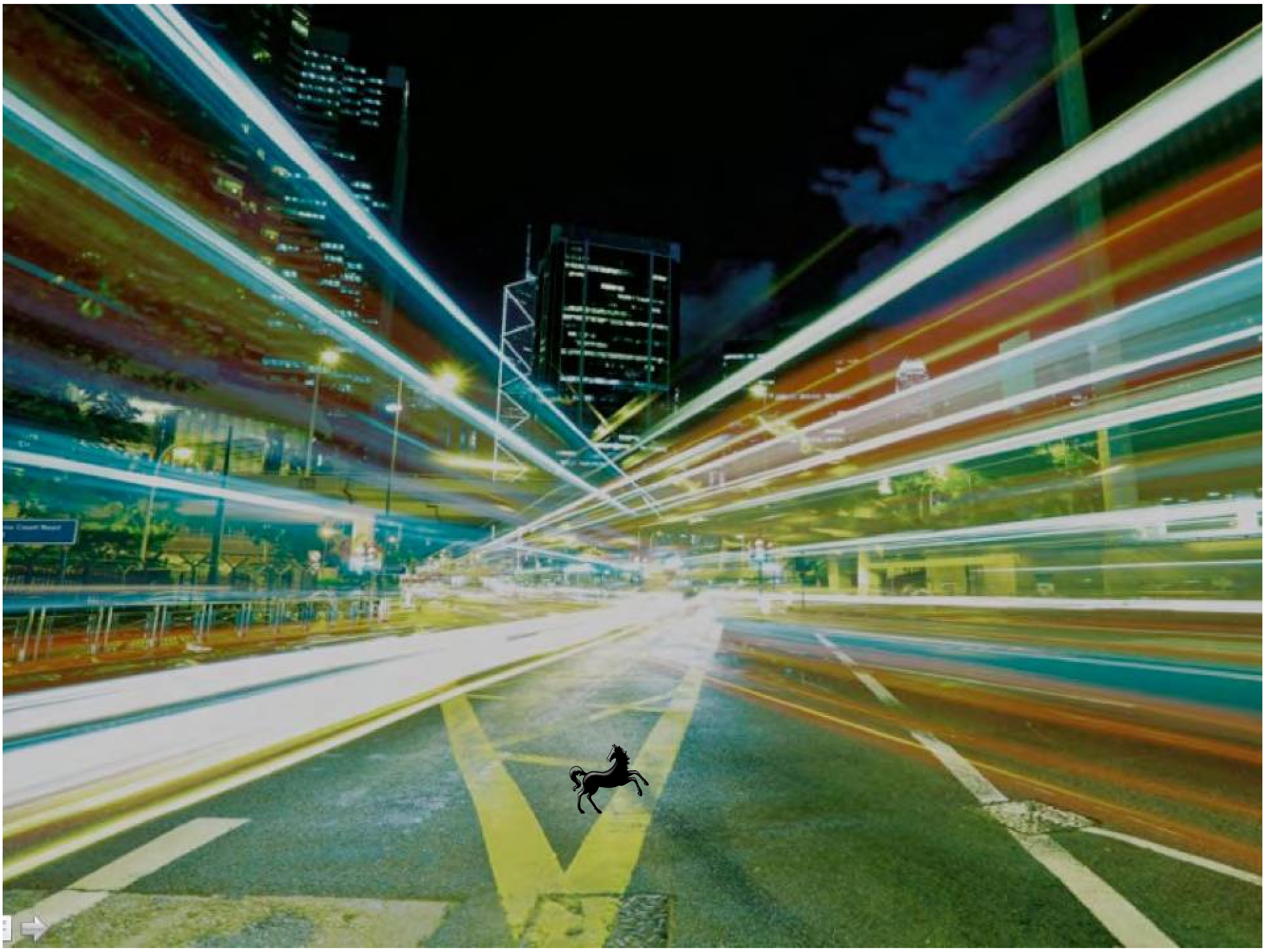
COMMERCIAL BANKING

LLOYDS BANK CHIEF ECONOMIST INSIGHT

Spring 2016



The information in this document summarises a presentation given by Patrick Foley, Group Strategy Director and Chief Economist at Lloyds Banking Group, on May 13th.

> 'It's easy to lose sight of how quickly the world is changing. The last time the Bank of England raised interest rates the iPhone hadn't been launched.'
>
> Patrick Foley
> Group Strategy Director and
> Chief Economist at Lloyds Banking Group

Six key points from our Group Chief Economist:

1 Beware rising debt levels in China
Chinese growth is increasingly reliant on credit, which history suggests increases the risk of the country having a crisis in the next few years.

2 Holding back on investment
Whatever your view on the EU referendum, many British businesses are delaying investment until we have a more certain environment after the vote.

3 Oil volatility set to continue
OPEC is divided as Saudi Arabia wants to drive out non-OPEC suppliers with low prices while other countries would rather constrain supply.

4 Get ready for radical ways to pay
A cashless society could soon emerge and blockchain – the technology underlying Bitcoin – might provide the solution.

5 Robots are putting jobs at risk
Automation complements some high-paid jobs and cannot replace some low-paid jobs but those in the middle are at real risk.

6 Measuring productivity is problematic
Investment is increasingly directed towards intangibles, so how do we quantify the value of new ideas rather than new machinery?

UK Fact Box:

2007

July 2007 was the last time the Bank of England raised interest rates (from 5.5% to 5.75%). They have been unchanged at 0.5% since March 2009. The first iPhone was launched in the UK in November 2007.

Global Fact Box:

3.2%

The IMF has cut its global growth forecast four times in the past year and now predicts growth of 3.2% in 2016

AN AGE OF UNCERTAINTY

We live in a fascinating time because the world is very uncertain. Technology is causing huge changes in almost every industry but particularly in financial services. At Lloyds Bank, we've been looking at different scenarios for banking in ten years' time and all of them are quite different from today. Looking at the global economic picture, some things look better now than they did at the start of 2016. Markets have stabilised relative to earlier volatility, the oil price has started to recover after sinking through the floor and China has avoided a hard landing in the short-term. Whether it will in the longer term is a very big question. However, the International Monetary Fund (IMF) has also reduced its global growth forecast and the UK growth picture has weakened somewhat.

CHINESE CREDIT FUELS CRISIS FEARS

China's enormous rise in total debt in recent years has been akin to what we saw in the Western world before the financial crisis; if anything, it's growing faster. Chinese growth appears increasingly reliant on credit with the debt to GDP ratio going up and up. History suggests that in just about every country where that happens, it doesn't end well. The Chinese government is trying to keep the economy growing but how far can you kick the can down the road before it becomes impossible? I think that within the next three to four years we'll have some kind of crisis in China.

Global Fact Box:

237%

China's total debt has reached a record 237% of GDP compared to 148% at the end of 2007

Source: Financial Times

UK Fact Box:

↓2%

Business investment fell 2% in the final quarter of 2015 after three successive quarters of growth

Source: Office for National Statistics

EU REFERENDUM SPARKS INVESTMENT WAITING GAME

We're seeing a great focus on the impact of uncertainty on business spending, hiring and consumer spending plans. Most economists would say the weakening growth early in 2016 was in part due to UK companies holding back investment until after the EU referendum. Even if you think exit is good for the UK economy, it probably makes sense to delay it to see what happens. The last business investment figures were quite negative, showing a 2% fall. That was partly due to the oil price causing energy sector cutbacks, but I think there's some element of 'wait and see' with the referendum too.

96.23m

barrels per day of oil being produced in 2016, up from 93.31 million in 2014

Source: US Energy Information Administration

Oil: OPEC's split objectives

Demand for oil has dropped because the global economy is quite weak and supply has increased at the same time due to high prices a few years ago. OPEC faces two difficulties: one is increased non-OPEC supply, especially with US shale; the other is less unity of objectives within the cartel. Saudi Arabia wants to extract and sell as much oil as possible, partly to drive some non-OPEC suppliers out of the market but also to meet its own budget needs. Other countries would prefer to constrain supply to push the price back up as OPEC traditionally did. I don't like to think about a 'new normal' oil price because I expect volatility to continue.

0.5%

US growth was 0.5% in the first quarter of 2016 - down from 1.4% in the final quarter of 2015

47%

of jobs in the US are at risk of being automated in the next 20 years

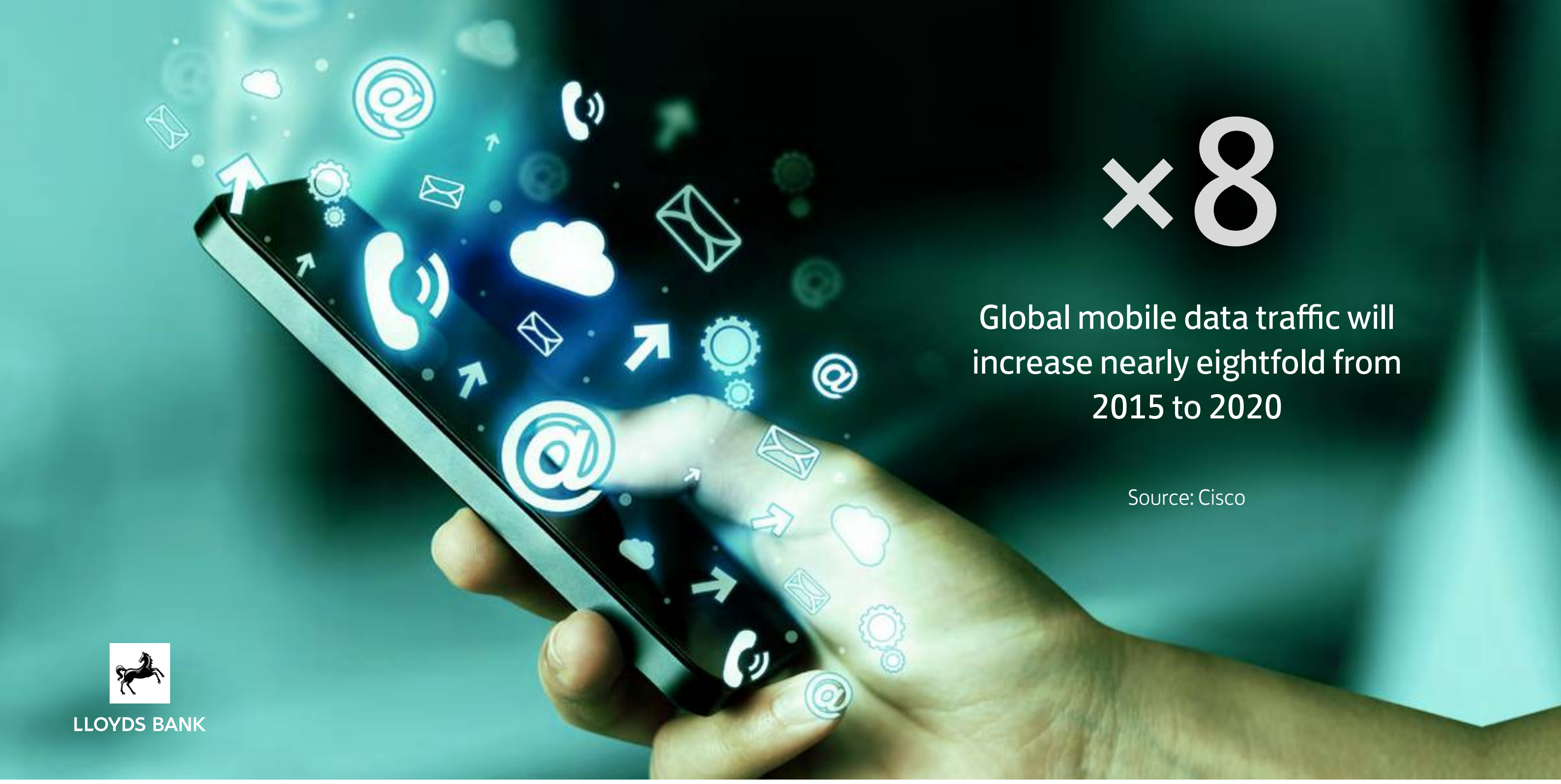
Source: University of Oxford

US slows as election tension grows

Corporate earnings in the US have reflected weaker than expected domestic growth - the slowest rate for two years in the first quarter of 2016. Many large corporates such as Apple are also very exposed to the slowdown in global markets. So far as the election is concerned, I expect the mudslinging in the Republican primaries to get worse in the presidential campaign. There will be concern because, to an outsider, Donald Trump's economic policies don't seem to make a lot of sense. And if Hillary Clinton wins, I think she'll be damaged by the campaign and that could impact on US economic prospects.

Eurozone requires reforms to survive

The Eurozone has improved somewhat on the upside but the problems haven't gone away. I'm still quite pessimistic long-term about where the Eurozone goes without further changes in the way it's run. The French Economy Minister Emmanuel Macron said last year that fiscal transfers between member states are needed to save the single currency. I agree that fiscal transfers from the richer countries to some of the poorer countries are needed. At the moment that's politically impossible but that has to be addressed at some stage if the Eurozone is to survive.



New ways to pay

Economists are increasingly talking about a cashless society. Often, buying online no longer even requires a card, for example when using PayPal . I expect big changes in the way we pay for things. Why not just walk into a supermarket, get a trolley, take everything you want and wheel it out? Sensors could register when you enter, detect what's in your trolley and charge you when you leave. It's also possible that we'll adopt blockchain, the technology behind Bitcoin, as an alternative payment method with electronic movements on a restricted ledger. If I make a payment to you, your account simply shows an increase in your part of the ledger and mine shows a decrease.

Technology and the pace of change

It's easy to lose sight of how quickly the world is changing. Technology companies say that in five years' time we'll be using seven to eight times as much mobile data as we use today. It's a potentially profound level of change. We've been trying to understand how disruptive new technology has been in other sectors to understand the potential impact on banking. Any large company today must look over its shoulder at smaller, new competitors for fear that in a few years' time they will do what Uber has done in the taxi market.

Rise of the robots

We're seeing polarisation in the jobs market as computers and robots increasingly replace middle-skill routine jobs. Some high-paid workers benefit as automation complements their work. For example, a surgeon who uses laser techniques becomes even more valuable as lasers get better. At the other end, hairdressers and gardeners do things that robots don't do very well. But the jobs in the middle are disappearing in the UK and many other countries and that's forcing those workers down the skill level. If you have a job that's easily done by a computer or robot you're at risk.

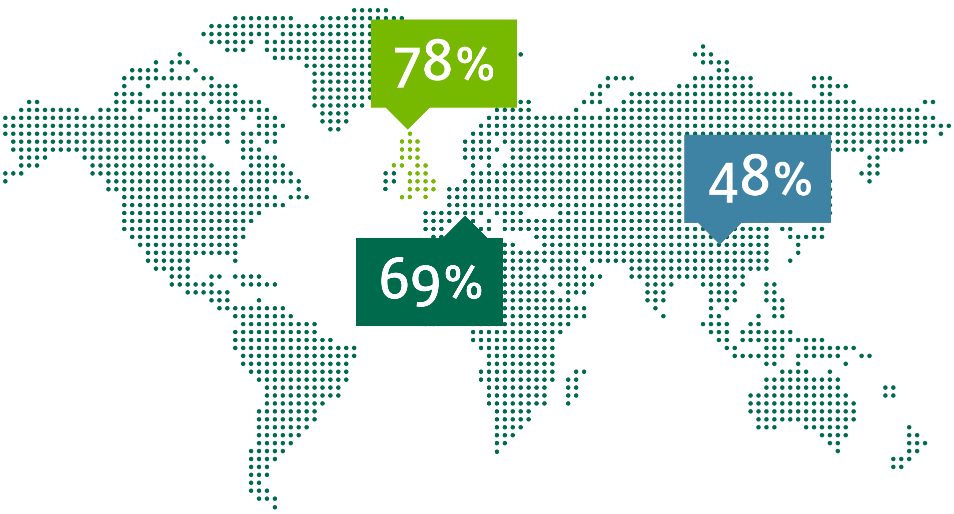
38% lower

UK productivity per worker is 38% lower than in the US, 15% lower than in France and 11% lower than in Germany

Source: Office for National Statistics

The UK's productivity puzzle

A lot is said about the productivity puzzle but I'm quite optimistic. I think the numbers are quite misleading and that we're bad at measuring output in the economy. Statisticians see no fundamental difference between someone buying an iPhone now or a Nokia ten years ago. We know the iPhone gives us a lot more of what economists call utility but those things aren't measured well. Companies are also investing less in physical infrastructure and more in intangibles – software and new ways of doing things. It's difficult to measure how much value new ideas create compared with a new piece of machinery.



Service industries account for 78% of UK GDP compared with 69% in Germany and 48% in China

Source: World Bank

UK as a services specialist

Politicians agonise over the fact that the UK is a services specialist but if our advantage is in IT, financial services and so on then why shouldn't we focus on those things? We'll buy Chinese manufactured goods and sell them IT services instead. Specialising in what you are best at is what takes countries forward. A bigger proportion of UK output comes from services than in most advanced countries, certainly much more than Germany. People tend to think it's bad that we've stopped manufacturing some of the things we used to but I don't think it is. Get someone else to make the television sets and we'll provide the programmes.

Keeping household debt down

Consumer confidence over the long-term tends to be quite negative in the UK, so where we are today isn't that bad by historical standards. The interesting thing is that this is the first recovery in the UK I can remember where growth in consumer spending hasn't been driven by debt. We are increasingly spending money that we have got. Levels of household debt relative to household income over the last five or six years have been going down. It started from a high level but we've seen a bigger reduction in household debt to GDP than just about every other country since the crisis.

0.4%

UK growth was 0.4% in the first quarter of 2016 compared with 0.6% in the previous quarter.

The year-on-year growth rate is 2.1%

UK economic outlook

I think we’re doing a bit better than headline figures suggest. For GDP growth, the Bank of England has not only a forecast but also a ‘backcast’ that suggests some recent figures may eventually get revised up. In terms of monetary policy, the Bank of England is thinking two or three years ahead when it decides interest rates because a change doesn’t have an immediate impact. Although it depends what happens, almost all economists expect growth to start recovering after the referendum. Core inflation is already 1.5% and heading towards the 2% target. If growth does recover and inflation continues towards target, then the Bank may start to think about raising rates. It’s not going to happen tomorrow but it could happen in the second half of 2017, conditional on the economy accelerating after the referendum.

"I like to think Lloyds Bank has always been more focused on doing the right thing for its customers than some other banks. Companies in general are now more focused on that. Some of it has been driven by regulation but I think people increasingly realise that if you fail your customers you won’t have a business in a few years’ time. Companies need to develop something compelling that makes customers want to come to you. We now see a corporate conscience and a desire to look after customers because that’s how you keep them in an increasingly competitive world."

Important Note:

The information shared during our Lloyds Bank Chief Economist interview presentation was accurate at the time of recording on 13 May, 2016.

Lloyds Bank Cardnet encourages clients to remain up-to-date on economic developments and regulations and we will continue to use a range of communications platforms to help you navigate the changing payments landscape.