appear to be re-evaluating their levels of saving, which have been historically low in recent years. As such, spending has fallen for a fourth consecutive quarter, with the rate of decline slowly gathering pace. The latest fall of 1.2% in Q1 was the sharpest since 1980 and followed contraction of 1.0% during the final quarter of last year.

With job losses expected to continue rising sharply for some time – leaving unemployment to peak just above 3 million next Spring – further belt tightening is inevitable. However, there are some encouraging signs. Consumer confidence (as indicated by both GFK NOP and Nationwide) is gradually improving – broadly back to where it was before the demise of Lehman Brothers last Autumn. This appears to have stabilised the trend in the retail sector, with our latest Distributive Trades Survey showing much weaker sales declines than earlier in the year. Also, there have been signs of improved activity levels and even isolated monthly price rises in the housing market, and recent stock market rallies may have improved individuals' perceptions of net wealth.

Monetary & fiscal policy

The Bank of England's policy of quantitative easing is now in its fourth month, while Bank Rate has been kept at its historic low of 0.5% since March. In May, the initial asset purchase programme of £75bn was extended by a further £50bn to £125bn, and minutes from that meeting showed the option of extending to the Treasury's limit of £150bn had been discussed. The Monetary Policy Committee (MPC) expressed concern that, although there were some indications of the contraction in output stabilising, the degree of spare capacity in the economy and loosening of the labour market (resulting in downward pressure on earnings) could see inflation falling, and then staying, below its 2% target level in the medium term. In its most recent June meeting, the Bank made no further extension to its £125bn quantitative easing programme, stating that at this current level it would take a further two months to complete.

HOUSEHOLD CONSUMPTION (% Q/Q)



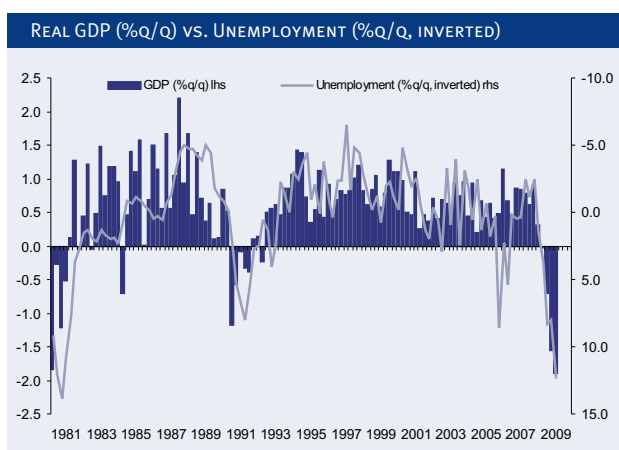
Labour Market

Lower private sector bonus payments saw the headline average earnings rate turn negative for the first time, falling at an annual rate of 0.4% in the three months to March. Weaker regular pay growth in the manufacturing sector – reflecting pay freezes/cuts and shortened working hours – has also contributed to the decline, with only a 1.1% annual increase seen in the most recent period. This is likely to fall further in upcoming months as data from the April pay reviews becomes available. In contrast to the trend in manufacturing, regular pay growth appears to be holding up better in the service sector – an increase of 3.3% in the year to Q1 down from a peak of 4.3% in early 2008.

Unemployment continues to rise at a rapid rate, with the 244k increase seen during the first quarter of the year the sharpest since Q4 1980. Continued cost-cutting by some

Government borrowing stood at £86.7bn in the 2008/09 financial year, over double the £34.6bn recorded in 2007/08, with the Budget forecast for the current 2009/10 financial year a staggering £175bn. April data suggest even this prediction could be on the optimistic side. In what is typically a surplus month thanks to income and corporation tax inflows, net borrowing was a worse than expected £8.5bn. The main tax revenue streams – income tax, national insurance, corporation tax and VAT – are collapsing, almost 15% lower than a year earlier, offsetting tentative signs of a stabilisation in spending. Public sector net debt is currently 53.2%, with the government predicting in the recent Budget that this would rise to 80% by 2012/13. Worries that it may rise even higher recently resulted in the UK being put on ratings watch by Standard and Poor's.

businesses and closures of others are likely to result in further notable increases in unemployment throughout the year, to an eventual peak around 3.03m next Spring. However, unlike trends in past recessions, unemployment during the current cycle appears to be moving coincidentally with GDP rather than lagging it (see chart below). If this trend continues as the rate of contraction in activity eases and an eventual recovery emerges, the increase in unemployment may be slightly slower than currently forecast.



Business sector

Despite quantitative easing now running into its fourth month and government initiatives to support the banking system up and running, evidence of a loosening in corporate credit conditions has been limited at best. Indeed, our April Industrial Trends Survey showed finance availability as a survey-record constraint on output and remaining close to its record high as a limit on capital expenditure. Meanwhile, M4 lending to the corporate sector, which appeared to be recovering from declines late last year, fell by a record amount (to 1997) in April. Although some lags are to be expected, and the availability of data is not always that timely, the Bank of England may have hoped for stronger evidence of a loosening in lending and could well increase the scale of quantitative easing again as a result.

Glimmers of hope on the lending front have come in the form of our May Access to Finance Survey – with expectations of a stabilisation in credit conditions over the next three months, and the Bank of England's Credit Conditions Survey – which showed bank's expected to increase the availability of credit in the coming three months.

Despite the depth of the recession, internal finance positions appear relatively healthy still, with private

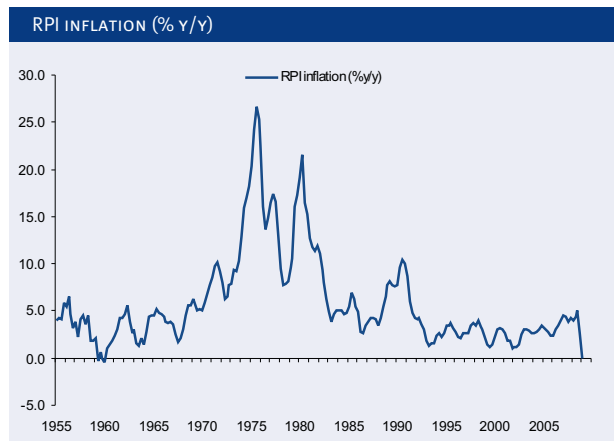
non-financial companies £8bn net lenders in the final quarter of 2008 (up from £5.9bn). However, £4bn of this came from massive inventory savings and, with gross operating surpluses starting to fall quite sharply (-3.9% y/y in Q4 2008 the worst since 1992), data for Q1 2009 may be somewhat weaker.

Inflation

The Retail Price Index (RPI) measure of inflation turned negative in March for the first time since the 1960's, and fell further to -1.2% in April. Unlike the Consumer Price Index (CPI) measure, the RPI includes housing depreciation and mortgage interest payments, both of which have fallen heavily in the last year due to the decline in house prices and aggressive cuts to the Bank of England base rate. As such, a negative reading on this measure should not be seen as a sign of widespread deflation.

Headline CPI inflation, though falling, remained slightly above the Bank of England's 2% target in April. Furthermore, core inflation, which strips out volatile elements such as food and fuel, was 1.5%, compared to a low of 1.1% in December. While falling demand has placed some downward pressure on prices, the recent weakness of sterling and the bold monetary stimulus undertaken by the Bank of England have served to offset the risk of widespread deflation.

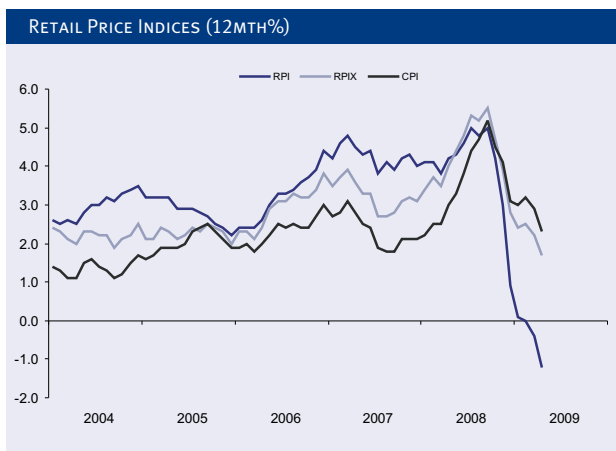
That is not to say, however, that we will not see inflation ease further. With salary reviews often carried out using the RPI measure of inflation, basic pay growth may well ease further and force more households to cut back spending, driving down prices for goods and services. Also, with sterling strengthening in recent weeks, imports may become cheaper, also forcing down prices in domestic markets. Though we expect it to remain positive, headline CPI inflation will fall noticeably below the 2% target in the months ahead.



Key Indicators

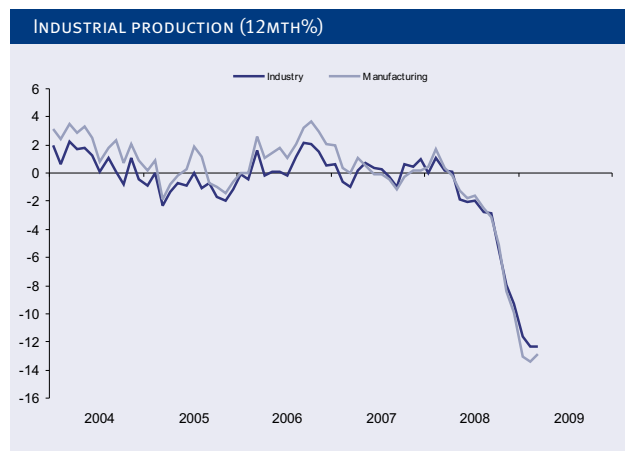
■ Retail price indices

Annual CPI inflation eased further to 2.3% in the year to April, down from 2.9% in March. The fall was largely due to lower gas and electricity bills and food prices. With the exception of a slight increase in February, CPI inflation has been on a downward trend since October 2008, and is set to fall below the 2% target in the third quarter of 2009 and remain there through 2010. RPI inflation fell to a record low of -1.2%, down further from -0.4% in March.



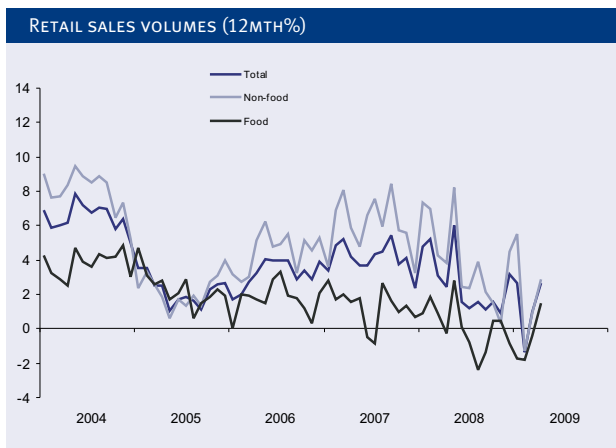
■ Industrial production

Manufacturing output was unchanged between February and March, but saw a year-on-year fall of 12.9%. The wider measure of industrial production fell by 0.5%, and by 12.4% on a year ago. By sector, declines in both capital and intermediate goods more than offset an increase in consumer durables and non-durables. The decline across different industries was broad based, the exception being a modest increase in food, drink and tobacco (0.7mom%).



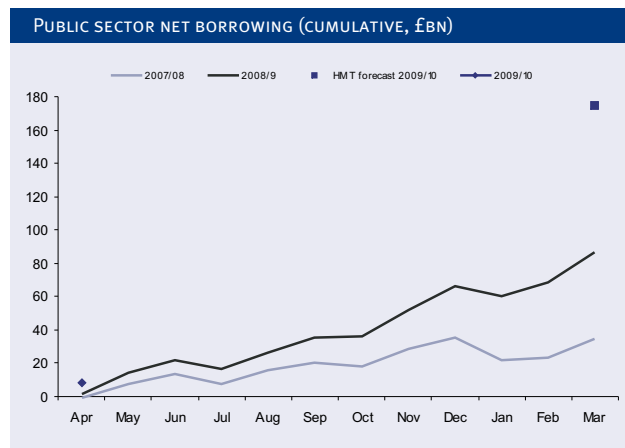
■ Retail sales

The volume of retail sales rose by 0.9% in April. The increase was driven by a rise in sales of both food and non-food stores, offsetting the 1.1% decline in non-store retailing and repair. On an annual basis, retail sales were 2.6% higher than April 2008, after a 0.9% rise in March. While the year-on-year rate of growth has increased since turning negative in February, retail sales volumes still remain well below their peak in May 2008, when annual growth had reached 6.0%.



■ Public sector net borrowing

Cumulative government borrowing stood at £86.7bn in the 2008/09 financial year, over double the £34.6bn recorded in the 2007/08 financial year and higher than the Pre-Budget Report prediction of £77.6bn made last November. The Treasury Budget forecast for the current 2009/10 financial year is £175bn. Public sector net borrowing was £8.5bn (i.e. a deficit) in April, much higher than the £1.8bn recorded in April 2008. Public sector net debt is £754bn, equivalent to 53.2% of GDP.



CBI Economic Forecast

- **UK GDP**

After a particularly steep fall in output at the start of the year, the UK economy now looks to be stabilising, as many recent economic indicators have shown the pace of contraction diminishing markedly. Demand is no longer "falling off a cliff", firms have less need to run down their stocks as rapidly as before, and the confidence of businesses and consumers is noticeably less downbeat than a few months ago - when the economic outlook appeared extremely gloomy. With the process of stabilisation in the economy gaining traction over the months ahead, it is likely that we will see an end to the recession (i.e. GDP no longer falling) before the year is out - a little sooner than predicted in our April forecast.

However, the massive negative shock that we have had from the credit crunch will take time to dissipate, and it is difficult to see where there will be sources of solid and sustained demand growth in the economy over the next few quarters. Consequently we still believe that the economic recovery will not fully get off the ground until well into next year, and that it will be fairly slow and gradual. We forecast marginal quarterly growth at the start of 2010, with momentum building to around trend rate by the end of the year. For 2010 as a whole we predict modest GDP growth of 0.7%, following a GDP fall of 3.9% in 2009.
- **Firms**

Although demand in the economy is stabilising, it is doing so at a level that is considerably below that of a year ago, and many firms are faced with excess capacity. Business investment has already been cut back very sharply, but further falls are expected over the remainder of this year, albeit at much slower rates of decline. Business investment in 2009 is forecast to be down 12.4% on last year, and despite some modest quarterly growth in 2010, it is expected fall another 1.4%. The remarkable degree of flexibility in the labour market with regards to wage restraint (far exceeding anything seen in previous recessions) is likely to help limit the impact of the downturn on job losses. This has prompted us to lower our forecast for the peak in unemployment to just over 3 million in early 2010.
- **Households**

Weakness in household consumption is forecast to persist through 2009 in response to rising unemployment, downward pressure on earnings growth, and a preference for higher rates of saving than in previous years - as households seek to repair their balance sheets. A 2.9% fall in consumption is predicted this year. Consumption is expected to pick up a little next year, but with only very muted quarterly increases compared to the much stronger growth in spending that was achieved during the period of easy credit earlier this decade.
- **UK trade**

Exports and imports fell very sharply at the beginning of this year, when world trade was collapsing, and further falls are expected, such that double digit declines are forecast in 2009. Nevertheless, net trade is expected to contribute positively to GDP again this year, more so than in 2008. However, this is unlikely to last into next year, when consumer spending is gradually recovering along with demand for imports, and given the expectation of a further slight appreciation in sterling which will lower relative export competitiveness.
- **Inflation and monetary policy**

CPI inflation is now expected to fall below the Bank of England's 2% target in the third quarter this year, and less rapidly than forecast in April, mainly reflecting higher oil prices. However, we still predict that inflation will remain below target throughout the forecast period. In order to sufficiently bolster nominal demand for inflation to be close to target in the medium term, the Bank may need to further expand its quantitative easing programme from the current £125 billion in the coming months. Looking further ahead, as the economy is recovering next year, it is likely that the Bank will then be focussing its attention on how it retreats from such a highly accommodative monetary stance. We still expect that the Bank Rate will start to be raised from its 0.5% historical low early in 2010.

CBI Economic Forecast

12mth% unless otherwise stated	2008	2009	2010	2009 Q1	Q2	Q3	Q4	2010 Q1	Q2	Q3	Q4
GROWTH & CONSUMPTION											
Real GDP	0.7	-3.9	0.7	-4.4	-4.7	-4.1	-2.6	-0.3	0.3	0.9	1.7
Manufacturing output	-2.6	-11.6	1.4	-13.5	-13.6	-12.0	-7.2	-0.9	1.2	2.1	3.2
Household consumption	1.4	-2.9	0.5	-2.7	-3.3	-3.3	-2.3	-0.9	0.3	1.0	1.5
Government consumption	3.4	4.6	1.0	3.5	4.1	5.3	5.5	4.4	1.9	-0.1	-1.9
Household savings ratio	1.9	4.2	4.6	3.9	4.1	4.5	4.4	4.6	4.4	4.5	4.7
INVESTMENT											
Fixed investment	-3.1	-11.1	-0.5	-10.7	-12.5	-10.9	-10.3	-4.3	-1.0	0.8	2.7
of which:											
Total business	0.1	-12.4	-1.4	-9.2	-13.3	-13.8	-13.3	-5.6	-1.6	0.0	1.7
General government	21.1	1.5	2.0	-0.5	4.1	1.2	1.0	1.3	-0.7	2.3	5.3
Manufacturing	-1.8	-15.1	-2.4	-10.7	-14.0	-18.4	-17.4	-8.8	-3.3	0.8	2.3
EXTERNAL TRADE											
Exports	0.1	-11.1	0.1	-11.0	-11.9	-12.4	-8.9	-2.7	0.3	1.0	1.8
Imports	-0.6	-11.8	0.6	-13.1	-13.0	-13.2	-7.7	-1.2	0.4	1.3	2.0
Current account (£bn)	-24.5	-30.6	-41.3	-6.4	-7.2	-8.1	-9.0	-9.6	-10.0	-10.6	-11.2
% of GDP	-1.7	-2.2	-2.9	-1.8	-2.0	-2.3	-2.6	-2.7	-2.8	-2.9	-3.1
PRICES											
CPI	3.6	1.9	1.6	3.0	2.0	1.2	1.4	1.9	1.6	1.3	1.4
RPI	4.0	-1.2	2.1	-0.2	-1.6	-2.0	-0.9	1.2	2.0	2.2	2.8
RPIX	4.3	1.3	1.5	2.4	1.1	0.5	1.2	1.5	1.6	1.4	1.4
Producer output prices	7.3	0.9	1.1	2.9	0.1	-0.5	1.0	1.5	1.0	1.2	1.4
LABOUR MARKET											
Unemployment (ILO, mn)	1.82	2.60	3.00	2.27	2.51	2.72	2.90	2.99	3.03	2.99	2.97
Unemployment rate (%)	5.8	8.2	9.5	7.2	8.0	8.6	9.2	9.4	9.6	9.5	9.4
Unemployment (CC, mn)	0.94	1.76	1.99	1.46	1.73	1.90	1.96	1.97	1.98	2.00	2.00
Claimant count rate (%)	2.8	5.4	6.2	4.2	5.4	5.9	6.1	6.2	6.2	6.3	6.3
Employment (mn):	27.31	26.34	25.94	26.75	26.38	26.18	26.06	25.99	25.93	25.91	25.92
Average earnings inc. bonus	3.7	0.0	2.3	-0.4	-0.1	-0.2	0.5	1.7	2.2	2.4	2.7
PUBLIC SECTOR											
Net borrowing (£bn)***	86.7	172.3	182.2								
% of GDP	6.0	12.2	12.6								
*** 2008/09, 2009/10, 2010/11											
FORECAST ASSUMPTIONS											
	2008	2009	2010	2009 Q1	Q2	Q3	Q4	2010 Q1	Q2	Q3	Q4
OECD GDP	0.9	-4.3	0.6	-4.2	-4.9	-5.0	-3.0	-0.7	0.3	1.2	1.8
UK Bank Rate	4.63	0.63	1.25	1.00	0.50	0.50	0.50	0.50	1.00	1.50	2.00
Oil prices \$ per barrel	97.4	58.5	65.0	44.8	59.0	65.0	65.0	65.0	65.0	65.0	65.0
GBP Trade-weighted index	90.9	79.9	82.4	76.8	80.2	81.1	81.4	81.9	82.1	82.4	83.0
USD/GBP	1.85	1.53	1.62	1.43	1.54	1.56	1.58	1.60	1.61	1.62	1.63
EUR/GBP	1.26	1.14	1.21	1.10	1.13	1.15	1.17	1.18	1.20	1.22	1.25

International Economy

- The US economy is still in a profound recession with falling consumer spending.
- Europe's current account surplus country Germany needs to consume more, and the larger number of deficit countries in EMU and the near east to export more and consume less. It is hard to see this happening quickly.
- Japan's recession has been deep due to the drop in export demand. As companies respond by cutting employment, pay and bonuses, and the state by increasing future tax liabilities, consumers will retrench and save more for future bills.
- There is much improvement in indicators of default risk in wholesale credit markets, implying the stabilisation of the financial system, but loan terms are continuing to be tightened by banks, and consumers seem more inclined to save than borrow.

The World's Central Banks and Treasuries have fought off the system-threatening aspects of last Autumn's financial panic, and the bulk of the output and trade adjustment appears to be behind us. But there is still a mismatch between lenders and borrowers expectations which will keep liquidity weak, while recessionary effects will be slow to clear because private demand will be feeble while firms and households rebuild their balance sheets. It will probably be early to mid 2010 before recovery forces are dominant.

Euro area

■ Growth

The first quarter showed the euro area in deepening recession. GDP fell by 2.5% in the first quarter, down 4.8% compared to one year ago, after a quarterly fall of 1.6% and year-on-year decline of 1.4% in the final quarter of 2008. (Forecasts for 2009 now typically range between -4% and -5%). Germany experienced a post 1970 record quarterly contraction of 3.8%, so that GDP was 6.9% below its year ago level, led by heavy quarterly falls in machinery and equipment investment (-16.2%) and in exports (-9.7%). Italy's GDP also fell sharply, by 2.4% quarterly and 5.9% year-on-year respectively.

The speed of descent in the euro-area's near neighbours was striking. The first quarter saw output fall by 11.2 % in Slovakia and Latvia, by 10.5% in Lithuania, and by 6.5% in Estonia. There will be further write-offs of loans made in euros by Western banks in eastern bloc and Baltic countries to come, as recessions deepen and where relevant, currency links come under pressure as

countries try to compensate for the flight of footloose Western capital since the crunch.

Within the euro area detail, gross fixed capital formation fell by 4.2% after -4.3% in the fourth quarter, while exports fell 8.1% after -7.2% (in the fourth). Imports also fell faster this time, by 7.2% (after -5.1%), so that the deduction from growth due to net exports was not as great. Household spending fell by 0.5%, only marginally worse than the prior quarter's -0.4%. The big difference this time was in the -1.0% contribution of inventories to

EUROZONE ECONOMIC INDICATORS (12MTH % UNLESS STATED)

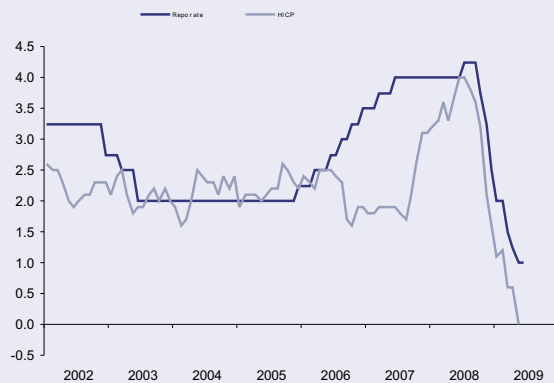
	2008				
	2008	Q2	Q3	Q4	Q1
GDP	0.6	1.4	0.5	-1.7	-4.8
Private consumption	0.3	0.5	0.1	-0.6	-1.1
Fixed investment	-0.3	1.6	-0.3	-5.6	-10.4
Government consumption	1.9	2.0	2.0	2.1	1.8
Current account (euro bn)	-93.6	-31.1	-23.1	-22.0	-25.4
	2009				
	2008	FEB	MAR	APR	MAY
Inflation (HICP)	3.3	1.2	0.6	0.6	0.0
Producer prices	4.8	-3.9	-5.1	-5.8	NA
Unemployment rate (%)	7.6	8.7	8.9	9.2	NA
Retail trade (m/m)	-1.3	-0.5	-0.1	0.2	NA
Industrial production	-1.8	-18.3	-18.5	NA	NA
Manufacturing	-2.0	-20.2	-20.3	NA	NA
Current account (euro bn)	-93.6	-2.1	-3.5	NA	NA
Trade balance (euro bn)	-39.9	-1.0	0.4	NA	NA
Industrial confidence indicator	-10	-36	-38	-35	-34
Consumer confidence indicator	-18	-33	-34	-31	-31
PMI - manufacturing	33.9*	33.5	33.9	36.8	40.7
- services	42.1*	39.2	40.9	43.8	44.8
* Dec. 2008					

Euro area monetary policy

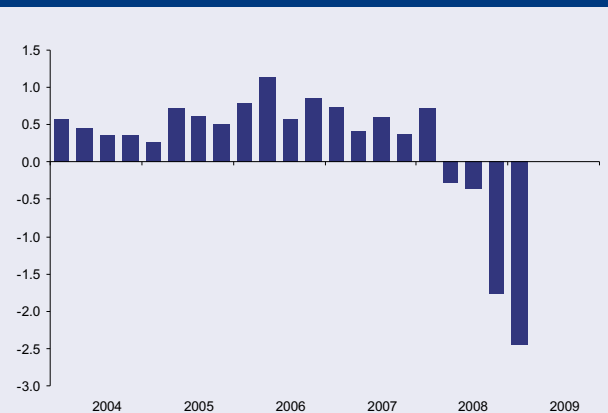
The ECB left the repo rate at 1% in their June meeting. But in May they introduced 12 month maturity repos, on top of existing repos, at fixed rate tenders with full allotment, to be at the repo rates payable at the time, plus a possible premium in future. The European Investment Bank will become an eligible counterparty in July. They provide loans (51.5bn to European companies in 2008), guarantees and venture capital up to half the value of a project, so this move will give help at the margin to European SME's. The ECB also announced a program to buy 60bn euros of covered bonds over a timeframe of more than six months from July onwards. These are low risk assets backed by public sector loans or mortgages, and 60bn is about one tenth of the amount outstanding in what has been a liquidity-constrained market - enough to make a difference to it, though there are a lot of questions about how the purchasing program will operate, whether it will be sterilised, whether indeed,

it is a form of quantitative easing. The ECB expect to both make some money and drive covered bond prices higher, but are so far refraining from the more aggressive action of their UK and US counterparts.

INTEREST RATES & INFLATION (12MTH%)



EUROZONE GDP GROWTH (3MTH%)



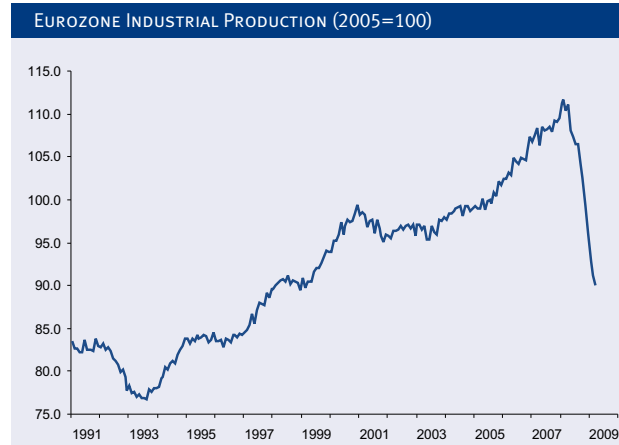
the change in GDP, after mild additions in the previous two quarters. This holds out the hope that shelves will be relatively bare and so output will respond more quickly to demand; though given the severity of the recession in the zone and its neighbours, a more realistic expectation would be for a quarterly decline of about 0.6% in the second quarter, followed by declines of about 0.2% per quarter in the second half of the year. The ECB Staff project a contraction of between 4.1 and 5.1% this year and of between -1.0% and +0.4% for 2010, positive growth returning by mid 2010. Recent monthly declines in industrial production have moderated to -2.0% in March from -3.0% in December, though the year-on-year decline steepened, with output now down 20.2%.

■ Leading Indicators and Surveys

A general pattern is emerging where after reaching record lows very recently, indicators show a partial rebound that in no way makes up the lost ground. However, financial markets are hungry for turning points. An example being the Purchasing Managers Index for manufacturing, which rose from 36.8 in April to 40.7 in May. While well below the 50 mark and consistent with deep contraction, the gain was hailed as the biggest rise since the survey began in 1997. One issue that will show up time and again is that industry, though a smaller share of economies, is far more directional than services and so its output is a major constituent of some leading indicators like the OECD's. As the rate of decline in output will slow, the effect will be to boost leading indicators. Meanwhile, many surveys hit record lows after October's financial crisis and subsequent drop in world trade, so that there is nowhere to go but upwards (Consumer Confidence and PMI's for example) and the confusion is whether to note the record low level or the pace of escape from it.

Looking at the OECD's composite leading indicators, as of June, there are still strong slowdowns expected for the USA, Japan and Germany, but possible troughs in the euro area, Canada, Italy, France and the UK. The National Bank of Belgium's Business Barometer of manufacturing and business-related services rose from its record low point for the second month running in May, hinting at

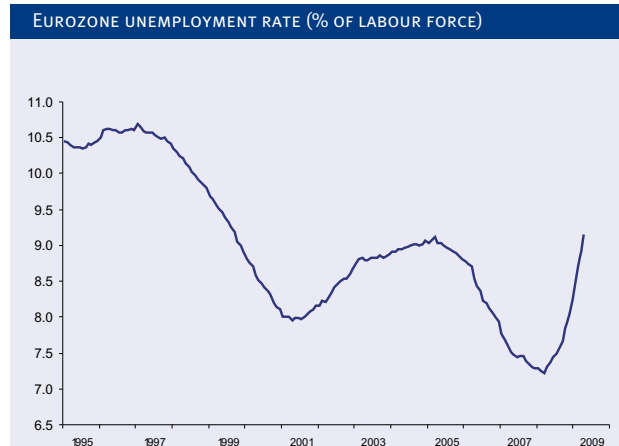
some stabilisation in euro area activity at a new lower level in the second half.



■ Inflation

Consumer prices, as measured by the harmonised index, were stable compared to one year ago in May. Inflation expectations at the ECB are for a few months of negative inflation, due to price rises of a year ago (oil, for example) flattering the comparison, before gradual price increases at the end of 2009 and into 2010.

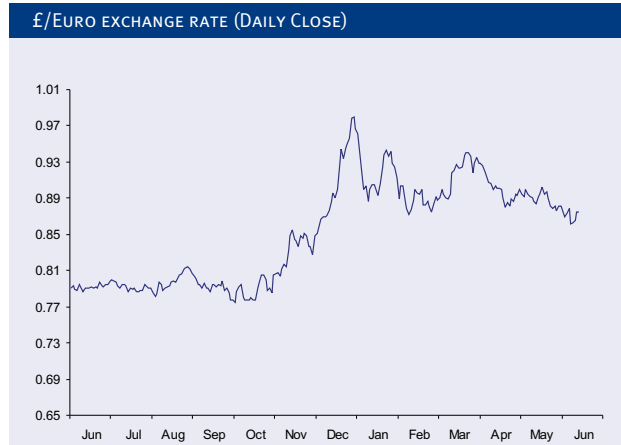
■ Unemployment



The seasonally adjusted unemployment rate for the euro area was 9.2% in April. It was 7.3% in April 2008. The biggest increases in unemployment rates over the last year were in the Baltics: Lithuania (4.3% to 16.8%), Latvia (6.1% to 17.4%) and Estonia (3.7% to 13.9%). Youth (under 25) unemployment rates are also increasing fast. The euro area had a rate of 18.5%, and Spain 36.2% in April; rates are 22% in France, 24% in Ireland, and UK in February by comparison was 17.6%.

■ Exchange rate

The euro has moved little (1%) in the past year on a trade weighted basis, but against its main trading partners it has been livelier. It gained 10.2% and 8.8% versus the Pound and the US Dollar respectively, while falling by 16.5% against the Yen, between 3rd June 2008 and 3rd June 2009. Within that period there has been an 11.6% gain by the Pound since the end of last year, when parity was nearly reached (98 pence per euro on 30 December).



■ Lending Conditions

The Eurosystem's latest Bank lending survey, conducted between March 20th and April 3rd, saw a further tightening -by a net 43%- of credit standards on loans and credit standards to enterprises. This has been hailed as it is below the prior quarter's 64%, but is in fact still a further tightening of credit standards. Corporate loan demand declined further, though at a slightly slower rate. Both supply and demand factors have been diverging now since the third quarter of 2007. There was some further net tightening in credit standards for households, both for house purchase and consumer lending; though again confusion is caused by the phrase "the net percentage reporting a tightening of credit standards for loans likewise decreased". That is euphemism for "more difficult to obtain loans".

■ Conclusion

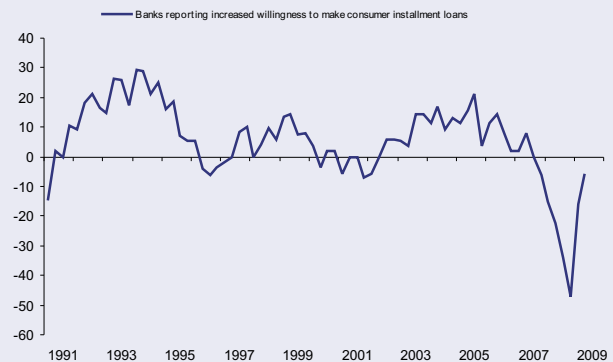
The euro zone is still going deeper into recession, though at a slower rate. The year as a whole is likely to see an economic contraction of between 4 and 5%. There is a tendency to overplay the positive in leading indicators at the moment, given the infancy and small pullbacks of the indices from record low levels. A year of stagnation is predicted from mid 2009. Strong setbacks to economic development in the near East and on labour market activity for a large portion of Europe's young people are already being seen in this recession.

US monetary policy makers supportive of fiscal activism in current circumstances

The Fed see merit in activist fiscal policy based on their modelling scenarios where the funds rate is effectively set at zero and expected to stay there, while output is way below its potential, and inflation undesirably low, as now. The usual leakage in higher bond yields, lower asset prices and higher dollar may not occur so quickly. This would allow for stronger multiplier effects in the meantime. Meanwhile by buying lots of IOU's from Government and private sector, and crediting banks with lots of extra reserves, Fed policy looks inflationary to some. But this is only so if Banks lend these excess reserves and a process of more lending, and then more demand and higher prices, gets underway, burning away excess capacity. At present the process is stuck. Banks are not lending the excess reserves, but using risk pricing and risk averse non-price criteria to deter loan applicants, for example requiring applicants to get a lot of paperwork ready in order to cover any potential loan loss, while

applicants are themselves exhibiting lower loan demand, shown for example in successive Senior Loan Officers Opinion Surveys run by the Fed.

SENIOR LOAN OFFICER SURVEY - LOANS TO HOUSEHOLDS (NET %)



United States

Growth

The US economy is still deep in recession and shows little sign of leaving it soon, though the speed at which output is falling will reduce, compared to the strong decline in the six months around the turn of the year. Based on its second measurement, real GDP fell at an annual rate of 5.7% in the first quarter, after 6.3% in the fourth. Gross

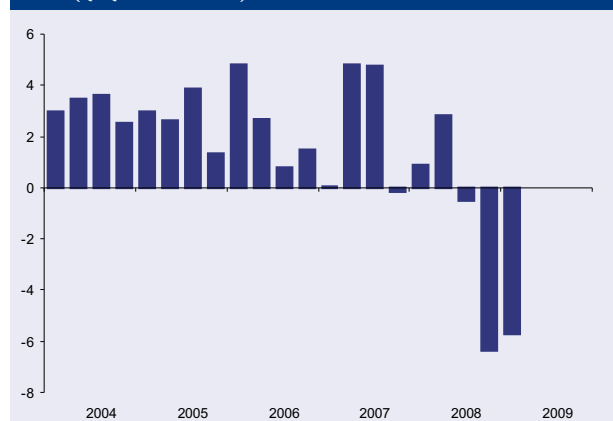
private domestic investment fell at a 49.3% annual rate, while the change in non farm inventories deducted 2.3% - news that would normally be positive for future output, were it not for the inventory to sales ratio for total business being so hugely misaligned. Net exports actually lifted GDP because imports fell at an even faster rate (-34.1%) than exports (-28.7%). Personal consumption advanced at an annual rate of 1.5% after falls of 4.3% and 3.8% in the two prior quarters. The inference from a small rise in durable goods spending is likely to be a false one because it fell by two quarters' worth in the prior quarter, and the monthly series is running at -10% year-on-year so far in 2009. Personal saving as a percentage of personal disposable income is its highest in 14 years (5.7% in April). This will help repair household balance sheets battered by declines in home and equity prices, but is ominous for personal consumption going

US ECONOMIC INDICATORS (12MTH % UNLESS STATED)

	2008	2008 Q2	2008 Q3	2008 Q4	2009 Q1
GDP	1.1	2.8*	-0.5	-6.3*	-5.7*
Personal consumption	0.2	1.2*	-3.8	-4.3*	1.6*
Private domestic investment	-6.7	-11.5*	0.4*	-23.0*	-49.3*
Government consumption and investment	2.9	3.9*	5.8*	1.3*	-3.5*
Current account (\$ bn)	-673.3	-182.24	-181.30	-132.8	NA
* annualised					
	2008	2009 Feb	2009 Mar	2009 Apr	2009 May
Consumer price index	3.8	0.2	-0.4	-0.7	NA
Producer prices index	9.9	-7.2	-10.5	-11.6	NA
Unemployment rate (%)	5.8	8.1	8.5	8.9	9.4
Non-farm payrolls (ooo's)	-257	-681	-652	-504	-345
Retail sales	-0.7	-8	-9.6	-10.1	NA
Consumer credit (\$bn)	2563	2562	2551	NA	NA
Consumer confidence index	60.1**	56.3	57.3	65.1	NA
New home sales (ooo's, sa)	374**	362	351	352	NA
Housing starts (ooo's, sa)	556**	574	525	458	NA
Industrial production	-2.2	-11.4	-12.6	-12.5	NA
Capacity utilisation	72.8**	70.6	69.4	69.1	NA
ISM/NAPM - manufacturing	32.9**	35.8	36.3	40.1	42.8
- services	38.9**	40.2	44.1	45.2	42.4
International trade (\$bn)	-681.1	-26.13	-27.58	NA	NA

** Dec. 2008

GDP (QOQ ANNUALISED %)



forward. Corporate profits rose by 6%, lifted by a 95% gain in domestic financials, thanks to exceptionally low borrowing costs for the Banks, but for non-financial corporations they fell by 8.6% or \$64bn in the first quarter, following a fall of 10.7% or \$89bn in the fourth.

■ Industrial output

US manufacturing output is now 16% below its level of December 2007, when the recession started, and is still falling on a monthly basis (by 0.5% in April and 1.7% in March). Output is also falling in a broad-based fashion across industry groups, rather than being due to the recession in motor vehicles. Indeed, output of automotive products has actually risen for three months after sharp output cuts early in 2009. Capacity utilisation is at a post 1967 record low of 69.1%, giving more reasons for past and future weakness in the GDP investment data.

■ Labour market

Employment declines have accelerated since last autumn. Total employment has fallen by 4.2 million between November and May using the nonfarm payrolls measure, and the unemployment rate has been advancing 0.4% a month and is now up to 9.4%. This is starting to impact measures of late payment and loan delinquencies in the prime mortgage market. The secular decline in manufacturing jobs has accelerated in the recession. Two million such jobs have gone since March 2007, so that their total is now down to 12 million, 9% of nonfarm employment. The only real growth areas are health care and education. Professor Robert Reich, President Clinton's former advisor, has drawn attention to the widening gap or duality in US rewards to labour between "symbolic analytical" work (that which cannot be routinized, such as research, design, or systematising information) and the relative crowding of local service work, with low benefits and low pay, for example in hotels, or big box retailers, or food service, which he sees as requiring wider educational provision to address.

■ Housing

Growing joblessness and the fall in house prices mean that home equity is below mortgage balance outstanding for 15.4 million homeowners, encouraging mortgagors to hand back the keys. There is new Federal help potentially available to reduce mortgage repayments, but certainly none for reducing the principal owed or for providing payment holidays in the event of job loss. That, or illness, can then cause family income to be insufficient to meet even lowered repayments. The resultant foreclosures then reappear on the market at sale prices, depressing prices further. Prime fixed rate mortgagors are now the highest

proportion (29%) of new foreclosures, as the housing crisis mutates from being a subprime issue to a job loss issue. Slow progress is being made otherwise. New home sales pace in March and April was the slowest since 1982, but the April total equates to 10.1 months supply, down from January's record 12.4 months, and 10.2 months for existing homes, which is down year-on-year. New housing starts are at all time record lows, so inventories should keep declining slowly, but for the time being house prices are still falling and likely to fall further in 2009.

INVENTORY TO SALES RATIO: TOTAL BUSINESS



■ Outlook

This recession is still deepening, though at a slower rate. In popular cliché, the end to cliff diving has not yet given rise to green shoots! The yield curve (10 year bond yields less 3 month interbank rates) gave a lead of two years ahead of the recession by being negative. It has now been positive for 15 of the last 16 months, excepting October's financial panic, which would suggest a recovery from the early part of 2010. The ten year less two year curve is also steep, and indicators of financial stress are looking much healthier. However, the normal leaders out of recessions, consumption and residential investment, are damped this time by the huge overhang of debt and excess housing stock from the expansion. Consumers will not be wind-assisted by easy credit and rising net worth, and instead are saving more, using less credit than a year ago and paying off debts, emasculating easier monetary policy. Slowly shifting the economy towards producing more than it consumes, as is recommended to reduce the trade deficit and dependence on foreign funds, is the obvious next stage, but that is likely to involve a number of years of slow growth and is having to start in a global recession. Impositions on business, such as carbon pricing and taxes to pay for extension of healthcare are likely to grow, while the stimulus of the past year will have to be paid for, suggesting a slower than normal expansion to come.

Japan & rest of world

Japan's recession - now one year old - deepened in the first quarter, with a record quarterly fall in output of 4%, or 15.2% at an annualised pace, after a revised quarterly fall of 3.8% in the final quarter. Exports are the main culprit. They fell 26% in the first quarter and 14.7% in the fourth. Regional first quarter falls were 35.7% to the USA, 27% to the EU, and 22% to East Asia. Japan's high export share of higher value capital and durable consumer goods rendered it vulnerable to foreign investment and credit crunches. At home, falling profits, funding constraints and excess capacity are causing a deepening downtrend in capital investment.

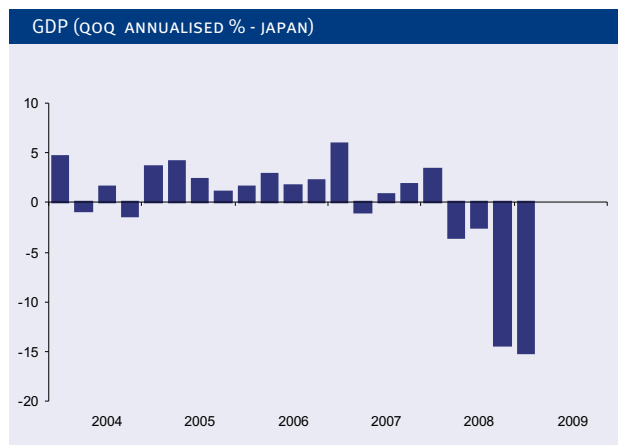
There are positive signs regarding the second quarter, such as the levelling out of exports in March and April, and the local belief that they will start rising soon. This is supported by a 5.2% jump in industrial output in April, after the fall of one-third in the previous six months. The bulk of the shift to a new lower level for exports - they fell 49.1% year on year in February, 45% in March and 39.1% in April - appears to be over. Inventory adjustments in key markets appear to be over for the time being. Falling imports, due to weak domestic demand, will support the move back into monthly trade surpluses and, with a rise in orders for public works from a very low level, could support a small rise in second quarter GDP. However, the boost from net exports will prove temporary unless consumer and corporate spending in the West pick up faster than appears likely given the desire to pay down debt there. Meanwhile, domestic demand in Japan is set to weaken further. Personal consumption fell 1.1% in the first quarter, and total cash earnings were 4% below one year ago. The labour market is quite harsh, with a rising ratio of part timers with limited rights, unemployment now 5% and rising, and falling numbers of full timers, wages, overtime and bonuses, all of which are corroding

perceptions of income certainty in future, and therefore consumption prospects.

Elsewhere in the region, India and China grew by 5.8% and 6.1% year on year in the first quarter. Both are likely to power ahead at similar rates as they have relatively low levels of per capita GDP, while their huge populations allow some insulation from the global downturn. Chinese fixed asset investment continues at a 30% rate and local retail sales are advancing at 15% per annum.

Japan and East Asia's growth models rely on producing more than they consume, and exporting the excess output to major deficit countries (like the USA and UK) where consumers would borrow to spend more than they produce. But as the latter group will now need to shift towards consuming less than they produce, so Asian economies will lose foreign sales and need to ramp up local consumption. The product specialisation on cars, electronics and consumer durables for export has also proved to be very cyclically sensitive and dependent on credit access for firms and consumers in the West.

Accumulated Asian financial reserves once used to buy risk-free US Treasuries really need to be loaned to locals given property rights that they can use as collateral to start or expand small businesses. And to provide safety nets such as pensions, health, education and jobless benefits that will reduce the need to have high saving ratios. China is moving in this direction, allowing farmers to use land as collateral for loans or to set up companies, and providing \$125bn for a basic health insurance scheme until 2011, but these shifts in the world's main creditor and debtor zones will take time and politicians' immediate temptation will be to subsidise consumption in the West and to steer lending towards building more production facilities in the East.



CONSENSUS ECONOMIC FORECAST (12MTH %)

	2008	2009	2010	2009 Q2	2009 Q3
REAL GDP					
World	2.0	-2.3	1.9	NA	NA
Eurozone	0.7	-3.7	0.3	-2.9	-2.7
France	0.7	-2.5	0.4	-2.0	-2.0
Germany	1.3	-5.0	0.4	-3.6	-3.0
Italy	-1.0	-4.0	0.1	-3.6	-3.1
United States	1.1	-2.9	1.8	-3.7	-3.5
Japan	-0.7	-6.1	1.3	-1.9	-6.5
INFLATION					
World	4.7	1.2	2.2	NA	NA
Eurozone	3.3	0.4	1.2	0.3	0.0
France	2.8	0.2	1.1	0.0	-0.1
Germany	2.6	0.3	0.9	0.3	0.0
Italy	3.3	0.8	1.6	0.7	0.2
United States	3.8	-0.8	1.6	-1.3	-2.5
Japan	1.4	-1.2	-0.6	-1.1	-2.0

Source: Consensus Forecasts (May 2009)

Current Focus:

UK: World leader in fiscal profligacy

It is well known that the UK's public finances are dire. But how does the UK compare with other countries? The answer is: not well. With the highest fiscal deficit in the G20, the UK has some significant challenges ahead if it wants to reclaim its reputation for fiscal prudence.

The dramatic deterioration in the UK's public finances has caused some consternation, particularly to investors in UK plc. Indeed, the UK has recently been put on ratings watch by Standard & Poor. There is little doubt that public borrowing will rise astronomically this year - to its highest level since the Second World War - as a result of the financial crisis and the resultant sharp recession. Although the UK government has taken unprecedented action to support the banking system, this is not the major driver behind the worsening in the public finances. The purchase of bank shares, for example, is not counted in public sector borrowing as it is the purchase of assets, although the balance sheets of the nationalised banks do contribute to national debt.

The increase in borrowing in the UK is partly the result of the automatic response to a downturn that is a feature of the tax and benefit system – the 'automatic stabilisers'. These typically include the effects of higher benefit payments as unemployment rises, lower tax receipts as profits and incomes fall and lower stamp duty receipts from housing and share transactions. Overall, these automatic stabilisers represent a boost to the UK economy of around 2% of GDP this year due to the sharpness of the recession. This has then been added to by the government's attempts to alleviate the worst of the downturn by undertaking a fiscal stimulus package, worth 1.5% of GDP this year. In this recession, because the financial and housing sectors have been particularly badly affected, there has been an extra hit to financial sector corporation and income tax receipts and stamp duty on housing.

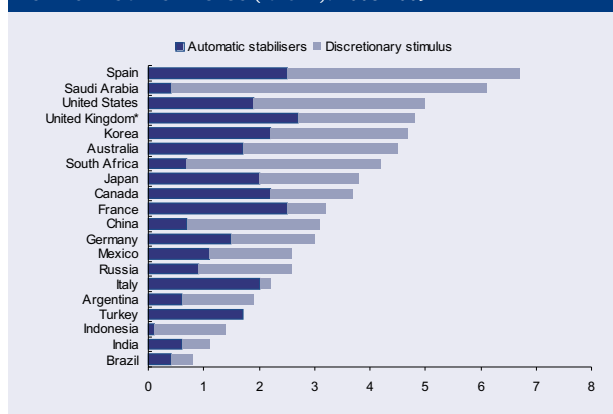
■ The global picture

There is no doubt that the UK is fairing particularly badly in this recession. But how does its public finance position compare with other countries?

This is the first synchronised global downturn for some thirty years, and it has had a negative impact on public finances across the globe. But the extent of the deterioration varies substantially between countries. This reflects differing factors:

- The size of discretionary fiscal stimulus packages
- The strength of automatic stabilisers
- The underlying state of the public finances going into the crisis

SIZE OF FISCAL STIMULUS (% GDP): 2008-2009

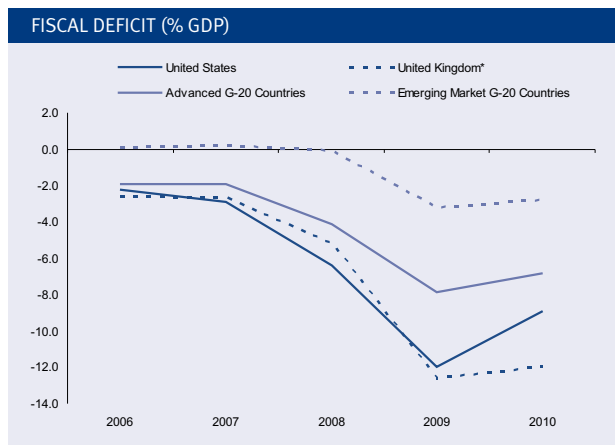


Source: IMF
*UK data is from HMT on a financial year basis

The shock to the financial system has led governments to initiate widespread support packages for the broader economy to limit the effects of the crisis. G20 countries have implemented a wide variety of policies to help support their economies through the recession. Fifteen of the G20 have increased infrastructure spending (e.g. UK, Canada, France, Germany, and Korea), some are supporting vulnerable groups, such as the unemployed (Russia, UK, US) and some are supporting SMEs (e.g. UK, Russia). There have also been policies looking beyond the

recession to address longer-term challenges, e.g. improving health and education (Australia and China) or introducing incentives for environmentally-friendly technologies (UK, China, Germany). Nine of the G20 have cut personal taxes (UK, US, Canada, France, Germany, Indonesia, Japan, Spain and Brazil) and six have cut indirect taxes. There have also been cuts in corporation tax (Canada, Korea and Russia) and investment incentives (UK, France and Korea).

Almost all of the G20 countries have announced discretionary stimulus packages. And these are boosted by automatic stabilisers which vary significantly in strength across the G20, with the lowest being 0.1% of GDP for Indonesia (see chart). The UK's discretionary stimulus looks modest relative to other countries, at around 2% of GDP over two years compared with, say, around 3% for the US. However, the UK's automatic stabilisers are the strongest in the G20, at 2.7% of GDP over 2008 and 2009 – partly reflecting the strength of the recession in the UK. This helps push up the value of the UK's overall fiscal boost to the sixth highest in the G20. In general, those countries who have greater automatic stabilisers have implemented a smaller discretionary stimulus, as is the case for the UK. But the scope for the UK to go for a bigger discretionary stimulus is further limited by the UK's overall fiscal position.



Source: IMF

* UK data is from HMT on a financial year basis for 2009 and 2010

Note: Fiscal deficits refer to general government only.

The fiscal stimulus has had a dramatic effect on fiscal deficits in the G20, particularly in advanced economies. The chart above shows the UK's general government fiscal deficit relative to the rest of the G20. Despite not having the largest fiscal stimulus, the UK's deficit, and indeed the US's, is well above other countries. This partly reflects the

way the financial crisis has affected the financial and housing sectors in both countries, which are particular rich tax revenue sources. The UK's deficit is currently forecast to average 12.3% of GDP over the next two years and the US is almost as bad, at 10.5% of GDP.

■ The UK and US: in the same boat?

The UK and the US have been at the forefront of the financial crisis due to their large financial and housing sectors. The size of their respective fiscal deficits is a source of concern for investors in both countries: the dollar's reserve status has increasingly been called into question, while the UK's triple A rating may be at risk. This is partly because their deficits do not simply result from the financial crisis, as both countries were in deficit going into the crisis, despite the fact that economic growth was well above trend. Indeed, in both countries, around three quarters of the deficit in 2010 will reflect factors other than the impact of the recession – the so-called 'structural deficit'. The size of the structural deficit is a concern because, unlike its counterpart 'cyclical' deficit, it will not reduce automatically as a result of economic growth picking up. Rather, tax increases and/or public spending cuts will be needed to reduce structural deficits. At this point, differences start to emerge between the UK and the US.

According to the OECD, government spending in the UK in 2010 will be 49% of GDP, compared with 40% of GDP in the US. And government spending in the UK has risen by twice as much as the US since 2000. On the tax side, tax revenues are expected to reach 42% of GDP in the UK and 33% of GDP in the US in 2010. Tax revenues in the US have actually fallen relative to the size of the economy since 2000, while they have risen slightly in the UK.

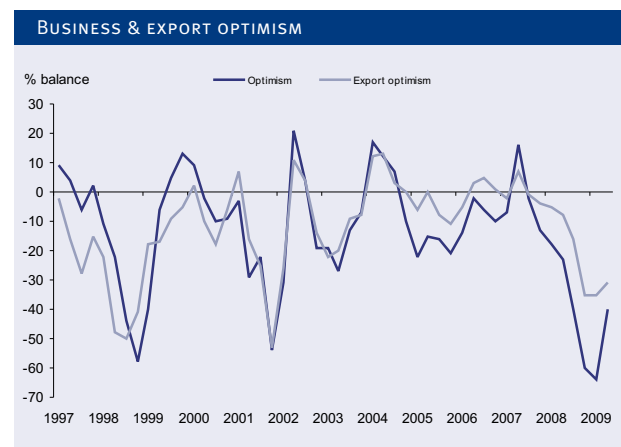
So the size of the UK state is around 10%pts bigger relative to the size of the economy compared with the US, and well above the OECD average. This suggests that, in bringing down the fiscal deficit, the UK will need to focus on public spending cuts and efficiencies to a far greater extent than the US. Furthermore, HM Treasury's forecast recovery in the UK's fiscal deficit is highly dependent on a strong economic recovery, which the IMF has described as "highly uncertain". All in all, there are significant challenges ahead for the government in returning the UK's finances to health.

CBI Industrial Trends Survey

- Manufacturing saw a very sharp downturn in activity over the quarter to April. Domestic demand fell slightly faster, while export orders declined more sharply than expected. Despite more rapid de-stocking, stock levels remained more than adequate
- Difficult credit conditions continued to exacerbate an already challenging business climate, with credit and finance concerns a record high constraint to future output.

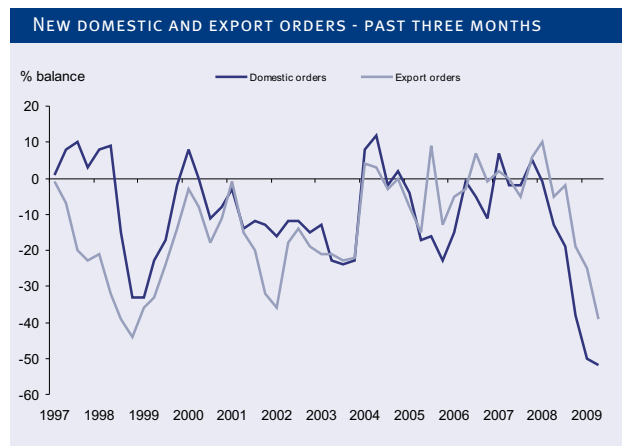
Business optimism

Business sentiment deteriorated further in April, although at a considerably slower rate than the previous quarter; this was the first time in seven quarters that the rate of decline eased (to equal that of July 2008). Export optimism was also lower than three months ago, again falling more moderately than the overall fall in confidence.



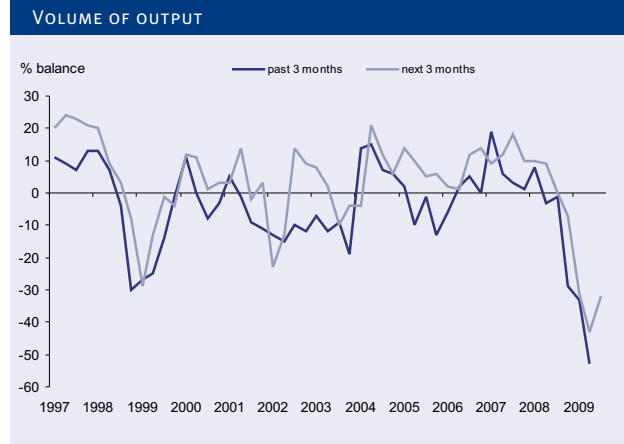
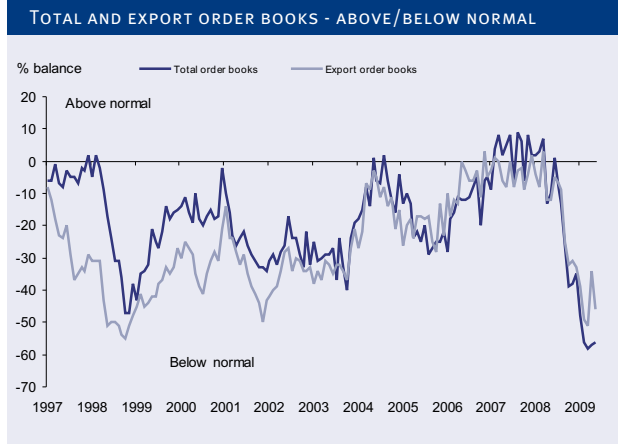
Demand

Domestic demand recorded a slightly steeper fall over the past quarter, exactly in line with expectations. The fall in domestic orders was the sharpest since October 1980. The decline in domestic demand was expected to slow next quarter.



The decline in export orders accelerated over the past quarter, falling much faster than anticipated, however this was still less steep than the fall in domestic demand. Firms were increasingly concerned about political and economic conditions abroad as a constraint on future export orders, while concerns over credit and finance remained elevated. It was expected that export orders will fall at a much more moderate pace in the next three months.

The latest Monthly Trends Enquiry showed that manufacturing demand was still very weak. Total order book levels have remained broadly unchanged in relation to seasonal norms for the past four months, following further sharp declines at the start of the year. Export order books fell further below normal in May, reversing most of the improvement seen between March and April.



Output

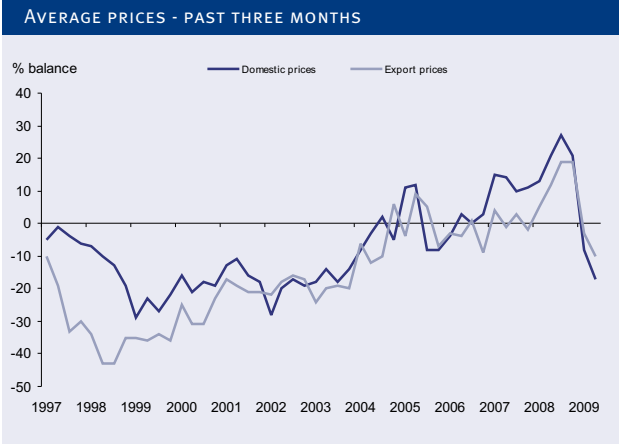
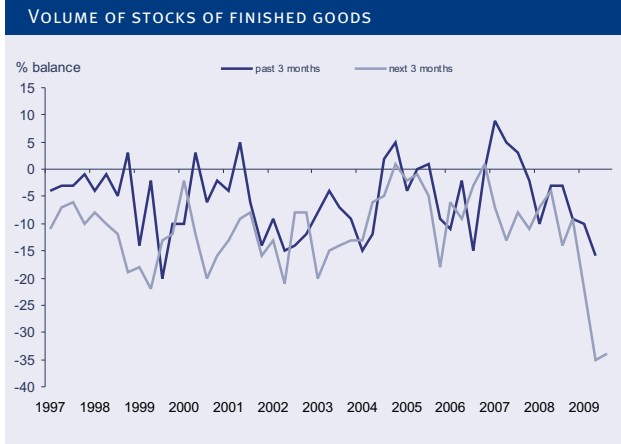
Manufacturing output fell faster than expected in the past quarter, experiencing its steepest decline since records began in 1975. Consistent with expectations for both domestic and export orders, the contraction in output was expected to decelerate in the next quarter. As well as cutting production, companies continued to run down their inventories at pace, although not quite as aggressively as expected. Despite this, stock levels remained more than adequate and more rapid de-stocking was expected to continue in the next three months.

The latest Monthly Trends Enquiry (May) showed that expectations for output improved markedly in the last two surveys after equalling the 1980 record low in March. Manufacturers of both capital and intermediate goods were anticipating a significant deceleration in the decline of production in the next three months, while consumer goods manufacturers no longer expected output to fall - marking a distinct change from the expectations over the past year.

Stocks

May's Monthly Trends Enquiry showed that stock adequacy remains high relative to demand despite a recent period of aggressive de-stocking.

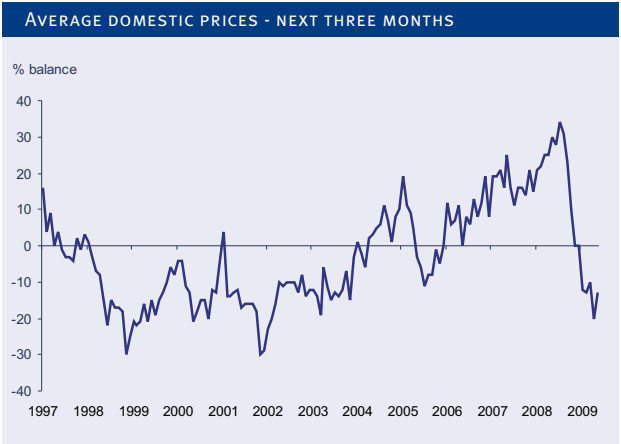
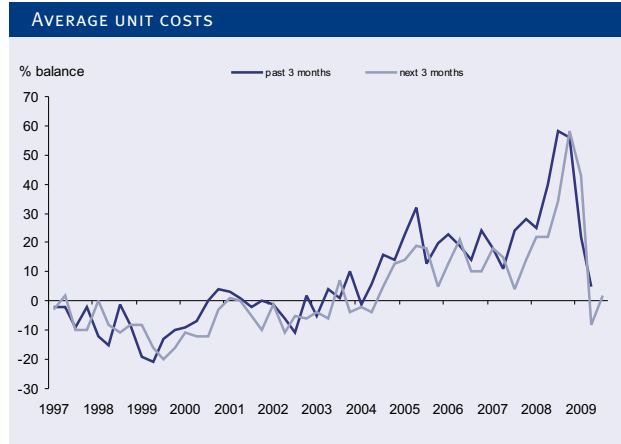
			2008				2009	
			JAN	APR	JUL	OCT	JAN	APR
Business optimism		-18	-23	-40	-60	-64	-40	
Volume of output	- past 3 mths	+8	-3	-1	-29	-33	-53	
	- next 3 mths	+9	0	-7	-31	-43	-32	
Volume of total new orders	- past 3 mths	+11	+1	-3	-30	-43	-47	
	- next 3 mths	+4	+2	-12	-36	-54	-36	
Volume of domestic orders	- past 3 mths	-1	-13	-19	-38	-50	-52	
	- next 3 mths	+3	-9	-21	-42	-52	-40	
Numbers employed	- past 3 mths	-14	-15	-7	-15	-38	-48	
	- next 3 mths	-19	-17	-27	-33	-49	-39	
Average unit costs	- past 3 mths	+25	+40	+58	+56	+22	+5	
	- next 3 mths	+22	+34	+58	+43	-8	+2	
Average domestic prices	- past 3 mths	+13	+21	+27	+21	-8	-17	
	- next 3 mths	+21	+25	+34	+10	-12	-20	
Capital expenditure on: (12mth forecast)	- buildings	-21	-21	-24	-44	-56	-43	
	- plant & machinery	-12	-18	-24	-38	-57	-42	



Costs

Average unit cost inflation fell sharply again in the past quarter, however the fall in costs which had been anticipated failed to materialise. Firms were anticipating a marginal cost increase in the next quarter.

May's Monthly Trends Enquiry showed that manufacturers expected domestic prices to fall over the next quarter, but at a slower pace than had been anticipated in April. Intermediate goods manufacturers were planning to cut prices most aggressively, while the consumer goods sector was not expecting to change its output prices.

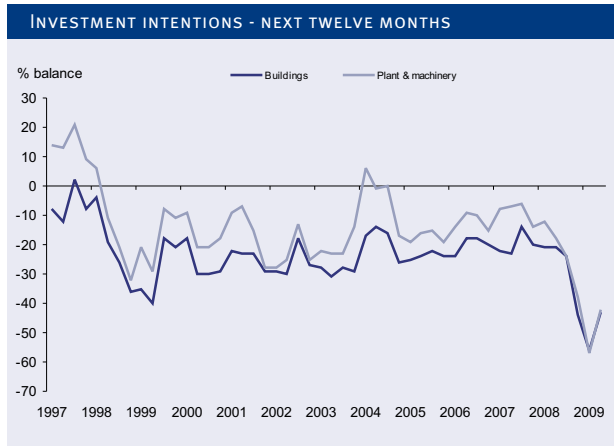


Prices

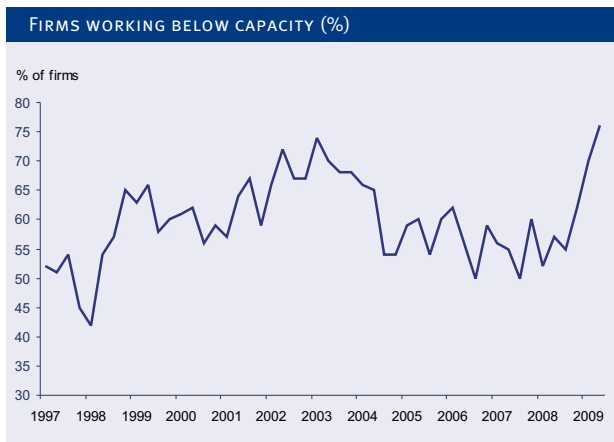
Domestic prices fell for the second consecutive quarter in April, at a rate slightly faster than had been expected; this was the fastest decline in prices since July 2003. Further price cuts were expected in the next three months at a slightly accelerated rate. As expected, export prices also fell for the second consecutive quarter in April, with the rate of price cuts equalling that of July 2004. Price cuts were expected to pick up pace in the next three months, with expectations at their weakest since October 2003.

Investment

Overall investment intentions remain extremely weak, with plans for training and re-training being cut back at the fastest rate since records began in 1989. Forecasts for planned capital expenditure were less negative in the past quarter following the weakest ever readings in January 2009. The proportion of firms citing internal finance shortage as a constraint on investment increased to a second consecutive record high (since the series began in 1979), reaching 31%.



Companies' concern over credit and finance as a constraint on output increased dramatically again in April to 26% - over eight times greater than the long-term average, and the highest level since records began in 1960. The issue remains a more acute problem for larger sized firms (500 + employees). Inability to raise external finance remains a strong concern for investment plans, with the proportion of firms citing this barely changed at 14% since peaking in October 2008 at 16%. The cost of finance has however moderated as a concern (4%), now equal to April last year having peaked at 8% in October 2008.



Capacity

Excess capacity continued to grow as a problem for manufacturers, with the proportion of firms working below capacity increasing to 76% – the highest since January 1983. Capacity utilisation was lowest for metal manufacturers, with 100% currently working below capacity. The proportion of firms planning capital expenditure in order to expand capacity was at its lowest, at 14%, since January 1983.



Employment

As expected, job losses accelerated over the past three months at the fastest rate since October 1991. A further sharp drop in employment was expected in the next quarter, although the rate of job cuts was expected to moderate.

CBI Distributive Trades Survey

- Retail sales volumes declined in the year to May, in line with expectations. The fall came after sales were broadly flat in April; however, May's decline was less severe than that seen in recent surveys and sales were set to fall at a similar pace next month.
- Price inflation eased significantly, while the business situation was expected to deteriorate only modestly over the next three months, marking a significant improvement in sentiment on previous quarters.

Retailing

Retail sales volumes declined in the year to May, after fairly stable sales in April. The fall was in line with retailers' expectations, but the rate of decline was significantly slower than that seen in recent surveys. Sales were expected to fall at a similar pace once again next month.

Retailers had anticipated sales to remain below average for the time of year, but May's survey balance was worse than expected. Sales were expected to stay below seasonal norms next month.

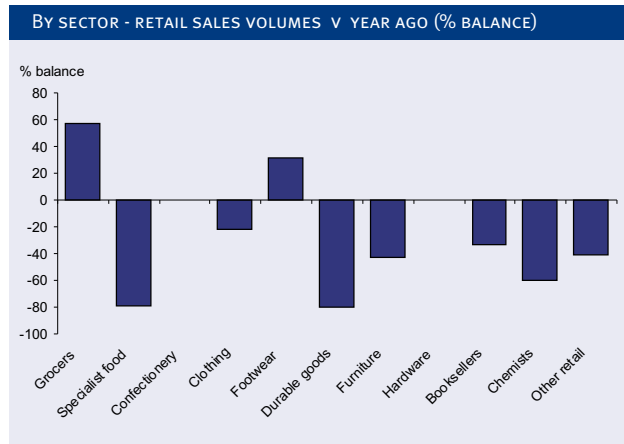
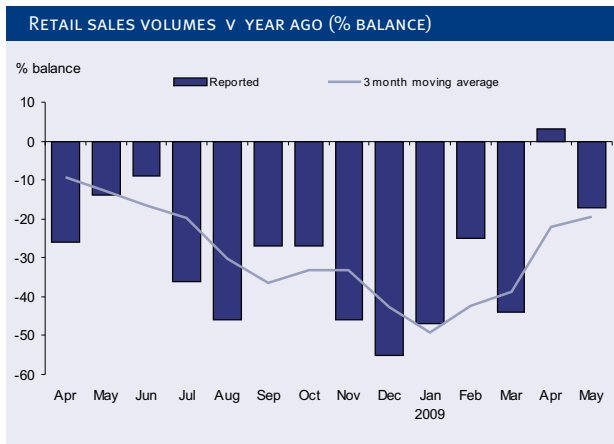
The volume of orders placed upon suppliers declined at a faster rate than last month, largely echoing the movement in sales volumes. Orders were set to be cut at a similar pace in June.

The three month moving average of retail sales volumes remained negative in May.

The volume of stocks fell back significantly relative to expected demand in May, with the survey balance falling below its long run average and standing at its lowest since June 2007. Stocks were expected to remain at similar levels next month.

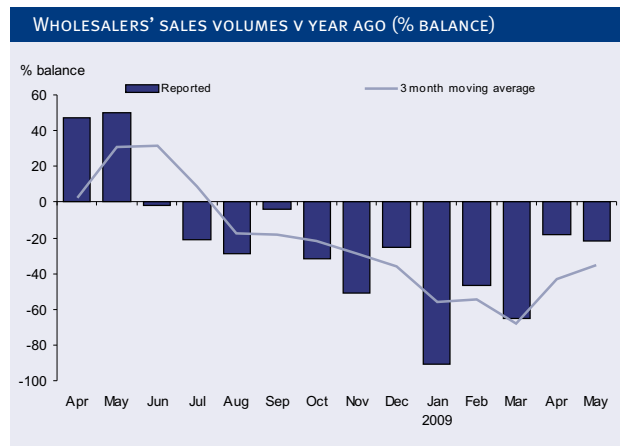
Sector breakdown

By sector, grocers and footwear & leather retailers saw strong growth in sales volumes on a year ago, but the rate of increase in both had eased markedly on last month. All other sub-sectors saw sales fall, with steep declines in durable household goods and furniture & carpets. Growth in sales volumes was flat in the hardware, china & DIY sub-sector.



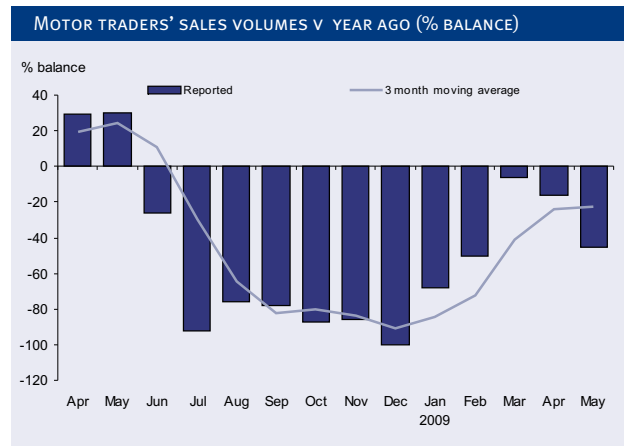
Wholesaling

Sales volumes continued to fall in the year to May, at a slightly faster rate than last month and in line with expectations. A more rapid rate of decline was expected next month. Food and drink wholesalers saw no change in sales volumes, while most other sub-sectors saw a fall in sales on a year ago; this was particularly marked for industrial materials, durable household goods and builders' merchants wholesalers. Sales were below average for the time of year in May, although less so than any time in the last nine months, in line with what wholesalers had anticipated in April. The volume of orders placed upon suppliers deteriorated sharply in the year to May, at a faster rate than last month and than that expected. Wholesalers expected to cut orders more next month, at the fastest pace since October 1990.



Motor traders

Sales volumes in the motor traders sector fell more rapidly over the year to May than in the past two months, albeit not quite as steeply as expected. While the decline in sales of vehicles accelerated on last month, parts & accessories sales were unchanged on a year ago. Overall sales volumes were set to fall again in June. Sales volumes were reported to be significantly below average for the time of year, and were expected to remain well below seasonal norms in June. The volume of orders placed upon suppliers fell over the year to May, albeit at a slower rate than last month. With the weakness in demand expected to continue, orders were set to decline with a faster rate in June. Average selling prices grew over the year to May - at the fastest rate since August 1990. A similar increase in prices was expected next month.



Distributive Trades Survey: Selected Results

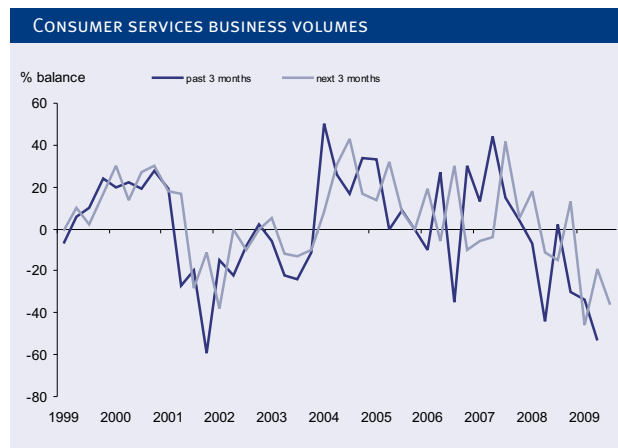
	2009							
	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY
RETAILING								
Volume of sales versus year ago	-27	-46	-55	-47	-25	-44	+3	-17
Volume of sales - 3 month moving average	-33	-33	-43	-49	-42	-39	-22	-19
Volume of sales: level for the time of year	-35	-42	-50	-47	-39	-42	-12	-36
Volume of orders placed upon suppliers	-36	-46	-58	-51	-31	-47	-11	-24
Volume of stocks in relation to expected sales	+17	+19	+23	+19	+19	+15	+22	+8
WHOLESALESALES								
Volume of sales versus year ago	-32	-51	-25	-91	-47	-65	-18	-22
Volume of sales - 3 month moving average	-22	-29	-36	-56	-54	-68	-43	-35
MOTOR TRADERS								
Volume of sales versus year ago	-87	-86	-100	-68	-50	-6	-16	-45
Volume of sales - 3 month moving average	-80	-84	-91	-85	-73	-41	-24	-22

CBI Service Sector Survey

- The May survey saw further strong falls in the volume of business, and levels were regarded as well below normal. Having said that, there was a degree of optimism that next quarter will see slower rates of decline in business, particularly in business services.
- Profitability fell further, though at the slowest rate since last August. Neither sector shows much interest in expanding capacity, and both shed jobs heavily.

Consumer services

Business volumes and values both fell quite strongly, particularly volumes. Those dropped at their fastest pace since November 2001. That was much faster than had been predicted, though values' gloomy prediction was slightly too pessimistic. The level of business was well below 'normal' in value and volume terms, indeed the divergences of both from what was considered normal set records for the survey. The prediction for the next three months was for the volume and value of business to decline again, but each at a slower rate than they did in this survey.



Consumer service firms increased selling prices at an above average rate, after one quarter of price stability. Meanwhile, total costs per person employed barely grew and were expected to even fall marginally next quarter; both scores representing lowest readings in the post 1998 history of the survey. Selling prices were predicted to be flat next quarter.

Numbers employed fell at a record rate, though they had been expected to shrink faster still last quarter.

Training/retraining expenditure was likewise being cut back fairly sharply, with the outlook being that it will be reduced at a similar rate next quarter. Firms foresee a more marginal reduction in numbers employed in the next survey.

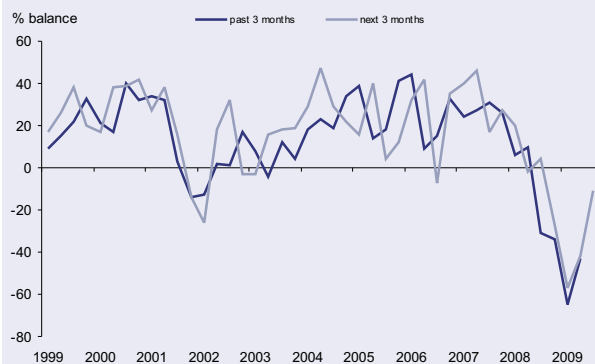
Investment intentions for the coming year (relative to last) are negative. Firms expected to spend less in the coming year on each of IT, land & buildings, and vehicles, plant and machinery. This has been the case now for one year. The inability to raise external finance was seen as constraining capital investment to a record degree. Of the reasons for investment, the moderate revival in interest in e-business continued, but last quarter's high interest in capacity expansion was followed by low interest this time. The desire to increase efficiency/speed or exploit new technology was at its lowest since November 2007, equalling that quarter's record apathy.

A substantial majority of firms did not expect to expand their business more in the coming year than they did in the past year. This was the sixth consecutive quarter when responses to this question were more depressed than the long run average, although to the least degree during that time. When asked what factors were likely to inhibit their ability to increase their level of business in the coming year, the level of demand/sales was out in front, although once again to the lowest degree since November 2007. Ability to raise funds increased further as a concern, reaching a survey high. The only other factor seen threatening ability to increase business was domestic competition.

Business & professional services

Business volumes and values both fell quite strongly, particularly volumes. Those dropped at their fastest pace since November 2001. This was much faster than had been predicted, though values' gloomy prediction was slightly too pessimistic. The level of business was well below 'normal' in value and volume terms, indeed the divergences of both from what was considered normal set records for the survey. The prediction for the next three months was for the volume and value of business to decline again, albeit at a slower rate.

BUSINESS & PROFESSIONAL SERVICES BUSINESS VOLUMES



There was currently a much more deflationary bias in providing services to businesses than to consumers. Average selling prices at business & professional services firms fell at their fastest pace yet in the three months to May (exactly as predicted), with the trend rate of decline

accelerating over the past three surveys. Firms expected average selling prices to fall sharply again in the next quarter.

The decline in profitability continued for the fourth consecutive quarter, albeit less rapidly either than expected or in the prior two quarters.

Employment, which has now fallen for one full year, fell very heavily for the second successive quarter, just shy of last quarter's record rate. A further fall in employee numbers was expected next quarter, at a slower pace. Training expenditure contracted for the third quarter in a row and was expected to fall a little in the coming quarter.

Investment intentions for the coming year were negative in all three categories for the fourth quarter in a row. Expenditure plans, while falling, did not fall quite as strongly as in the last survey. Interest in expanding capacity was at a record low, the desire to reach new customers was at its lowest since November 2007, and there were above average fears of an inadequate net return on investment. Financial constraints on investment were perceived to be less severe, with the cost of, and shortage of, internal finance both below their long term averages.

For the sixth consecutive quarter firms did not expect to expand their businesses as much in the next year as they have done in the previous twelve months.

Service Sector Survey: Selected Results

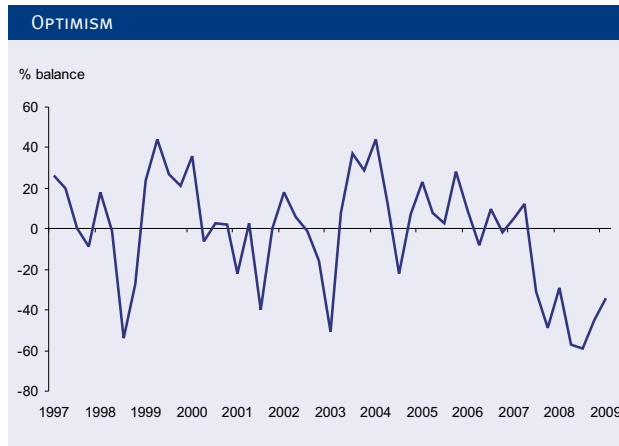
	2008				2009	
	FEB	MAY	AUG	NOV	FEB	MAY
CONSUMER						
Business optimism	-48	-60	-61	-81	-53	+15
Volume of business	-7	-44	+2	-30	-34	-53
Overall profitability	-9	-39	-34	-41	-68	-33
Numbers employed	-6	-12	-1	+9	-22	-30
Capital expenditure on:						
(next 12mths)						
- Land & buildings	+14	-21	-32	-48	-47	-17
- Information technology	-1	+4	-26	-23	-34	-18
BUSINESS & PROFESSIONAL						
Business optimism	-28	-18	-42	-79	-46	-6
Volume of business	+6	+10	-31	-34	-65	-43
Overall profitability	+9	-2	-25	-39	-44	-26
Numbers employed	+20	+15	-6	-18	-51	-45
Capital expenditure on:						
(next 12mths)						
- Land & buildings	-10	+6	-16	-49	-43	-35
- Information technology	+23	+9	-16	-39	-37	-15

CBI/PricewaterhouseCoopers Financial Services Survey

- Conditions within financial services remain extremely tough. Business volumes fell sharply for the sixth consecutive quarter in the three months to March.
- Firms saw the value of their non-performing loans rise further, following December's record rate of increase, while average spreads narrowed for the first time since late 2007.

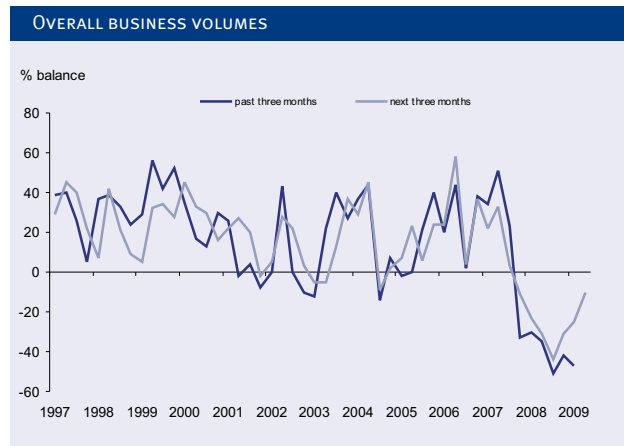
Optimism

Financial services firms were less optimistic about the overall business situation than they were three months ago.



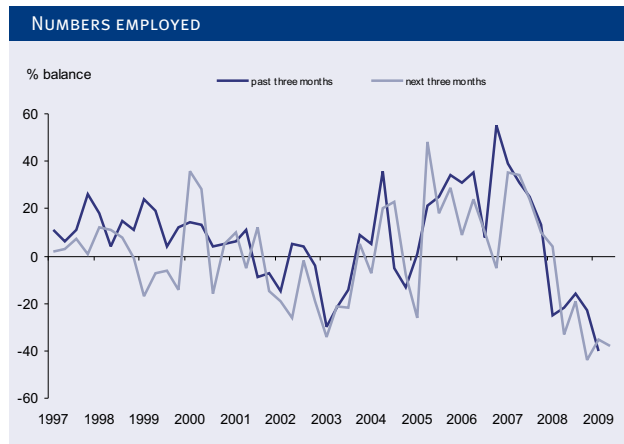
Business volumes

Business volumes were considered well below normal with domestic customers, and below normal with overseas customers. Business fell at a faster rate than had been expected, which has become a pattern lately, and more quickly than in the quarter to December. Volumes of business were lower with all customer categories – though the falls had slowed with all except overseas customers. Firms expected volumes to contract further, though at a far slower rate, over the next three months. The reduction in volumes next quarter was expected to be limited to private individuals and industrial and commercial companies.



Employment

Numbers employed fell at their fastest rate since June 1993. The prediction for next quarter was for a similar rate of decline. Staff turnover was lower for the fourth successive quarter, and training budgets were cut back again.



Income

The value of fees, commissions and premium incomes and income from net interest, investment or trading both fell at a record rate in the last three months. For the next three months, firms expected further falls in the value of both types of income, though by far the bigger fall was anticipated in net investment, interest and trading income.

Costs

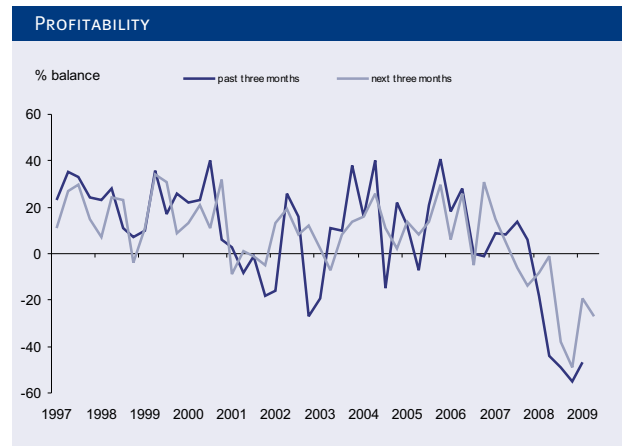
Total operating costs (excluding costs of funds) fell broadly as predicted, indeed, at their fastest rate since the end of 1993. Average operating costs per transaction fell fairly quickly. Staff costs fell as a proportion of total costs at the fastest rate since December 1993 for the second quarter in a row, while the value of non-performing loans increased further, but did so much more slowly than in the final quarter of 2008.

Prices

Spreads between lending and borrowing rates fell marginally after a year of increases. Financial services firms predicted another small decrease in spreads over the next quarter. Average commissions, fees and premiums paid fell strongly for the second quarter running. A marginal decline in them was foreseen for the coming three months.

Profitability

Profitability fell at a strong rate for the fourth quarter in a row (fifth sequential fall). Firms expected another contraction in profitability next quarter, though at a slower rate.



Investment

Capital expenditure in all categories is expected to be lower in the next twelve months than in the past year, particularly land and buildings where intentions were at a record low, and vehicles, plant and machinery where the intent was the weakest since 1992. Demand uncertainty was the greatest investment impediment, followed by inadequate net returns and then shortage of finance. Firms expected to spend less on marketing in the year ahead to the greatest extent in the survey's history.

Financial Services Survey: Selected Results

		2008				2009	
		DEC	MAR	JUN	SEP	DEC	MAR
Business optimism		-49	-29	-57	-59	-45	-34
Volume of business	- past 3 mths	-33	-30	-35	-51	-42	-47
	- next 3 mths	-23	-31	-44	-31	-25	-10
Value of fee, commission, or premium income	- past 3 mths	-11	-44	-29	-42	-51	-53
	- next 3 mths	-15	-31	-28	-27	-26	-14
Total operating costs	- past 3 mths	+17	+11	-23	+3	-25	-40
	- next 3 mths	+5	-2	-18	-14	-37	-35
Overall profitability of business	- past 3 mths	+6	-18	-44	-49	-55	-47
	- next 3 mths	-8	-1	-38	-49	-19	-27
Numbers employed	- past 3 mths	+13	-25	-22	-16	-23	-40
	- next 3 mths	+4	-33	-19	-44	-35	-38
Capital expenditure on: (12mth forecast)	- Land & buildings	+34	-39	0	-23	-47	-57
	- Information technology	+4	-37	-14	-34	-42	-44

CBI/GVA Grimley Survey

- Firms reduce property holdings and expect sharper cuts to come.

CBI Access to Finance Survey

- Credit crunch grip weakening as conditions start to stabilise.

CBI/GVA Grimley Survey:

May: 2009

According to the May 2009 CBI/GVA Grimley survey, firms reduced their property holdings in the last six months and expected this to accelerate over the next six months, after two years of gradually slowing demand.

The twice-yearly survey, conducted between 19 February and 11 March 2009, revealed that while 9% of firms increased the amount of space they occupied in the last six months, 26% reduced it, giving a balance of -17%.

The survey also showed a sharper fall expected in property over the next six months (a balance of -25%), reflecting widespread cuts planned to both output and headcount.

Extraction, chemicals & utilities, construction and transport firms saw the steepest falls in the past six months. The sharpest declines in the next six months will be in finance, business services and manufacturing, reflecting trends in the broader economy.

Cost reduction and cash flow were the most important issues affecting property decisions, as business expansion slipped down the agenda.

Firms were again asked about the impact of the credit squeeze and the slowing economy on their business. This time, access to credit was having an effect on 88% and the economy on 98%, an increase from 80% last time for both measures.

CBI Access to Finance Survey:

May: 2009

According to the latest CBI Access to Finance survey, access to finance remained a serious problem for businesses, but the rate of deterioration in credit conditions slowed further over the past three months, and conditions were expected to stabilise in the months ahead.

Responding to the CBI's latest Access to Finance Survey, businesses were less negative than they were in March about the supply of new and existing credit.

Asked about the availability of new credit lines over the past three months, a net 20% reported that the situation had deteriorated. While this indicates that supply remains tight, conditions have eased since March (-36%) and January (-62%). For existing credit lines, the balance was -10%, compared with -16% in March.

The easing of conditions for new credit supply was expected to continue. Only a net 7% of firms see a further fall in new credit supply over the next three months. Meanwhile, no further worsening was anticipated for existing credit supply. 10% of firms expected the situation to improve, and another 10% expect it to deteriorate, giving a balance of zero per cent, which indicates that conditions for existing credit will be stabilising.

UK Economic Statistics

12mth% unless otherwise stated	2007	2008	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1
GROWTH									
Real GDP	3.1	0.7	3.1	3.1	2.6	1.8	0.4	-2.0	-4.2
Household consumption	3.1	1.4	3.6	3.7	3.5	2.1	0.7	-0.8	-2.7
Government consumption	1.5	3.4	1.7	1.5	2.6	3.4	3.3	4.4	3.5
Fixed investment	6.8	-3.1	4.6	4.4	-0.2	-0.4	-3.5	-8.0	-8.3
of which: Manufacturing	5.9	-3.6	3.8	7.0	-2.3	-0.1	1.4	-5.7	-8.4
Household savings ratio (%)	2.2	2.0	2.2	1.6	-1.2	2.3	1.7	4.8	NA
PUBLIC SECTOR									
Net borrowing (£bn)	33.7	65.1	6.9	15.1	-1.1	21.6	13.6	31.0	20.5
Current balance (£bn)	-8.0	-30.0	-1.5	-8.9	16.8	-17.0	-7.1	-22.6	-2.7
EXTERNAL TRADE									
Visible trade balance (£bn)	-89.8	-92.9	-23.8	-24.0	-23.7	-23.4	-23.5	-22.3	-20.8
Current account (£bn)	-40.3	-24.5	-12.7	-5.9	-3.3	-5.4	-8.2	-7.6	NA
COSTS & PRICES									
CPI	2.3	3.6	4.1	3.1	3.0	3.2	2.9	2.3	NA
RPI	4.3	4.0	3.0	0.9	0.1	0.0	-0.4	-1.2	NA
RPIX	3.2	4.3	3.9	2.8	2.4	2.5	2.2	1.7	NA
Producer prices - input	3.0	21.6	8.1	3.2	1.7	0.7	-0.5	-5.8	-9.4
- output	2.5	7.3	5.0	4.6	3.5	3.0	2.0	1.3	-0.3
Manufacturing unit wage costs	0.0	2.7	7.6	8.2	11.1	10.2	8.2	NA	NA
Average earnings*- whole economy	3.8	3.7	3.1	3.0	1.7	0.2	-0.4	NA	NA
- manufacturing	3.5	3.0	2.7	2.3	1.9	1.4	1.0	NA	NA
- services	3.9	4.0	3.3	3.4	1.8	0.1	-0.7	NA	NA
Halifax house price index	9.4	-7.9	-14.9	-16.2	-17.2	-17.7	-17.5	-17.7	-16.3
* 3m average									
BUSINESS SECTOR									
Industrial production	0.1	-2.6	-6.9	-9.4	-11.4	-12.5	-12.4	NA	NA
Manufacturing output	0.2	-2.5	-7.4	-10.2	-12.8	-13.8	-12.9	NA	NA
Purchasing managers' - services index	56.3	47.6	40.1	40.2	42.5	43.2	45.5	48.7	51.7
- manuf.	54.4	45.0	34.4	34.9	35.8	34.7	39.5	43.1	45.4
HOUSEHOLD SECTOR									
Retail sales volumes	4.2	2.6	0.9	3.1	2.7	-1.3	1.0	2.7	NA
Consumer credit (£bn)	221.0	233.1	233.6	233.1	232.8	232.4	231.9	231.9	NA
Mortgage borrowing (£mn)	108437	40345	803	1858	986	1431.0	640.0	973	NA
Gfk consumer confidence	-7	-29	-35	-33	-37	-35	-30	-27	-27
LABOUR MARKET									
Unemployment (ILO, mn)	1.65	1.78	1.92	1.97	2.03	2.10	2.22	NA	NA
Unemployment rate (%)	5.3	5.7	6.1	6.3	6.5	6.7	7.1	NA	NA
Employment (mn)	29.22	29.44	29.39	29.36	29.38	29.27	29.20	NA	NA

Further information

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The CBI economics website is available at: www.cbi.org.uk/economics

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Publications & services

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