



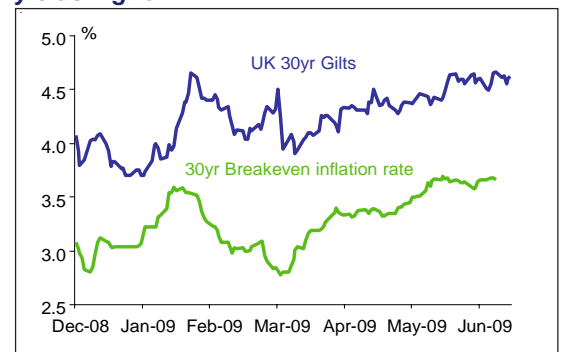
Economics Weekly

22 June 2009

How real is the inflation threat?

Recent developments have raised concerns that the UK could be facing an upsurge in price inflation over the coming years. Since early March, oil prices have doubled; the economy has found a firmer footing; and broad measures of inflation expectations have shifted higher. The rise in some of the forward-looking inflation indicators has occurred as the Bank of England has embarked on an unprecedented loosening in UK monetary policy. Having cut interest rates to a record low, the Bank has turned to the unorthodox policy of quantitative easing (QE) in an effort to stimulate lending and demand through expanding money supply.

Chart a: Rise in inflation breakevens push gilt yields higher



Inflation expectations have turned upwards

The concern about future potential inflation has started to unsettle bond markets. Medium and long-dated gilt yields have backed up sharply since early March (see chart a). Part of this upward adjustment reflects rising concerns over the current and prospective level of public sector debt issuance. Part of it reflects rising real interest rates and a more general reassessment of risk premia as equity markets have improved. But the rise also reflects a noticeable shift higher in the market's perception of inflation risk.

Since the Bank unveiled its quantitative easing programme in early March, long-dated breakeven inflation rates have risen by around 1 percentage point, to 3.7%. RPI inflation swaps tell a similar story. Since last November, the annual RPI two years forward has risen from less than 1% to 3% (see chart b). Adjusting for differences in methodology and definition, the increase in inflation expectations suggests financial markets doubt the ability of the Monetary Policy Committee (MPC) to meet the government's 2% inflation target over the medium term. But it is not just the markets that have started to exhibit some scepticism. The latest Bank of England/NOP Inflation Attitudes Survey shows that the public's perception of the inflation outlook over the next twelve months picked up slightly in May, to 2.4% from 2.1% in February, despite slower actual inflation (see chart c).

But medium-term inflation concerns are overdone

While there may be justifiable concerns about the inflation outlook over the longer term, the creeping pessimism about the medium-term prospects looks misplaced. With the economy still in recession and unemployment continuing to rise sharply, the current economic environment is more consistent with *deflationary*, rather than *inflationary* conditions. Although 'green shoots' have started to emerge, the prevailing level of space capacity indicates that businesses are operating well below potential – hardly a recipe for a significant demand or supply induced rise in prices. We estimate that the UK is currently operating with a negative output gap of around 6% - i.e. the level of *actual* output is about 6% below the level that could *potentially* be produced given the current pool of available labour, labour productivity and capital stock (see chart d).

Not surprisingly, inflation and the output gap are reasonably closely correlated. As demand weakens, unemployment tends to rise, putting downward pressure on wage and, with a lag, consumer price inflation.

Chart b: Market expectations of inflation have shifted higher

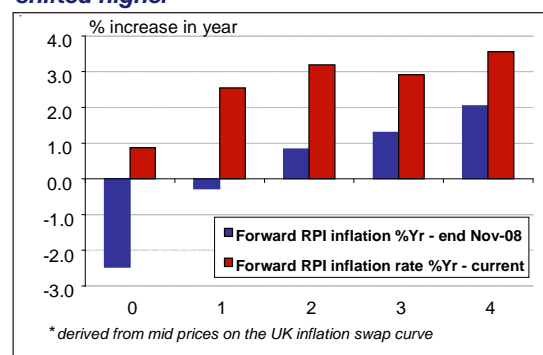
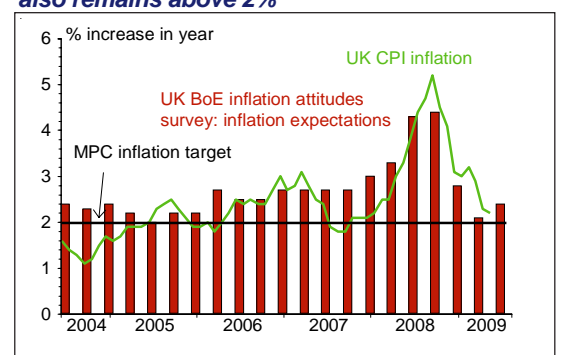


Chart c: The public's expectation of inflation also remains above 2%



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2009 calendar of central bank meetings

European ECB (1.00%)
2 July, 6 August, 3 September, 8 October
US FOMC (0-0.25%)
12 August, 23 September, 4 November, 16 December
UK MPC (0.50%)
9 July, 6 August, 10 September, 8 October

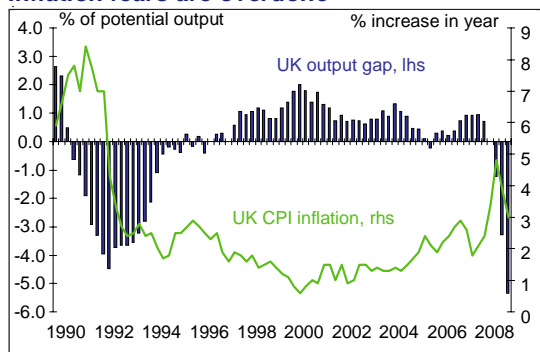
Rolling calendar of UK data releases and events

Consumer credit (29/6)
Mortgage approvals (29/6)
GfK consumer conf (30/6)
Q1 GDP (30/6)
Manufacturing PMI (1/7)
Services PMI (3/7)
Industrial production (7/7)

Rolling calendar of US data releases and events

Chicago PMI (30/6)
Consumer confidence (30/6)
ADP employment (1/7)
ISM manufacturing (1/7)
Non-farm payrolls (2/7)
Average earnings (2/7)
Factory orders (2/7)

Chart d: Level of spare capacity suggests inflation fears are overdone



Indeed, this describes what has occurred over the past year or so. Since February 2008, claimant count unemployment has risen by 760,000 and underlying average earnings growth has slowed from 3.7% to 2.7% (see chart e); since last September, consumer price inflation has dropped from 5.2% to 2.2%. With unemployment almost certain to continue rising over the remainder of this year and into 2010, we expect CPI inflation to fall further – to below 1% by the end of this year, (see chart f). Over the coming months, the fall in inflation also is likely to be accentuated by favourable base effects, as last summer's sharp rise in food and energy prices drop out of the annual comparison. Although unemployment is still expected to be increasing for much of next year, headline inflation is expected to gravitate slightly higher, as the temporary cut in VAT expires in January and demand conditions gradually improve.

Even if GDP bounces strongly, the output gap will remain negative for some time..

Nonetheless, it is difficult to make a strong case for a fundamental shift higher in inflation until the output gap closes. Such an outcome requires a sustained period of above-trend growth. While recent indicators suggest the inventory adjustment may now be largely complete, this points to a stabilisation in output, not necessarily a resumption of growth. Moreover, even if the economy were to exhibit a sharp rebound, it would take time for the level of spare capacity to erode to the point where inflation pressures started to build again. Broadly speaking, for the current output gap to close, GDP would have to rise by 2% above trend over the next three years. While low interest rates and quantitative easing may pose longer term risks, the degree of spare capacity poses a formidable obstacle to a pick-up in inflation in the short term.

...trend growth may have fallen, but not by enough to induce price pressures

Admittedly, there is a caveat to this. Estimates of the output gap are almost impossible to derive with precision as the growth potential of the economy changes over time in response to changes in the capital stock, productivity, and the available pool of labour. Since the credit crisis erupted, the capital stock has clearly been depleted as a result of the decline in business investment and rising corporate bankruptcies. This represents a permanent loss of output. Moreover, reports suggest that migrant workers are increasingly leaving the country. Proponents of rising inflation argue that these developments leave the UK more exposed to inflation pressures when demand picks up. While this may be true over the longer term, we believe it is highly implausible that the UK's trend rate of growth has fallen to such a degree that the UK is exposed to supply-side price pressures. Although the capital stock has been depleted, the proportion of the UK population that is economically active has actually risen slightly, as the downturn has obliged some individuals to re-enter the labour market.

Finally, demand conditions pose little threat to inflation

Moreover, from a demand perspective, there appears little threat of inflation. Unemployment continues to rise sharply, credit availability remains constrained and household indebtedness is close to a record high. None of these seem consistent with an imminent improvement in corporate pricing power. Inflation looks set to stay low for a while longer. Consequently, fears of an early rise in interest rates seem premature.

Chart e: Average earnings head lower as unemployment rises

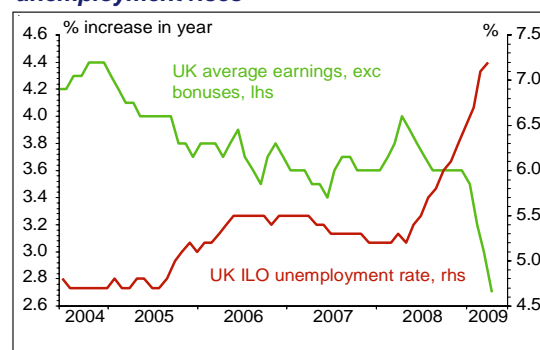
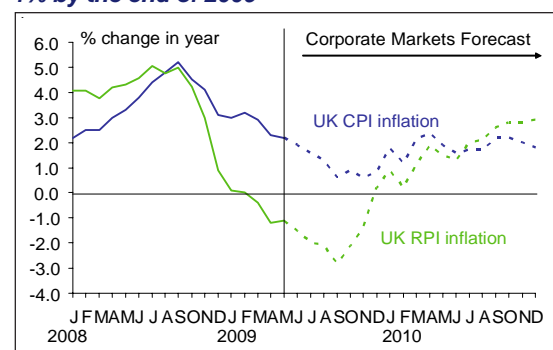


Chart f: Our inflation forecasts shows CPI below 1% by the end of 2009



Adam Chester, Senior UK Macroeconomist, Corporate Markets

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg and Datastream

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Weekly economic data preview

22 June 2009

Fed and BoE to quash speculation of early rate hikes

The improvement in economic activity data in recent weeks has raised market speculation about the potential 'exit strategies' central banks may employ from the various initiatives undertaken to tackle the financial crisis. However, with considerable uncertainty still overshadowing prospects for future economic growth and inflation, we believe such considerations may be premature at this time. We expect both the Fed and the BoE to communicate messages along these lines this week. The FOMC will be armed with updated economic forecasts which, though likely to show an improvement in underlying economic conditions, may also predict that economic growth could remain weak for some time, increasing spare capacity and reducing the medium-term threat posed by inflation. We expect the committee on Wednesday to maintain the target range for the federal funds rate at 0-0.25% and to keep its total purchases of Treasury securities unchanged at \$300bn on Wednesday. Members of the BoE MPC testify to a Treasury select committee on the May Inflation Report on Wednesday. We expect the main message here to be that with recovery still not assured, Bank rate will remain at 0.5% for some time, while additional quantitative easing also cannot be excluded. It is another big week for government bond issuance, with the US Treasury auctioning a record \$104bn. Euro zone PMIs, the German IFO survey, final US Q1 GDP and US personal income and spending for May provide the main data highlights this week.

- It is a very quiet week for data in the UK, with the CBI distributive trades' survey on Wednesday and BBA lending figures on Tuesday potentially the only releases of market interest. We expect the CBI headline reported sales index to show a further decline to -20 in June, from -17 last month, as rising unemployment and tight credit conditions increasingly weigh on retail spending. We forecast BBA mortgage approvals rose above 30,000 in May, from 27,685 in April, equating to year-on-year growth for the first time since November 2006. However, the number of loans approved for house purchase in November 2006 was 79,981, highlighting how subdued market activity actually remains. The Nationwide house price survey may also be published this week. However, the main focus in the UK this week will be on the BoE MPC testimony on Wednesday on the May Inflation Report, where we expect to hear more about the economic outlook, the progress of quantitative easing so far and how the timing and mechanics of an eventual exit strategy will be determined. Senior BoE members, including governor King, will also testify on the banking crisis later on Wednesday.
- Although we expect to hear that the overall policy stance will remain unchanged following the FOMC meeting on Wednesday, the press statement will be closely scrutinised for any clues about future direction. We look for the FOMC to dampen recent market speculation of an early interest rate rise, primarily by highlighting the high degree of uncertainty and risk still surrounding prospects for inflation and economic growth. The need potentially for increased purchases of treasury securities may also feature in the press statement, although the current \$300bn remit is unlikely to be changed at this time. The Fed is already more than half way through its current programme, which it expects to complete by Autumn. US data this week are likely to support the view that the economy will return to modest growth in coming quarters. We look for a solid rebound in personal spending in May, underpinned by the boost to incomes provided by the recent stimulus plan. There is a chance that initial jobless claims dipped below the 600k level in the week to June 20 for the first time since January, a further indication that labour market trends are improving. We also forecast modest increases in new and existing home sales for the second consecutive month in May, as lower prices spur renewed activity. Confirmation that the economy contracted by an annualised 5.7% in Q1 2009 is unlikely to elicit much market reaction on Thursday.
- Data in the euro zone this week are also expected to show that the worst of the downturn may have passed, although prospects for recovery there may not be as strong as in the US or UK. We look for further rises in both the manufacturing and services PMIs, to 42.5 and 46 respectively, though crucially still deep in contractionary territory. The German IFO survey is also forecast to show a third consecutive rise in its business climate index, to 85.5 in June, but this is still consistent with weak output growth.

Jeavon Lolay, Senior global macroeconomist

Chart 1: UK retailers face difficult trading conditions

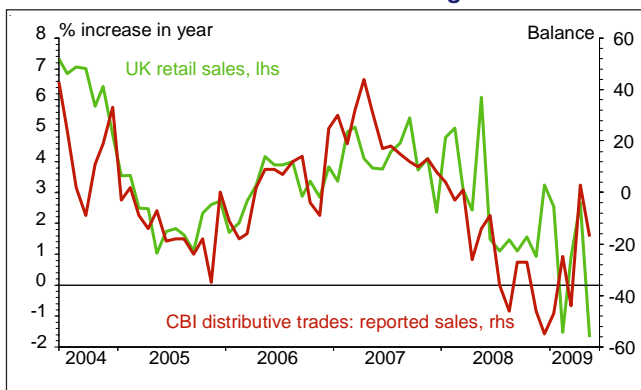


Chart 2: German IFO survey consistent with weak growth



Date	United Kingdom	United States	EU-16
Mon 22	Rightmove house prices (00:01) Jun (act) -0.4% Y-O-Y -5.5%		German IFO business survey (09:00) May 84.3 Jun (act) 85.9 Median 85.0 Range 84.2:87.0
Tue 23	Nationwide house prices (07:00) (Jun) (23-30) May +1.2% Y-O-Y -11.3% BBA mortgage lending	Existing home sales (15:00) Apr 4.68mn May (f'cast) 4.82mn Median 4.80mn Range 4.65m:4.95m	German GfK consumer confidence (07:10) Jun +2.5 Jul (f'cast) +2.5 Median +2.5 Range +2.0:+2.7 French consumer spending (07:45) Apr +0.7% Y-O-Y +0.6% May (f'cast) zero Y-O-Y -0.7% Median +0.2% Range -1.0%:+2.3% French business confidence (07:50) May 72 Jun (f'cast) 73 Median 74 Range: 72:76 French manufacturing PMI (08:00) (prel) May 43.3 Jun (f'cast) 45.5 Median 44.5 Range 43.8:45.8 French services PMI (08:00) (prel) May 48.3 Jun (f'cast) 49.0 Median 48.6 Range 48.0:49.5 German manufacturing PMI (08:30) (prel) May 39.6 Jun (f'cast) 42.0 Median 41.0 Range 38.5:43.0 German services PMI (08:30) (prel) May 45.2 Jun (f'cast) 46.0 Median 46.0 Range 44.0:47.2 EU-16 manufacturing PMI (09:00) (flash) May 40.7 Jun (f'cast) 42.5 Median 42.1 Range 40.2:45.6 EU-16 services PMI (09:00) (flash) May 44.8 Jun (f'cast) 46.0 Median 45.6 Range 44.7:47.5
Wed 24	CBI distributive trades' survey (11:00) May -17 Jun (f'cast) -20 Median -17 -25:-8	Durable goods orders (13:30) Apr +1.9% Y-O-Y -26.6% May (f'cast) -1.0% Y-O-Y -27.3% Median -0.9% Range -2.4%:+0.6% New home sales (15:00) Apr 352k May (f'cast) 360k Median 360k Range 350k:370k FOMC interest rate decision (19:15) Current: 0-0.25% Forecast: 0-0.25%	EU-16 current account (sa) (09:00) (Apr) Mar -€6.5bn
Thu 25		GDP (sa, annualised) (final) (13:30) Q1 (2nd estimate) -5.7% Q1 (f'cast) -5.7% Median -5.7% Range -5.8%:-5.4% GDP deflator (sa, annual) (final) (13:30) Q1 (2nd estimate) +2.8% Q1 (f'cast) +2.8% Median +2.8% Range +2.8%:+2.8% Initial claims (w/e 25/6) (13:30) Previous 608k Forecast 600k Median 602k Range 590k:620k	EU-16 industrial orders (10:00) Mar -0.8% Y-O-Y -26.9% Apr (f'cast) zero Y-O-Y -33.9% Median zero Range -1.4%:+0.3%
Fri 26		Personal income (13:30) Apr +0.5% Y-O-Y +0.7% May (f'cast) +0.4% Y-O-Y -0.7% Median +0.3% Range -0.2%:+1.0% Personal spending (13:30) Apr -0.1% Y-O-Y -1.5% May (f'cast) +0.4% Y-O-Y -1.7% Median +0.3% Range +0.1%:+0.7% Core PCE deflator (13:30) (Apr) Apr +0.3% Y-O-Y +1.9% May (f'cast) +0.2% Y-O-Y +1.9% Median +0.1% Range +0.1%:+0.2% Uni. of Michigan confidence (final) (15:00) Jun (prel) 69.0 Jun (f'cast) 69.0 Median 69.0 Range 68.5:69.7	German CPI (07:00) May -0.1% Y-O-Y zero Jun (f'cast) +0.2% Y-O-Y -0.1% Median +0.2% Range -0.2%:+0.4% French GDP (final) (07:45) Q1 (prel) -1.2% Y-O-Y -3.2% Q1 (f'cast) -1.2% Y-O-Y -3.2% Median -1.2% Range -1.2%:-1.2%
Mon 29	Money supply, M4 (final, sa) (May) Apr +0.2% Y-O-Y +17.4% Consumer credit (May) Apr +€0.3bn Net mortgage lending (sa) (May) Apr +£1.0bn Mortgage approvals (May) Apr 43K		EU-16 consumer confidence (10:00) (Jun) May -31 EU-16 industrial confidence (10:00) (Jun) May -35

NB: UK data released at 9.30 a.m., unless otherwise stated. Market medians are as of preceding Friday. Release times of US data are stated in brackets after the description of the indicator. Events are listed in the events column on the next page.

Date	Japan	Other Countries	Main events
Mon 22		Canada int'l secs transactions (13:30) Mar +C\$6.8bn Apr (f'cast) +C\$7.5bn	<ul style="list-style-type: none"> • UK DMO to auction 1.125% index linked bonds due 2037 (amount tbc) (22-26) • ECB President Trichet speaks in Madrid (13:00) • US Fed to purchase notes/bonds (16:00) • Bank of England to purchase £3.5bn of gilts at a reverse auction
Tue 23	Leading index (final) (06:00) Apr (prel) 76.5% Apr (f'cast) 76.5% Coincident index (final) (06:00) Apr (prel) 85.8% Apr (f'cast) 85.8%		<ul style="list-style-type: none"> • Bank of England member Dale speaks in London (09:05) • UK DMO to auction £4bn of 4% gilts due 2022 (10:30) • ECB member Ordonez speaks in Madrid (11:00) • ECB member Weber speaks (14:00) • US Treasury to auction \$40bn of 2yr notes (18:00)
Wed 24	Trade balance (BoP) (00:50) Apr +Y67.7bn May (f'cast) +Y110.0bn Median +Y210.0bn Range -Y2.5bn:+Y485.4bn		<ul style="list-style-type: none"> • Bank of England members King, Bean, Fisher, Sentance and Barker testify to Parliament's Treasury Committee on the May 2009 Inflation Report (14:30) • Bank of England members King, Haldane and Bailey testify to Parliament's Treasury Committee on the banking crisis (15:45) • US Treasury to auction \$37bn of 5yr notes (18:00) • US FOMC interest rate decision (interest rates expected to stay on hold at between 0.0-0.25% (19:15)) • Bank of England to purchase £3bn of gilts at a reverse auction
Thu 25			<ul style="list-style-type: none"> • ECB member Bini Smaghi speaks in Rome (08:00) • ECB member Stark speaks in London (19:30) • US Fed Chairman Bernanke speaks in Washington (15:00) • US Fed to purchase notes/bonds (16:00) • US Treasury to sell \$27bn of 7yr notes (18:00)
Fri 26	Tokyo core consumer prices (00:30) May Y-O-Y -0.7% Jun (f'cast) Y-O-Y -1.1% Median -1.0% Range -1.2%:-0.8% National core consumer prices (00:30) Apr Y-O-Y -0.1% May (f'cast) Y-O-Y -1.0% Median -1.1% Range -1.3%:-0.7%		<ul style="list-style-type: none"> • Bank of England releases Financial Stability Report (00:01) • US Fed member Fisher speaks in Dallas (18:00)
Mon 29	Industrial output (00:50) (prel) (May) Apr Y-O-Y -30.7% Retail sales (prel) (00:50) (May) Apr Y-O-Y -2.9%		