

DANGEROUS TIMES

During its first meeting of 2009, the Bank of England pushed the bank rate down to 1.5%, the lowest level ever recorded in its long history. Ironically, this further cut was, according to some, not deep enough to restore health in the lending activity, with credit condition surveys showing a further tightening of credit supply over the last months of 2008 and the dreadful data for the industrial production encouraging a very aggressive approach. On the other hand, simply lowering the policy rate is not enough anymore. 2009 will be the year of quantitative and qualitative easing.

Difficult times for the Old Lady

Over the last decade, the independence of a central bank was considered the sancta sanctorum of the whole economic theory built over the post-Keynesian era. Yet, even the ultimate bastion of what was considered sound economic governance is today questioned. Independence of the bank, deemed as a necessary condition for the pursuit of price stability and for avoiding the short-sightedness of the political cycle, seems to succumb to the extraordinary measures that the bank will be forced to take. Measures that, with the spreads of private debt instruments over the expected average future policy rate (as measured by the OIS rate) still high, will consist in decreasing the cost of private borrowing by targeting the liquidity risk premia and credit risk premia that this instruments incorporate, hence massively engaging in quantitative easing (increase in the size of the balance sheet of the bank holding constant the average liquidity and riskiness of its asset portfolio) and qualitative easing (shift in the composition of the assets of the central bank towards less liquid and riskier assets). Unfortunately, as it was made clear by the Chancellor of the Exchequer in recent weeks, with quantitative and qualitative easing being adopted (as it is even more patent from January 20, see table on the left) the Treasury and the BoE will have to work "hand-in-hand", alias the central bank will have to give out its substantive operational independence in order to preserve its inflation mandate, should a massive loss on its eventual exposure on private securities require a non-inflationary rescue by the Treasury, or in other words, a recapitalisation of the central bank financed through tax-payers money. The Treasury will definitely have the final word on the types of private securities the bank will purchase and, as a consequence, it will directly affect the yield curves of these products on the market.

Nonetheless, the reduced autonomy of the central bank in conducting its operations (and the dangers that causes for the long-term independence of monetary policy) sounds a minor sacrifice when the risk of a great depression materializes, as it is the case today. The latest economic indicators and survey data speak loud: even the sharp downward correction in economic forecasts made in the Inflation Report of November didn't grasp the magnitude of a recession which will be astoundingly deep and it will probably last till the last months of 2009. After a further contraction over Q4 (-1.5%), we expect GDP growth to linger -2.5% in 2009. The contraction would be even stronger without the incentives to private consumption coming from the fiscal boost (including the cut in the VAT rate) and the sharp decrease in the bank rate, providing some respite to mortgagors and passed, although very slowly, to final customers.

We estimate that the budgetary and monetary measures taken reduce the contraction up to half percentage point in 2009 but we also recognize that the fiscal boost provided by the government is quite short-lived. On the other hand, if monetary policy is not extremely aggressive and lending picks up again, corporate defaults will multiply, unemployment rate, at 6.1% in December, will explode, the rapid fall in inflation (at 3.1% in December, while still at 5.2% in September) might easily assume deflationary traits and the recession could potentially assume monstrous shapes.

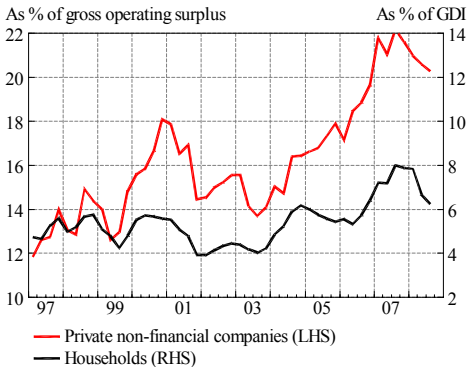
Internal demand will continue to deteriorate

If we exclude public consumption and investment, all the main components of internal demand will be in negative territories for most of 2009, with private consumption further

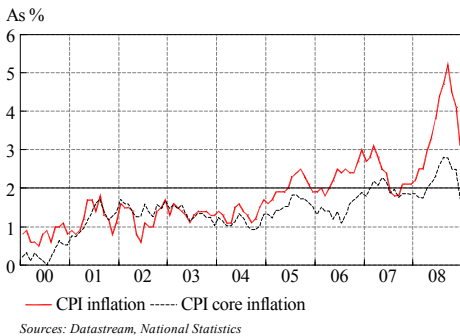
QUALITATIVE EASING : MAJOR MEASURES

BoE's direct purchase of up to £50 bn of high quality private sector assets
Credit guarantee scheme on banks' funding extended until the end of 2009
Creation of a guarantee scheme for ABS of both mortgages and corporate and consumer debt.
Insurance for risky debt held by banks, these former still liable for 10% of the eventual losses on the value of the assets

U-TURN IN DEBT-SERVICING COSTS



CORE INFLATION ALREADY BELOW THE 2% THRESHOLD



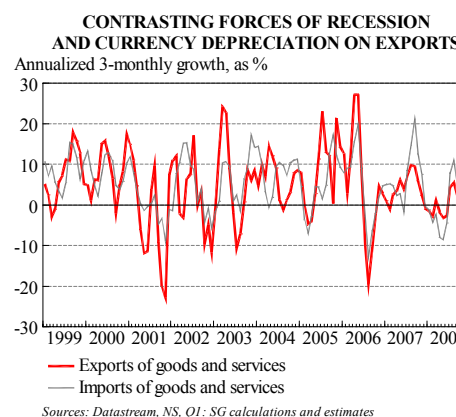
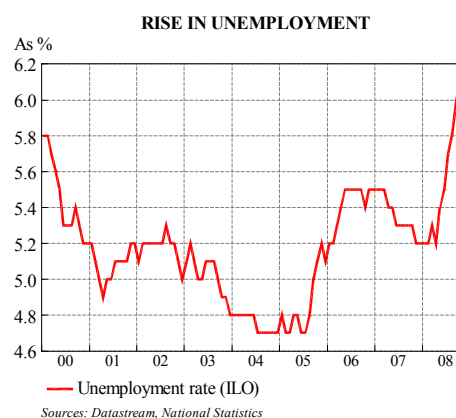
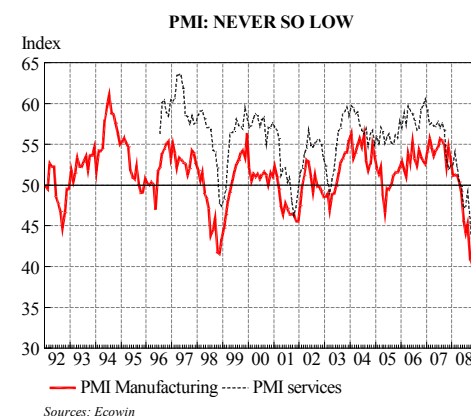
contracting over at least the first half of the year, and investment receding throughout the manufacturing sector. As far as private consumption is concerned we expect it to contract of approximately 1% over 2009, with the steepest fall in the first semester and a very slow recovery over the second part of the year. Dwellings investment is also bound to further contract in 2009, if we compound the effect of the 48% decrease in housing starts by private developers and housing associations in the third quarter of 2008 and the usual lag in the construction cycle which will translate this drop over the first semester of the year. We forecast a significant contraction of more than 20% in annualised terms over the first quarter of 2009 followed by further contractions during Q2 and Q3.

More controversial is the outlook for the productive investments, with the latest data on industrial production pointing towards a sharper fall than expected. The ONS data showed that industrial production dropped by 2.7% in the three months to November, versus a 1.3% fall in the previous three months, with the manufacturing component particularly depressed (-3.3% in the three months to November). These numbers are sadly consistent with reports of an increasing numbers of small and medium enterprises shutting down or laying off workers, and the situation cannot but worsen if credit does not start to flow again towards businesses that, albeit viable, are getting short of working capital. We expect productive investment not to pick up again before 2010, contracting over the first three quarters of 2009 and stagnating over the fourth. This in turn will further exacerbate the gloomy outlook in the labour market, with unemployment rate, still at 5.6% in 2008, likely to reach 7.5% in 2009 and 2010. This will further squeeze the tight wallets of British households, whose access to credit is still blocked. Total lending to individuals in November was still at very subdued levels (£1.5bn), with the twelve-month growth rate slowing further to 4.1%. With the "secured on dwelling" component also resorting below the six-month average (0.7bn vs 1.9bn), house prices will continue to fall throughout 2009 and MEW will stay constantly negative.

External demand will fall short to support growth

Net trade contribution, while positively affected by the major devaluation of the pounds against the currencies of its main trading partners over the second semester of 2008, will be less significant than in normal times, due to the virtually universal recessionary trends in Europe and the United States. For this reason, we expect a smaller impact than the one envisaged by the rule of thumb used by the MPC over normal times, according to which a 1pp fall in Sterling has similar effect on output as a 0.25pp cut in interest rate. The loss of almost one third of its value, would not make the weaker pound to account as much as a rate cut of 7pp, as it can already be noticed in the negative data on net trade contribution over the third quarter of 2008. We expect a positive contribution over the coming months, but again, no major movement capable to support growth. Furthermore, we expect the situation to reverse during the second half of the year, with a weaker euro bringing to an end the devaluation effect enjoyed by the pound sterling and with the economies of UK's main trading partners still contracting.

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As %	2005	2006	2006	2008(f)	2009(f)
Real GDP	2.1	3.2	3.0	0.7	-2.5
Consumer prices (CPI)	2.0	2.3	2.3	3.6	0.8
Unemployment rate (ILO)	4.8	5.4	5.4	5.6	7.5
Current acc. bal. (% GDP)	-2.6	-3.4	-2.8	-1.8	-2.1
Public sector bal. (% GDP)*	-2.9	-2.3	-2.5	-5.0	-5.6

* fiscal year

	04/02/09	Mar. 09	June 09	Sept. 09	Dec. 09
3-month EuroGBP	2.16	1.15	0.95	0.80	0.95
10-year gilts	3.97	3.90	4.00	4.10	4.10
EUR/GBP	0.89	0.97	0.96	0.94	0.92
GBP/USD	1.44	1.29	1.30	1.38	1.41

WORTH WATCHING

Inflation. The temporary 2.5pp cut in the VAT has already played a part in reducing the inflation rate, although the 1.3% reduction estimated by the ONS seems to us too optimistic, with December's CPI at 3.1%. What is really bringing inflation down is the sharp fall in commodities prices and the sharp and rapid deterioration in the economic outlook. The medium term outlook for inflation is nonetheless particularly uncertain. An extremely volatile oil price, together with the uncertain future for gas supplies, might create a second u-turn. The end of the cut in the VAT rate will also contribute to make inflation at the beginning of 2010 to marginally increase. On the other hand recession might be deeper and more prolonged than in the central scenario and the risk of deflation is not negligible.

UNITED KINGDOM

% Change at annual rate, 2003 prices	2006	2007	2008(f)	2009(f)	2008 Q3	2008 Q4(f)	2009 Q1(f)	2009 Q2(f)
Private consumption	2.1	3.1	1.8	-1.9	-0.6	-1.2	-1.1	-0.1
Public spending *	1.7	1.9	4.3	3.9	3.1	-0.9	6.4	6.1
Housing investment	11.2	2.5	-21.2	-22.8	-32.8	-33.0	-20.0	-20.0
Business investment *	4.3	9.9	-0.2	-8.4	-5.2	-16.0	-12.0	-8.0
Total investment	6.0	7.2	-4.4	-9.7	-10.9	-17.2	-11.1	-8.6
Contrib. of inventories to GDP growth	0.0	0.2	-0.3	-0.2	-0.2	-1.3	-0.2	0.0
Domestic demand (incl. inventories)	2.6	3.6	0.7	-2.3	-1.7	-5.3	-1.3	-4.6
Exports of goods and services **	7.6	2.0	1.3	0.7	1.8	1.0	1.2	0.8
Imports of goods and services **	6.9	3.8	1.4	1.2	4.2	2.4	0.7	0.8
External trade contribution	0.0	-0.7	-0.1	-0.2	-0.9	-0.5	0.1	0.0
Gross Domestic Product (GDP)	2.8	3.0	0.7	-2.5	-2.6	-5.9	-1.2	-4.8
% change year-on-year	3.2	3.0	-1.8	-1.0	0.3	-1.8	-2.4	-3.6
Consumer prices (CPI)	2.3	2.3	3.6	0.8				
% change year-on-year, end of period	3.0	2.1	3.1	1.3				
Productivity per head	2.0	2.3	0.3	0.2				
Compensation per head	3.7	4.1	2.7	1.3				
Unit wage costs	1.7	1.8	2.5	2.3				
Employment	0.9	0.7	0.7	-0.9				
Unemployment rate	2.9	2.7	3.1	5.9				
Unemployment rate (ILO)	5.4	5.4	5.6	7.5				
Real Disposable income	1.5	0.0	2.0	7.0				
Household saving rate	4.2	2.2	1.7	9.4				

* Data excluding transfer of nuclear reactors from British Nuclear Fuels plc (BNFL) to the Nuclear Decommissioning Authority (NDA).

** Excluding trade associated with MTIC fraud

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