Paul Robinson +44 (0)20 7773 0903 paul.robinson3@barcap.com

Sterling event conference

OPERATOR:

Good morning, ladies and gentlemen, and welcome to the Sterling event conference call. My name is Steffi and I will be your coordinator for today's conference. For the duration of the call you will be on listen only. However, at the end of the call you will have the opportunity to ask questions. If at any time you need assistance on the call, please press star, zero on your telephone keypad and you will be connected to an operator. I am now handing you over to the host of today's conference, Mr Paul Robinson.

PAUL ROBINSON:

Thank you, Steffie. Good morning, everyone, and Happy New Year. I hope the holiday season was very good for you. Unfortunately, everyone around the world though seems to be getting more worried about prospects for global economies and in particular, prospects for the UK economy. So what I thought I'd do today is to discuss a bit where we think the UK is going. But also try to think about where the Euro area and the United States, our two major trading partners' economies are going. We always time these conference calls just before the MPC do their decision and, as last month, I think this is a very closely balanced call and I'm going to try to explain to you some of the reasons why I think the MPC might be tempted to decrease rates, but also why they might be somewhat nervous about decreasing them. And then I'm going to talk about the other central banks around the world, in particular the Federal Reserve in the US and the European Central Bank. And then, finally, talk a bit about the implications we see for exchange rates.

I think it's worth actually starting with exchange rates because I think it highlights quite what an important time we've been having over the last couple of months. Now, at the November Inflation Report press conference which the governor of the Bank of England holds each quarter when the Bank of England releases the Inflation Report, he said that if we want to look for a currency that is stable in trade weighted terms you couldn't do any better than look at Sterling. Since then, however, Sterling has depreciated really very strongly. It's depreciated by about 6.5% against the US Dollar, and by about 7% against the Euro. Now, in historical terms these are big moves, in particular the fall against the Euro is really very sharp indeed, and it's brought the Sterling-Euro rate to its lowest level for 11 years. Now, 11 years might not sound a long time, but bear in mind this is before the MPC was set up. It was in the day when the Bundesbank controlled European exchange rate policy and interest rate policy. There was, indeed, no such thing as the Euro in those days. So it has been, historically, a very important move against the Euro, and I think it demonstrates the extent to which worries about the UK economy and prospects for the UK have increased over the past couple of months. So what I thought I'd do is to start off and try to tell you what I think is going on in the UK and, therefore, what is likely to happen over the coming months and years.

We've actually had a couple of pieces of data which I think quite nicely frame the debate this morning. The first is that the British Retail Consortium published their retail sales monitor for December. This is the first formal data we have on how well the retail sector did over Christmas, and they suggest that really the Christmas period was not very good news at all for retailers. They had 2.3% year on year growth of retail sales. Now, that's in nominal terms so it doesn't take inflation into account, but that's markedly weaker than it has been for some time. And if you account for the amount of floor space available, which they do, growth falls to 0.3% year on year, so really very weak, weaker than the market was expecting. That's consistent with the growth of household sector consumption over Christmas being less than has been the case in previous years. We've also had some data on the housing market, the poor, beleaguered UK housing market, from HBOS, and their index actually shows an increase month of month of about 1.3% which is, in contrast to the retail numbers, stronger than the market was expecting. That said, house prices data are very volatile at the moment. As I've talked about before, it's a difficult series to actually construct reliably so the

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way we like to think about it is not just to use the HBOS numbers, but to combine them with those produced by the Nationwide, who also have a house price series, and use the three-month on three-month growth rate, and that still shows negative numbers. So even though the HBOS number was pretty strong this morning, we still think that house prices are falling in the country as a whole and the housing market continues to look pretty worrying.

So this is negative. These are bad numbers, really. There's a lot of cause for concern. But before we start getting too worried, I would like to stress one thing and that is that a lot of the indicators are still suggesting that the UK economy is growing. So, for example, the Chartered Institute of Purchasing and Supply – CIPS - produces an index which is widely looked at, and in particular by the MPC. What they do is ask purchasing managers about how much activity is going on in their industry. And their latest data suggests that both the manufacturing and the service sectors are still growing, albeit at a slower rate of growth than had been the case earlier in 2007. The way the numbers work is 50 is just zero growth. Zero's just complete depression. 100 I guess suggests spectacular boom times. So the numbers tend to hover in the 40 to 60 range, and at the minute the manufacturing numbers are close to 53. Service is a bit weaker at 52.4. The surveys suggest growth, albeit relatively muted growth, but growth in the UK economy.

However, as I said, people are becoming more pessimistic and it's easy to find reasons why they're becoming pessimistic about growth. I think the single most important, long-term reason behind this is that UK consumption needed to slow. Now, we've been consuming more quickly than GDP has been growing, than the whole economy has been growing, for some decades, and this has allowed consumption as a portion of total income in the economy to increase over time quite markedly. This cannot persist indefinitely. Indeed, there's some evidence that consumption is too strong relative to the amount the UK is producing, and I'd point to two numbers on that. The first is we have a current account deficit that has been increasing recently, and the latest numbers from the Office for National Statistics suggest that the current account deficit was actually close to 6% of GDP in the third quarter. Now, that is too large. In the long run that is just simply not sustainable. The current account deficit needs to narrow and that is going to require a greater amount of saving by the UK economy in general, and by the household sector in particular. A linked way of thinking about this is the savings ratio of the household sector which has been hovering somewhere between 2% and 4% in recent quarters. Again, in historical terms this is a very low savings rate. So over the next few years the household sector is likely to start saving more and spending less. And part of the reason why that may already be happening is interest rates facing the household sector have increased and the availability of credit, which has been pretty available over the past few years, has become somewhat tighter.

Now, you know, as we've been talking about for some months: as everyone in the newspapers, on the television, has been talking about, this is the "credit crunch." I think it's worth thinking about what exactly a credit crunch is. A credit crunch does not mean that the the price of credit is tightening. Over the past few years the cost of credit has probably been somewhat too cheap and that's encouraged people to go on something of a spending spree. What a credit crunch really means is when people who would be able to pay back any debts they have can't find credit. The availability of credit shrinks, even relative to the price, and there's not a massive amount of evidence that things are getting that serious yet. That said, things have definitely tightened.

The Bank of England has a survey of credit position which is published each quarter. The previous quarter suggested that, perhaps somewhat surprisingly, credit for household sector wasn't expected by banks to get any worse in Q4, but credit was expected to become somewhat tighter to the corporate sector. The latest numbers, which have just been published by the Bank of England, now suggest that credit has been tightened quite markedly for the household sector and for the corporate sector, and that this is going to become yet tighter. So even though the Bank of England cut interest rates by 25 basis points in their last meeting in December, the effective interest rates facing the UK economy have probably increased. Put that together with the fact that consumption is slowing, as suggested by the British Retail Consortium numbers this morning, plus suggested by lots of other evidence as well, eg house prices remain very weak, as I was saying earlier, consumption is likely to slow over the next couple of years. You might think that it's a no-brainer.: the Bank of England surely needs to cut interest rates when the MPC meets, and perhaps by more than 25 basis points. For example, Kevin Hawkins, the Director General of the British Retail Consortium, this morning suggested the interest rates should be cut by 50 basis points. And two of the members of the shadow MPC, over the weekend, also suggested the interest rate should be cut by 50 basis points.

However, I think it's worth bearing in mind that it's not all downside in terms of news for interest rates, and on the upside, unfortunately, it's not stronger growth, but stronger inflation. Now, the key for this stronger inflation is really

commodities prices, and in particular oil prices which have now reached the magical and psychologically important level of around $100 a barrel, and this, I think, has led global market commentators to become worried that we could be entering into a period of stagflation. Now, the most famous recent example of stagflation was in the 1970s when OPEC tripled the price of oil and the West - the US and Europe - went into quite a sharp depression. At the same time, inflation increased very sharply. So in the UK, for example, we had inflation rates of over 20%, at the same time as we were in a recession. To the economics world this was a real shock because conventional Keynesian analysis suggests a trade-off between inflation and growth, and that trade-off simply did not occur in the 1970s. This led to a very important change in the way that policy is conducted in many countries, but in particular in the UK. And if people are interested in this, which I think is a very interesting subject, I'd be very happy to talk a bit about it, if you want to ask a question. However, now is not like the 1970s. The oil price has increased sharply, true. But nonetheless, the UK and other economies are much better equipped to deal with higher oil prices. We also, I like to think, have sorted out the way we conduct macro economic policy to a much greater extent. So despite the high oil prices, I think the prospects are much brighter than they were in the mid 1970s. Although that is not saying a huge amount.

In addition to the oil price increase we've had the Sterling weakness that I was mentioning earlier, which means that all our imported prices have become more expensive, including oil. So whereas in the earlier months the higher oil price was offset to some extent for us because Sterling was depreciating against the Dollar, now this is going into reverse so we have a double whammy, as it were. Higher oil prices in Dollar terms and even higher oil prices for Sterling terms.

Okay. So we have a bit of a problem. We have weaker growth and higher inflation concerns. What's going to happen to interest rates in the face of this? If I was on the MPC, and I should point out that, rather bizarrely, the Chancellor of the Exchequer hasn't asked me to be on the MPC, but if I were on the MPC I would vote for an interest rate cut. The reason for that is that I think that inflation concerns matter in the short-run, but the interest rates are set with 2009 and even 2010 in mind - rates take a while to affect the economy. And I think the downside pressures on growth and the increases in effective interest rates facing the both the household and corporate sectors because of the credit squeeze, mean that there's scope to cut interest rates without leading to big inflation problems in those years. That said, I don't think it's a done deal by any means. On balance, economists seem to think that the MPC are likely to cut by 25 basis points, but as I say, it's a close call.

Now, in terms of what's going to happen to Sterling and what's going to happen going forward, what really matters I think is what's happening in our main trading partners' economies. The UK remains an open economy. External trade really matters for our overall output, and this is likely to be particularly true over the next couple of years if, as I was arguing earlier, consumption growth slows.

So I think it's worth briefly considering what is happening in the US and the Euro area. First, the US. Now, people have been worried about the US economy for the best part of a year now, in fact, perhaps slightly longer, and the main reason for this is that the housing market bubble in the US burst maybe about 15, 18 months ago. This led to very weak growth in the US economy over last winter, but actually over the summer months and the middle of the year, the US economy grew pretty quickly. Nonetheless people were worried about the US economy, and this was part of the reason for the credit market issues in the summer. This has led the Federal Reserve to cut interest rates in the US by one percentage point; there was actually little evidence that the overall economy had been slowing. What people were concerned about of course was the economy would slow. Now, however, we have got some more evidence of a slowdown in the US, in particular the manufacturing sector seems to have started slow over the winter, and the unemployment rate, which is obviously very important, has spiked up to about 5%. This is low compared with, for example, the 1970's period I was discussing earlier, but nonetheless, this is a reasonably marked increase. Inflationary pressures, especially from oil, are also threatening the US economy, not just the UK economy. They're probably more vulnerable to higher oil prices as we are. But the way the Federal Reserve in the US respond to higher oil prices is by looking more at their effect on disposable income and less on inflation in the US economy. So while oil prices increased overall inflation they probably decreased inflation goods and services in the rest of the economy and this, in the market's view, is going to dominate. So what they expect is that the Fed carries on cutting interest rates - a view with which we agree. Our US economics team has actually just changed the US interest mix more, so we now have 50 basis points, a half percent, cut in US interest rates in their next meeting, followed by another 25 basis point cut in the following one. This will lower interest rates in the US 3.5%.

I think the Euro area is even more interesting than the US because the conventional wisdom in the market is that the European Central Bank are not likely to cut interest rates in the foreseeable future. They expect interest rates to be on hold in the Euro area for the next year, essentially because higher inflation pressures, because of oil prices, commodity prices broadly speaking, are offset by the weaker global growth, and some weaker growth in the Euro area itself. Now, in my opinion, the market is slightly mispriced. Euro area interest rates are lower than those in the UK and the US. But I think that if the US goes into a recession, if the UK slows sharply, then the negative effect in the Euro area economy will force the European Central Bank to cut interest rates in much the same way as, in our view, would be the case with the Bank of England. So while you might have upside inflation risk in the short-term, we think growth would lead to downside inflation risks further out next year and the following year, and that that would be enough to force the European Central Bank to cut rates. So while inflation does remain a concern in the Euro area, I think that the market is placing too little weight on the slowing activity that is becoming more evident in the Euro area numbers. For example, the purchasing manager indices for Euro area manufacturing sector have slowed pretty much across the board in Europe in all of the major economies. I think the evidence is definitely there that the Euro area is slowing.

Okay. Let's pull that together a bit and think about the exchange rate consequences. The UK is slowing. Everyone expects interest rates to be cut. It's a bit unclear whether they're likely to be cut this week or if the Bank of England is likely to wait longer. We think that, overall, UK interest rates are likely to be cut sooner rather than later. For the US, everybody expects cuts and the likelihood of a 50 basis point cut increased recently. It'd be a major surprise if they didn't cut. In the Euro area growth is also slowing, but at the minute people do not expect interest rate cuts. We think there's a risk that they'll be proved wrong in the months to come. What can happen to Sterling which, as I started off by saying, has depreciated really very sharply recently, more quickly than we expected - and we had been expecting depreciation of Sterling? Well, in my opinion, against the Euro Sterling's done most of its depreciation. We think it could potentially go a bit further because if the Bank of England do cut interest rates slightly more quickly than the market expects, they might be expected to cut further than the market currently thinks. In other words, market expectations might fall a bit, but I don't think it's going to go very much further. So I think that Euro-Sterling moving from 1.31, 1.32 is likely to be the trough. That said, I don't expect any sharp appreciation of Sterling in the short term. The UK economy remains too precarious for that to occur. Against the Dollar Sterling has also depreciated fairly sharply recently, and it seems to be somewhat overvalued against the Dollar still. So I think there's downside risk to Sterling against the Dollar and our forecast has cable, as we call it: sterling against the Dollar, moving down to around 1.91 later this year, and it's likely to remain in the low 1.90s. And I think here there's a risk that it could go further, that it could fall into the 1.80s against the Dollar over the course of this year. So overall we expect further Sterling depreciation, more likely against the Dollar than the Euro, but we don't expect as rapid depreciation as has been over the last couple of months. That was all I was going to say. As ever, I'm very happy to answer any of your questions that you might have. Thank you very much.

OPERATOR:

Thank you. Ladies and gentlemen, if you do wish ask to any questions, please press seven on your telephone keypad. If you change your mind and would like to withdraw your question, please press seven again. You will be advised then to ask your question. The first question comes through from the line of Steve Dickson. Please go ahead.

STEVE DICKSON:

Paul, thanks for the briefing. I found it quite interesting talking to American colleagues through the summer and the fall period; they've been suggesting a risk of Pound Sterling at a rate of about 1.75. Do you have any comment on that?

PAUL ROBINSON:

I'm not sure what horizon they were talking about, so come back to me on that. I think that in the longer run it is possible because, as I was saying earlier, I think that Sterling is somewhat overvalued, certainly if you compare the relative price level of the UK and the US. That said, I don't think that Sterling is likely to fall down to 1.75 in the next year or so for a couple of reasons. First, because the US economy remains pretty precariously placed and we could easily have a US recession. In that case, I don't think that the Dollar's going to appreciate by that much. And the second reason is that there's a lot of people in the world as a whole who are holding Dollars, who will probably sell Dollars if the Dollar values a bit. In particular we have the sovereign wealth funds. I don't know if you've come across

them. They're essentially national government banks who set up agencies in order to manage their portfolios of assets. These portfolios of assets are absolutely gigantic. So the Chinese government, for example, hold something like 1.5 trillion Dollars worth of US debt, US government debt. Now, what they need to do is diversify away from the Dollar over time and what they're likely to do is, if the Dollar appreciates a bit, sell Dollars because they don't want to lose too much. And this is going to provide a kind of automatic stabiliser for the Dollar and, therefore, I think it's going to make very sharp Dollar appreciation against any currency somewhat less likely. So if you ask me, will the Sterling get to 1.75 at some point over the next years, I'd say, yeah, there's a reasonably good chance that will happen. Over the next year I think it is unlikely.

STEVE DICKSON:

Okay. Thanks very much for that answer.

OPERATOR:

Thank you. The next question comes through from the line of Prasanna Thombre from Barclays. Please go ahead.

PRASANNA THOMBRE:

Hi, Paul. I wanted to know if the UK economy will respond only through monitored stimulus rate cut, or you think there could be any fiscal leeway that government may have to pump prime the economy. Thank you.

PAUL ROBINSON:

That's a good question. I think it's worth thinking about what happened in the beginning of the decade actually on this point. After the dot.com bubble burst in the US, the US economy slowed very sharply and that led to more generally global growth slowing. The Euro area slowed as well and it did have a negative effect on the UK economy, but at that time government consumption was really strong. Government consumption growth, or fiscal policy, supported what was otherwise likely to be a fairly sharp slowdown of the UK economy, and what it ended up with was that the UK did slow down a bit, but nothing very major at all. At the minute, though, we have a government which is more constrained in what it can do and the reason it's constrained is because of its own rules. So when the labour government came to power in 1997, what they tried to do was to change the way that macro economic policy was made to make it more credible. But the way they did that was they tied their hands, to some extent. They tied their hands in monetary policy by giving the Bank of England operational independence, and they tied their hands in fiscal policy by instituting the golden rule which said that they can only borrow to invest over the business cycle as a whole, and by having restrictions on the debt to GDP ratio. Now, the problem is that over recent years the golden rule looks in danger of being breached, and the debt to GDP ratio has increased somewhat. This, if they stick by their rules, means that they're going to be much less able to have a stimulatory fiscal policy over the next couple of years. Now, we have no evidence whatsoever to suggest that they're not going to stick by their rules, and obviously politicians are in the business of doing what's right for the economy generally. So the rules are made for the economy to work well, not for it to all work badly, so they might relax the rules to a certain extent. Nonetheless, I think that the ability of fiscal policy to support the UK is somewhat limited at the minute. That probably isn't true with the US where George Bush has been talking about having a similar true package, and he might come to this when he gives the state of the union address later this month.

PRASANNA THOMBRE:

Thank you.

PAUL ROBINSON:

[unclear]

OPERATOR:

Thank you. The next question comes through from the line of Ishai Novick from Fast Crop Plc. Please go ahead.

ISHAI NOVICK:

Thank you, Paul, for the briefing. A couple of questions, one on the commodity prices over a one to three-year cycle. Do you see oil prices continuing to rise, or do you see the slowdown in the global economy and a combination of

global political events producing prices to drop down to the rates they were three to four years ago? And secondly, what are your predictions over the UK housing market?

PAUL ROBINSON:

Okay. On oil prices, the main reason I think the oil prices and, come to that, overall commodity prices have increased is a combination of very strong demand, particularly from Asia, and also somewhat limited supply. And that, most of that limited supply is from the non-OPEC oil producers - such as the UK, for example. Now, I think this is going to limit the amount to which oil prices are going to fall back. Our commodity analysts think the oil price might go a bit higher, not much higher and we certainly won't have oil price inflation that we've seen over the last couple of years, but we don't think it's very likely at all, that the oil price is going to fall back to the [unclear]. In terms of political events, this is very difficult to know. I think that some of the increase in oil prices is probably linked to politics, but as I was suggesting earlier, I think it's not that much. I think more of it is because of global demand. So I think that if the world economy slows sharply, oil prices are likely to fall to an extent, but only to an extent. Whereas if the world economy carries on growing reasonably strongly, and bear in mind that most of the growth in the world economy now is coming from Asia rather than from the US or from Europe, the oil prices are likely to remain pretty high. So summarising; I don't think they're going to carry on growing very quickly, but I don't think they're likely to fall back much either. That's particularly true of oil prices. Commodity prices more generally: again, I think they're likely to remain pretty high, but there might be some cyclical fallback, especially in base metal prices. But bottom line, they're going to remain pretty same.

In terms of the housing market, this is a very important question, but it's very difficult to know for sure. Our main forecast is that house price inflation is going to be negative, but not a complete crash over the year ahead. So we could see 5% year on year decline in house prices, but we're unlikely to see 15% or 20% decline. And some people are talking about house prices falling by 40%, we definitely don't think that's very likely. Some of the house price inflation that we've seen over the past couple of years probably does have a bubble element, and that's particularly true in the buy to let market where what you saw was the rental yield on newly-purchased properties falling very sharply. And the only way that really made sense was prospective buyers thought they were going to get capital gains, and that's a kind of bubble situation. But most of the house price rises we think has come from increased [unclear] population of the UK in response to relatively limited increases in supply. So what I think you'll see over the next couple of years is higher rents and lower house prices, to an extent, but not a huge crash. I hope that answers the question.

ISHAI NOVICK:

Thank you.

OPERATOR:

Thank you. The next question comes through from the line of Michael Flak from Wagner Spraytech. Please go ahead.

MICHAEL FLAK:

Yeah. Hello, Paul. Thanks for the briefing. It's the first time that I join this briefing. You mentioned that the risk for the Sterling to the Euro is at 1.31, 1.32 and as I buy all my goods in Euros I, it's important for me to have a kind of forecast what are the risks and the positive potentials. Do you see any positive potential that the Pound will then get back some strength against the Euro or not in the next few months?

PAUL ROBINSON:

It's certainly not our central projection. As I said, I think that we don't see a big upside to the Sterling. In fact, if anything, it's more downside, but there are ways that it could happen. One way it could happen is if the MPC and the UK decide that the inflationary risks are more important than we currently think they think (if that makes sense). There are upside inflation risks, higher oil prices, higher commodity prices more generally, Sterling is decreasing. So it is possible that the MPC hold back fast rate cuts and that would, I think, definitely support Sterling. So I'd say that was a risk rather than our central view. There's also the opposite case which is that the European Central Bank could cut interest rates more quickly than we're currently thinking. We do see a risk that the ECB will cut, and that risk could materialise as early as the second quarter this year. In our view, if that happens, then that would support

Sterling against the Euro because it would suppress the Euro. Do I think that Sterling has reached the levels that it reached against the Euro last year? Probably not this year. But is there a risk that Sterling could appreciate against the Euro? I think there is a risk but not my main exectation.

MICHAEL FLAK:

Yeah. Okay. Thank you very much, Paul.

OPERATOR:

Thank you. We've got no further questions in queue. Just a reminder, if you do wish to ask a question, please press seven on your telephone keypad now. We've got no further questions coming through, so I'll hand over to the host to conclude today's conference.

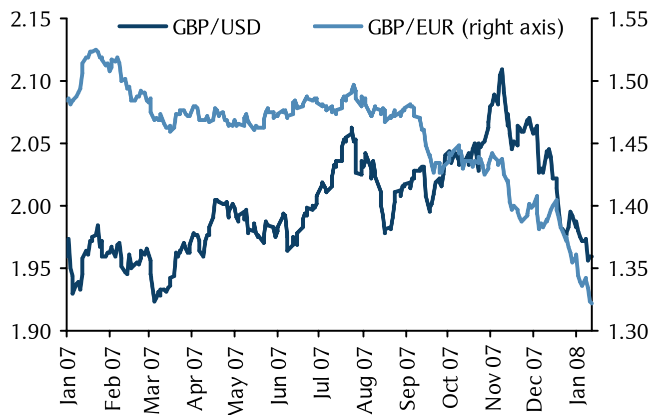
PAUL ROBINSON:

Okay. Well, thank you very much for dialling in, for listening, and for those of you who asked questions, for asking the question. As ever, we're going to produce a transcript of this and I'll add some charts illustrating some of the series I was talking about in this call. I think they say a picture tells a thousand words and I think that ours are very useful in this context. And, as ever, if you do have questions, do feel free to get in touch with us. I'm on holiday actually for a couple of weeks so I might not answer very quickly, but I'm always very pleased to receive questions and I will try and answer them as soon as possible. Anyway, thank you very much for listening.

OPERATOR:

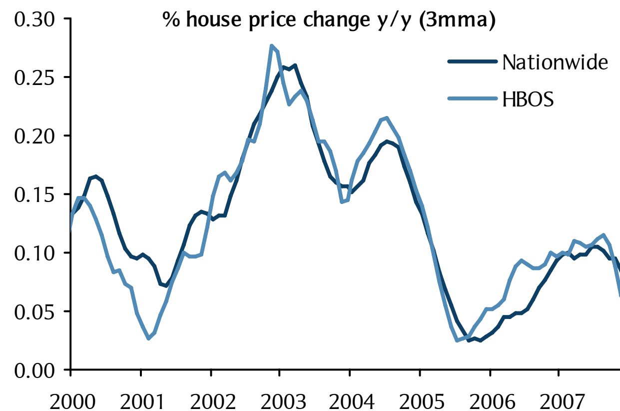
Thank you for joining today's call. You may now replace your handsets.

Sterling moves over the past year



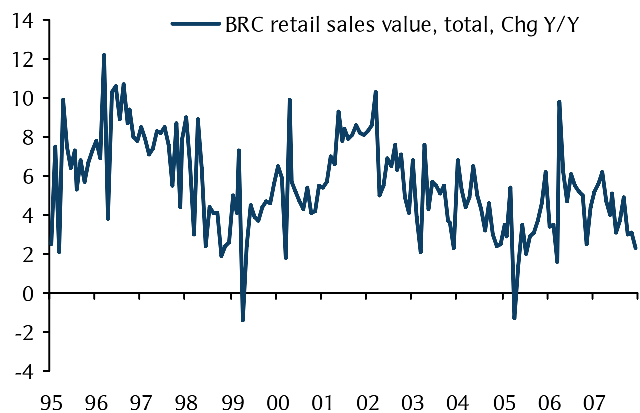
Source: Bloomberg

UK House prices



Source: Ecowin

Evidence of softening in UK retail sales



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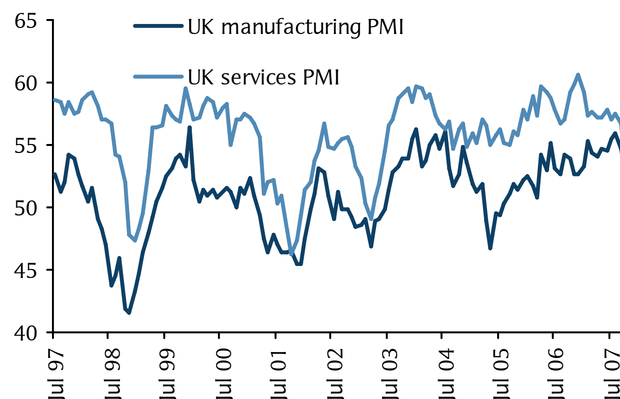
UK manufacturing and services PMI surveys



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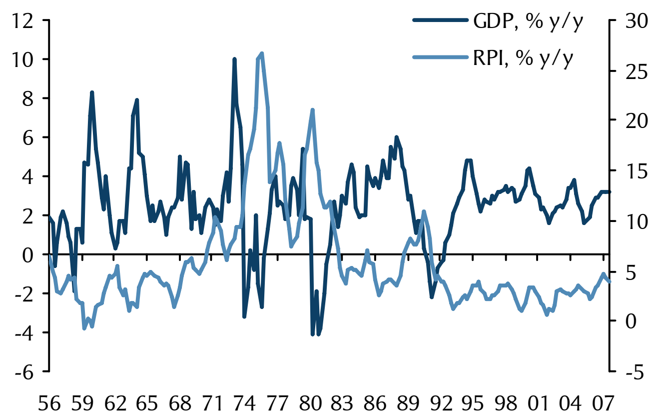
UK GDP and inflation



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