



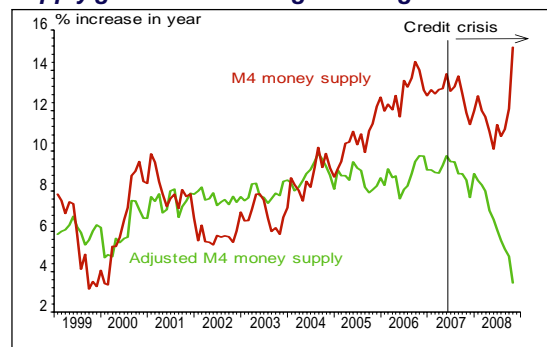
Economics Weekly

15 December 2008

Money supply growth - is it signalling bad news or good?

With the release of the latest UK monetary statistics this week, the spotlight should shine on what has been happening to money supply since the credit crisis broke in the summer of 2007. If the economic slowdown is going to be exacerbated by the credit crisis, then this is where the bad news should be evident. On the surface, there does not appear to be a problem at all with credit growth. UK money supply expanded by 15.3% in the year to October 2008, up from a rise of 12.4% in December 2007 and 10.1% in May this year. But this aggregate figure is very misleading. If the activities of other financial institutions (OFIs) are excluded, a completely different profile is revealed. On this adjusted basis, money supply rose by just 3.5% in the year to October 2008, down from 8.9% in December 2007 and 6.6% in May, see chart a.

Chart a: A divergent picture for M4 money supply growth - is it rising or falling?...



Adjusting for transactions amongst financial firms shows money supply is falling at an alarming rate...

But why leave out OFIs? The answer is that this sector contains the specialist financial companies that were most active in creating the credit instruments that lie at the heart of the current global financial market crisis. Many are now being wound up, are hoarding cash to meet obligations, and receiving loans from parent companies or from selling assets in order to do so. In October, bank lending to OFIs rose by 42.8% on the year before, and M4 deposits by them were up by 44.1% in the same period. These flows, and the behaviour driving them, is distorting, at the aggregate level, the overall picture of what is happening to lending and deposit flows by households and companies in the UK. The trend in real 'inflation adjusted' M4, shown in chart c, is bad news for the economy.

M4 money supply deposit growth and lending growth are weakening dramatically, reflecting, of course, tougher credit standards, wider spreads and less credit demand as households cut back on spending and companies cut investment and costs, see chart b. In October, annual bank deposit growth by households was 6% up from a year earlier, but down from an 8.8% increase at end-December 2007 and from 8.9% growth as recently as May. For companies, the fall-off in deposits has been even sharper, with deposit growth moving from an annual rise of 9.8% at the end of 2007, to a fall of 5.2% in October, see chart b. With these sorts of data now becoming the norm, it is no wonder that retail sales growth has fallen sharply and that company investment spending is being cut aggressively and hence that unemployment is now rising sharply.

...with deposits by the company sector falling for the first time since the 1980s and household deposits down sharply from a year ago, despite policy loosening...

Chart b illustrates the extent that money supply trends have turned down alarmingly for the non-financial corporate sector in the UK. This further explains the need to adjust the headline M4 money supply total by

Chart b: ...the answer is that it is falling, if adjusted for credit-related financial companies

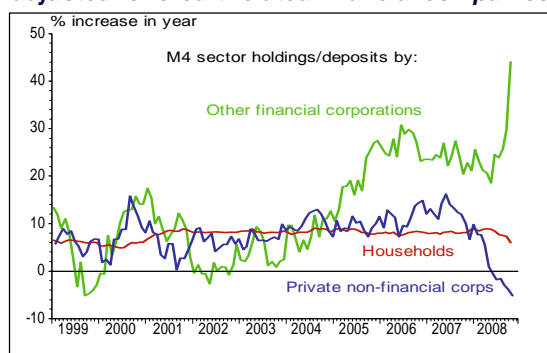


Chart c: In real 'inflation adjusted' terms, UK money supply has not grown this weakly since the 1990s recession



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2008/09 calendar of central bank meetings

European ECB (2.50%)
15 January, 5 February, 5 March

US FOMC (1.00%)
16 December, 28 January, 17 March, 29 April

UK MPC (2.00%)
8 January, 5 February, 5 March

Rolling calendar of UK data releases and events

Q3 GDP (23/12)
Q3 Current account (23/12)
BoE credit survey (2/1)
Mortgage approvals (2/1)
Manufacturing PMI (2/1)
Services PMI (6/1)
Industrial production (9/1)

Rolling calendar of US data releases and events

Q3 GDP (23/12)
Existing home sales (23/12)
Uni of Michigan conf. (23/12)
New home sales (23/12)
Core PCE deflator (24/12)
Durable goods (24/12)
Consumer conf. (30/12)

Chart d: Adjusted M4 money supply growth suggests further falls in inflation in the year ahead

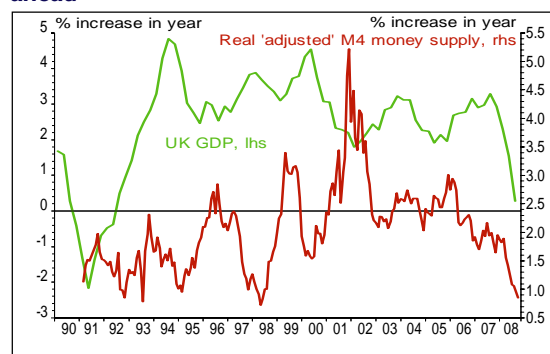
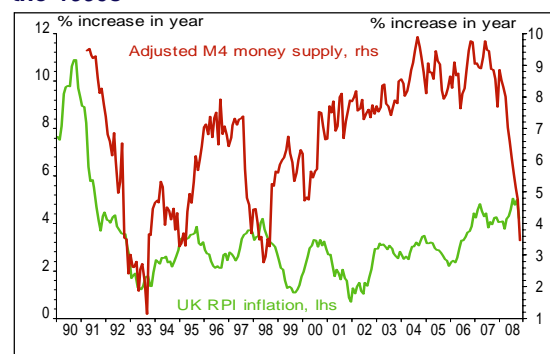


Chart e: Real M4 money supply growth suggests negative gdp growth next year - comparable to the 1990s



excluding the transactions taking place in the OFI sector in order to understand what money supply trends really mean for the economy. Companies are dipping into deposits, down by 5.2% in the year to October, to survive as lending growth weakens. Households are not in such a dire position, but they too are seeing weaker M4 lending growth as mortgage markets weaken sharply. However, lending growth roughly matches deposit growth, implying more balance than in the corporate sector.

...all of which points to the severity of the pressures on these sectors, which will lead to a fall in UK economic growth of 2% or so in 2009 and a muted recovery in 2010

There are two main economic effects at the macro level that falling growth in the adjusted M4 measure imply. The first is sharply lower near term price inflation. Chart d illustrates this clearly, with substantially less money in the system how can there be rising price inflation? This means that there is scope for Bank rate to fall to even lower levels than the current 2%, as the inflationary backdrop remains very weak. The data do not yet however suggest that the UK is on the verge of persistent price deflation - or falling prices year in year out - though retail price inflation could be negative next year due to cuts in VAT and official interest rates. The other implication, as shown in the final chart, is that UK economic growth could fall as low as it did in the 1990s recession. This implies a fall in gdp next year of 2.3% and only a weak recovery in 2010, of around 1%

Unfortunately, looking at the recent purchasing managers' indices (services, construction, manufacturing), retail sales, surveys of business and consumer sentiment and unemployment, they seem to confirm the depth of economic slowdown that the monetary data are suggesting. But official policy has responded aggressively in this downturn and quite quickly, with interest rates likely to be cut further below 2% in early 2009 and significant fiscal easing already in place. The one bit of good news is that this does imply that the recession should not be on the scale of the 1980s or the 1970s but does look on course to match the 1990s downturn.

Trevor Williams, Chief Economist, Corporate Markets

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

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Weekly economic data preview

W/c 15 December 2008
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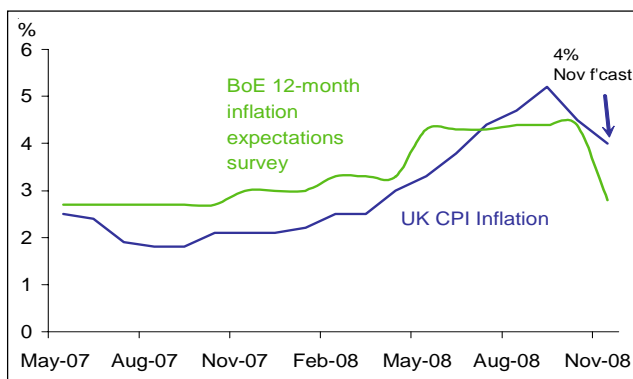
BoE minutes and more weak UK economic data

Another set of weak UK economic data and the minutes of the 3/4 December Bank of England meeting - which will probably show unanimous support for the last MPC interest rate cut of one percentage point to 2% while keeping open the option of cutting rates again soon - could increase negative sentiment towards sterling. Elsewhere, the US Fed is almost certain to lower its funding rate by at least 50bp to 0.5%, the Norwegian central bank will reduce official rates by at least 50bp to 4.25% and the Bank of Japan will hold rates at 0.3%. In terms of data, US, UK and the EU-15 (final) CPI inflation reports for November will confirm that prices on a monthly basis are falling, providing additional justification for further monetary easing. We will be looking to see whether or not monthly UK claimant count unemployment and weekly US initial claims figures worsen, adding to concern that the UK and US recessions are deepening.

- We are expecting more bad news about the UK economy, paving the way for further reductions in interest rates possibly next month. Labour market data will attract widespread interest on Wednesday as the extent of job cuts by firms is important in assessing the depth of the current recession - we expect claimant count unemployment to rise by 40,000, bringing the cumulative total to 226,000 since February. In addition, the CBI distributive trades survey for December and official retail sales volume figures for November are both likely to show further contraction - this has evidently led to heavy price discounting in the shops. Official consumer price inflation for November is also published and should reflect the trend of weaker price expectations shown in the latest quarterly BoE/GfK NOP Inflation Attitudes survey (the median 12-month inflation expectation was 2.8%, significantly below the record high of 4.4% in the previous quarter). CPI inflation is likely to have fallen by at least 0.2% in November, representing a decline in the annual growth rate to 4%, compared with 4.5% in October. RPI could fall as low as 3.2% as cheaper mortgage payments have a dampening effect. Public finance and money supply data are also published this week, for more on the latter see the main article.
- Although considered virtually a done deal that the US FOMC will cut interest rates by 0.5% at 19:15 on Tuesday, financial markets will look for confirmation and assess the accompanying statement, which will highlight the supporting economic rationale. As well as weekly initial jobless claims and CPI inflation for November, a selection of other domestic and external data will provide useful insight into the current state of the US economy. This data include official industrial production for November and the Empire Manufacturing and the Philadelphia Fed Surveys for December, which are all expected to show declines. Firms' capacity utilisation levels are expected to stay around 76%. In addition, lower housing starts and building permits will thwart any hopes that lower official interest rates have had a beneficial effect on the beleaguered housing market. External data include the Q3 current account deficit, which may fall to -\$180bn from -\$183bn in Q2, but this still leaves the US with a massive funding requirement. Treasury International Capital Data for October will inform on foreign appetite for US investments - we are expecting an inflow of \$40bn in October (\$66.2bn in September).
- A range of EU-15 business surveys for December will be collectively weak, but will they be worse than last month? As well as the aggregate figures, the PMI manufacturing and service surveys will provide interesting detail on regional differences, as well as information on firms' price, employment and new business expectations. The German IFO business survey fell close to a 16-year low of 85.8 in November and the consensus forecast is for a further decline to 84.0 in December, due to factors such as the strong euro and weak home and overseas demand. Speeches by ECB President Trichet and a selection of other ECB members will be gleaned for clues as to the timing and size of further ECB interest rate cuts - we expect another cut soon.

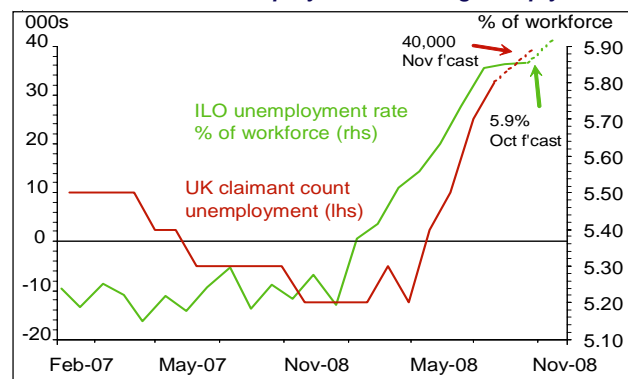
Nichola James, Senior Economist

Chart 1: UK CPI inflation expectations are falling...



Source: Thomson Datastream

Chart 2:..while UK unemployment is rising sharply



Source: Thomson Datastream

Date	United Kingdom	United States	EU-15
Mon 15	Rightmove house prices (00:01) Dec (act) -2.3% Y-O-Y -6.3%	Empire manu. survey (13:30) Nov -25.4% Dec (f'cast) -26.0% Median -27.5% Range -36.0%:-17.5% Treasury Internat. Capital Data (14:00) Sep +\$66.2bn Oct (f'cast) +\$40.0bn Industrial production (sa) (14:15) Oct +1.3% Y-O-Y -4.1% Nov (f'cast) -0.8% Y-O-Y -5.2% Median -0.9% Range -5.0%:+0.4% Capacity use (14:15) Oct 76.4% Nov (f'cast) 76.3% Median 75.6% Range 74.9%:76.6%	
Tue 16	Consumer prices index (nsa) Oct -0.2% Y-O-Y +4.5% Nov (f'cast) -0.2% Y-O-Y +4.0% Median -0.3% Range -0.5%:-0.1% Retail prices index (nsa) Oct -0.3% Y-O-Y +4.2% Nov (f'cast) -0.6% Y-O-Y +3.2% Median -0.6% Range -0.9%:-0.3% RPI ex-mortgage interest payments (nsa) Oct -0.3% Y-O-Y +4.7% Nov (f'cast) -0.1% Y-O-Y +4.2% Median -0.4% Range -0.6%:-0.1%	Consumer prices (13:30) Oct -1.0% Y-O-Y +3.7% Nov (f'cast) -1.3% Y-O-Y +1.5% Median -1.2% Range -1.6%:-0.4% Consumer prices ex-food, energy (13:30) Oct -0.1% Y-O-Y +2.2% Nov (f'cast) +0.1% Y-O-Y +2.1% Median +0.1% Range -0.3%:+1.7% Housing starts (sa) (13:30) Oct 0.791mn Nov (f'cast) 0.730mn Median 0.730mn Range 0.65mn:0.785mn Building permits (13:30) Oct 0.730mn Nov (f'cast) 0.700mn Median 0.700mn Range 0.60mn:0.72mn FOMC interest rate decision (19:15) Current: 1.00% Forecast: 0.50%	French consumer prices (07:45) Oct -0.1% Y-O-Y +3.0% Nov (f'cast) -0.3% Y-O-Y +2.1% Median -0.4% Range -0.7%:-0.2% French Manufacturing PMI (08:00) (prel) Nov 37.3 Dec (f'cast) 37.1 Median 35.4 Range 34.9:36.8 French Services PMI (08:00) (prel) Nov 46.2 Dec (f'cast) 45.6 Median 45.0 Range 44.0:46.0 German Manufacturing PMI (08:30) (prel) Nov 35.7 Dec (f'cast) 35.0 Median 34.6 Range 30.7:38.0 German Services PMI (08:30) (prel) Nov 45.1 Dec (f'cast) 44.5 Median 44.0 Range 41.0:48.7 EU-15 Manufacturing PMI (09:00) (flash) Nov 35.6 Dec (f'cast) 35.0 Median 34.2 Range 30.6:36.5 EU-15 Services PMI (09:00) (flash) Nov 42.5 Dec (f'cast) 42.0 Median 41.4 Range 39.8:44.5
Wed 17	Unemployment (sa, claimant count) Oct +36.5k Rate 3.0% Nov (f'cast) +40.0k Rate 3.2% Median +44.5k Range +34.0k:+60.0k ILO Unemployment rate Sep 5.8% Oct (f'cast) 5.9% Median 6.0% Range 5.8%:6.1% Average earnings (3m avg, headline, sa) Sep +3.3% Oct (f'cast) +3.2% Median +3.2% Range +3.1%:+3.3% Unit wage costs (3m avg, annual, sa) (Oct) Sep +2.7% CBI distributive trades survey (11:00) Nov -46 Dec (f'cast) -50 Median -40 Range -50:-35	Current account (13:30) Q2 -\$183.1bn Q3 (f'cast) -\$180.0bn Median -\$179.0bn Range -\$185bn:-\$172bn	German CPI (07:00) (final) Oct -0.3% Y-O-Y +2.5% Nov (f'cast) -0.5% Y-O-Y +1.5% Median -0.5% Range -0.5%:-0.5% EU-15 CPI (10:00) (final) Oct zero Y-O-Y +3.2% Nov (f'cast) -0.5% Y-O-Y +2.1% Median -0.5% Range -0.7%:-0.3%
Thu 18	Retail sales volume (sa) Oct -0.1% Y-O-Y +1.9% Nov (f'cast) -0.5% Y-O-Y +1.5% Median -0.7% Range -2.0%:-0.1% Public finances - PSNCR Oct -£4.9bn Cumulative +£16.7bn Nov (f'cast) +£10.0bn Cumulative +£26.7bn Median +£11.0bn Range +£5.0bn:+£15.4bn Public finances - PSNB Oct +£1.4bn Cumulative +£37.0bn Nov (f'cast) +£13.3bn Cumulative +£50.3bn Median +£13.4bn Range +£11.0bn:+£21.4bn Money supply, M4 (prel, sa) Oct +2.8% Y-O-Y +15.3% Nov (f'cast) +2.5% Y-O-Y +17.1% Median +1.8% Range +0.7%:+2.5%	Initial claims (w/e 13/12) (13:30) Previous 573K Forecast 535K Median 553K Range 550K:600K Philadelphia Fed Survey (15:00) Nov -39.3 Dec (f'cast) -40.0 Median -40.5 Range -47.9:-35.0	German IFO business survey (09:00) Nov 85.8 Dec (f'cast) 84.9 Median 84.0 Range 82.2:86.4 EU-15 trade balance (nsa) (10:00) Sep -€5.6bn Median -€4.5bn Range -€5.0bn:-€2.0bn
Fri 19	Consumer confidence (GfK) (00:01) Nov -35 Dec (f'cast) -40 Median -39 Range -42:-35		German producer prices (07:00) Oct zero Y-O-Y +7.8% Nov (f'cast) -0.4% Y-O-Y +6.5% Median -0.8% Range -1.4%:-0.2% French business confidence (07:45) Nov 80 Dec (f'cast) 78 Median 77 Range 75:82
Mon 22			French producer prices (07:45) (Nov) Oct -0.9% Y-O-Y +4.3%

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 15			<ul style="list-style-type: none"> • <i>ECB member Mersch speaks in Luxembourg (08:00)</i> • <i>ECB member Papademos presents the Financial Stability Review in Frankfurt (13:30)</i> • <i>ECB President Trichet speaks in Frankfurt (17:30)</i> • <i>ECB member Bini Smaghi speaks in Washington (22:15)</i>
Tue 16		Canada manu. shipments (13:30) Sep +0.1% Oct (f'cast) -2.0% Median -1.7% Range -2.0%:-1.0%	<ul style="list-style-type: none"> • <i>US FOMC interest rate decision (interest rates expected to be cut to 0.5%) (19:15)</i>
Wed 17	Leading index (final) (05:00) Oct (prel) 85.0% Oct (f'cast) 85.2% Coincident index (final) (05:00) Oct (prel) 97.6% Oct (f'cast) 97.6%	Canada wholesale sales (13:30) Sep +1.5% Oct (f'cast) -0.9% Median -0.5% Range -0.9%:-0.2%	<ul style="list-style-type: none"> • <i>Bank of England publishes minutes of 3/4 December MPC meeting (09:30)</i> • <i>Norwegian central bank interest rate decision (50bp cut to 4.25% expected) (13:00)</i> • <i>ECB member Noyer speaks in Paris (14:00)</i>
Thu 18		Canada int'l secs transactions (13:30) Sep -C\$0.3bn Oct (f'cast) -C\$1.0bn Median -C\$1.0bn Range -C\$1.0bn:-C\$0.9bn Canada retail sales (13:30) Sep +1.1% Oct (f'cast) -0.5% Median -0.7% Range -1.0%:-0.5%	<ul style="list-style-type: none"> • <i>UK DMO to auction £3.5bn of 3.25% gilts due 2011 (10:30)</i> • <i>US Fed member Fisher speaks in Dallas (18:30)</i>
Fri 19	Japan interest rate decision (04:00) Current: 0.30% Forecast: 0.30%	Canada consumer prices (12:00) Oct -1.0% Y-O-Y +2.6% Nov (f'cast) -0.5% Y-O-Y +1.8% Median -0.5% Range -1.0%:+0.4% Canada consumer prices, core (12:00) Oct -0.2% Y-O-Y +1.7% Nov (f'cast) -0.3% Y-O-Y +1.4% Median -0.2% Range -0.3%:+0.1%	<ul style="list-style-type: none"> • <i>BOJ interest rate decision, interest rate expected to stay on hold at 0.30% (04:00)</i> • <i>Bank of Japan releases its monthly economic report (06:00)</i>
Mon 22			