



Shadow Monetary Policy Committee

December 2012

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IEA's Shadow Monetary Policy Committee votes by six to three to hold Bank Rate in December

In its most recent e-mail poll, completed on 27th November, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be held at ½% on Thursday 6th December. Two dissenters wanted to raise Bank Rate by ¼% immediately, while another desired an increase of ½%. Most SMPC members thought that there should be no additional Quantitative Easing (QE) for the time being. One reason was that Mr Osborne's 9th November decision to transfer £37bn of gilt coupon payments from the Asset Purchase Facility (APF) to the Exchequer represented a *de facto* monetary easing. Several SMPC members expressed concern that the announcement blurred the distinction between fiscal and monetary policy, risked politicising the latter and brought forward revenues into fiscal 2012-13 at the cost of increased borrowing in later years.

The SMPC poll was largely completed before the announcement that Mark Carney would be the next Governor of the Bank of England. To the extent that SMPC members expressed a view of the appointment, it was that this was an excellent choice that sent a clear signal about the openness of the UK to global talent. The contrast between the strong Canadian economy and the weak British one helps explain Mr Osborne's decision. However, Canada has been helped by a noticeably less-competitive and internationally-open banking system and a far stronger fiscal background than Britain experiences. There was some concern that the new Governor might prove an unduly hard-line financial regulator in a way that was not appropriate at the current depressed point in the cycle.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses correspondingly should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 15th January 2013 and its minutes will be published on Sunday 3rd February. The next two SMPC e-mail polls will be released on the Sundays of 6th January and 3rd March, respectively.

For Further Information Please Contact:

David B Smith + 44 (0) 1923 897885 xxxbeaconxxx@btinternet.com

Philip Booth + 44 (0) 20 7799 8912 pbooth@iea.org.uk

Richard Wellings +44 (0) 20 7799 8919 rwellings@iea.org.uk

For Distribution Enquiries Please Contact:

Pippa Courtney-Sutton +44 (0) 20 7246 7811 pippa@lombardstreetresearch.com

Comment by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate and pause QE.

Bias: Adjust Bank Rate and QE to achieve appropriate growth in broad money.

Links between broad money growth and nominal GDP increase have survived past five years

The last five years have been the most difficult for the British economy since at least the 1970s and perhaps since the Second World War. The disappointments on both output and inflation have been severe, and were more or less completely unexpected in 2007. It is therefore worth emphasising that the data of the period are again consistent, in general terms, with the monetary theory of national income determination. A salient fact is that in the five years from mid-2007 to the third quarter of 2012, the compound annual growth rates of $M4^{ex}$ (2.4%) and nominal GDP (2.1%) have been extremely close. Despite the turmoil of events, the latest five-year period has seen both the lowest rate of increase in the quantity of money and the lowest rate of increase in nominal GDP since the 1950s. Moreover, in the period of the sharpest downturn from autumn 2007 to mid-2009, the parallelism of the changes in money and nominal GDP was striking, with money having a short lead over nominal GDP, just as Milton Friedman would have envisaged. The Great Recession in the UK, like the Great Depression in the USA, is to be interpreted – above all – as a monetary phenomenon.

Continuing validity of the monetary theory of national income determination

The continuing validity of the monetary theory of national income determination needs to be emphasised not just to restate an essential truth in economics, but also to comment on two of the latest fashions. The first fashion is to claim that the effectiveness of QE is subject to ‘diminishing returns’, so that the Bank of England will have to find another, new method of conducting expansionary monetary policy. The ‘diminishing returns’ claim has been made, for example, by Professor Charles Goodhart of the London School of Economics and Jeremy Warner of *The Daily Telegraph*. It is bunkum. The state can always create money balances, simply by making larger payments to the non-bank private sector than the non-bank private sector is making to it, while the effect of a 1% (or 5% or 50%) increase in the quantity of money is to raise – roughly speaking – the equilibrium level of money national income also by 1% (or 5% or 50%).

Higher inflation reflects big 2008 sterling depreciation and weak supply side

Secondly, at various points in the last few years concern has been expressed about the risk of high and rising future inflation. Inflation has indeed been disappointingly high in the immediate sequel to the Great Recession and the official inflation target has been exceeded by more than 1% for much of the five years since 2007. However, to characterise the UK as in the grip of a runaway inflationary process, akin to the 1970s, would be absurd. Also, the increase in nominal GDP since 2007 has been lower than in any other quinquennium for the past sixty years, if not longer. The setbacks on inflation should be seen as the consequence of the big 2008 devaluation and the economy’s poor supply-side performance.

Recent UK monetary acceleration is consistent with 5% plus rise in money GDP

The point here is that alarmism about inflation is justified only if the trend rate of money growth is changing. The latest data do show an upturn in the growth rate of $M4^{ex}$. In the six months to September, $M4^{ex}$ rose at an annualised rate of 6.1%. Given that the low return on money balances is compatible with a fall in the ratio of money to income/expenditure, that rate of money growth ought to be consistent with at least a 5% growth rate in nominal GDP. However, it does not seem to me that inflation is ‘out

of control' or anywhere near 'out of control'. The recent upward blip in money growth can be attributed to the resumption of QE operations, for which the justification was far less than clear-cut than it had been in early 2009. The QE operations should be paused, at least for a few months until there is greater visibility in the money growth outlook. One possibility should be welcomed, that the UK banking system is now able – at last – to resume steady growth 'under its own steam'. In other words, banks can respond to their customers' credit needs by expanding their balance sheets, in the way that was seen as normal before the regulatory excesses of the Great Recession.

Official statisticians underestimated growth before the crash and may be doing so again

Before closing, it is worth making a couple of rather miscellaneous comments. The first is that the numerous media stories about 'the UK slipping back into recession', which appeared in the middle of 2012, were misleading. Admittedly, they were based on the official statistics compiled by the Office for National Statistics (ONS), but the UK's GDP statistics are not reliable in short-run macro analysis. Far better in understanding the latest trends are business survey information and employment numbers; these have indicated an economy growing at about its trend rate or perhaps a little above it in recent quarters. The trend growth rate is maybe only 1% to 1½% a year. However, and in that context, growth of a mere 1½% to 2% is above-trend and we should be grateful for it! It cannot be overlooked that unemployment has been generally falling throughout 2012, while a detailed comparison of the ONS growth figures for the period 2002 Q1 to 2007 Q4 published in 2008 with the latest official estimates reveal that the ONS underestimated the growth rate by an average of 0.44 percentage points during this earlier period or a cumulated 2½% or so. If this 0.44% were added to the annual growth rate for every quarter in the past three years, the present 'recovery' would look appreciably more like a 'normal' cyclical recovery than the present ONS statistics are suggesting.

Eurozone represents a diminishing share of the world economy

The second of the miscellaneous comments relates to the world economy and, hence, the international environment for British exports and for British companies with a high ratio of foreign to domestic earnings. Too much attention is paid to the Eurozone and to Europe as a whole. Sure enough, the various dysfunctional features of the single currency area are now glaringly on display. They have caused a major economic and social disaster in our neighbours, and seem likely to continue to do so for a few years yet to come. That is bad news and will hold back our own economy to a degree. However, the Eurozone now accounts for only a sixth of world output and its share is falling rapidly. There is nothing much the matter with the rest of the world economy and it is reasonable to envisage a trend growth of total world output of at least 3% a year in the rest of the 2010s. In particular, the USA seems likely to enjoy a relatively standard cyclical recovery in 2013 and 2014. The US banking system has absorbed most of the losses of the sub-prime mortgage *debacle* and is now well-capitalised by past standards. The hullabaloo about the USA's 'fiscal cliff' is entirely misplaced. The return to positive broad money growth in the last few quarters and virtually zero short-term interest rates imply a rather good year for US economic activity in 2013.

No urgency to raise Bank Rate

As far as the UK's monetary policy dials are concerned, my view is that there is no hurry to move to a higher level of short-term interest rates for the present, although it is possible that a rise in interest rates will be needed during the course of next year. The overriding objective should be stable growth of the quantity of money at a low non-inflationary rate. As mentioned above, with broad money growth quite strong in recent months, QE should be paused. However, the pausing of QE does not mean that debt management policy is unimportant or that it has ceased to be effective as an

instrument of macroeconomic policy. The Bank of England, HM Treasury and the Debt Management Office (as a Treasury agency) need to coordinate the management of the public debt at all times, so that the state's transactions in public debt help in maintaining a low and stable rate of money growth.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate; no change in asset purchases.

Bias: Additional asset purchases, ideally in private assets.

Monetary indicators do not reveal a medium-term inflation problem

UK Consumer Price Index (CPI) inflation remains above the 2% target. It is unlikely now to fall below that level until the end of 2013 given larger-than-expected increases in domestic energy prices and the effect of the government's decision to hike university student tuition fees. Does this invalidate the Bank of England's decision to continue with ultra-easy monetary policy? A gaggle of commentators continue to argue that the explosion of the Bank's balance sheet represents a major threat to price stability in the UK. Based on a crude version of the quantity theory of money, this view should be refuted with vigour – broad money, the variable that is relevant for nominal demand and ultimately inflation ($M4^{\text{ex}}$ in Britain's case) has barely grown over recent years. Monetary indicators do not suggest that medium-term inflation will exceed the Bank's target. If anything, absent a swift pick-up in UK broad money growth (which remains unlikely without another large dollop of asset purchases), monetary data continue to suggest downside risks to price stability.

Problems on the real side of the economy

Concern about inflation, such as it is, stems from the real side of the economy. Output has been broadly flat over the last couple of years. Survey evidence suggests activity is growing but only just. Although real GDP expanded by 1% between the second and the third quarters this figure was heavily distorted by the loss of working days in the second quarter caused by the Diamond Jubilee and the August Olympics. There remains considerable debate about the causes of this weakness. Does it reflect permanent supply-side damage which has worsened the trade-off between output and inflation? Is it caused by temporary factors which have depressed effective supply? Or is it simply caused by insufficient demand? Undoubtedly, all three explanations are relevant. Amongst UK policymakers there is a growing sense that the weakness of UK output is a supply-side phenomenon, and that it is likely to be permanent. The MPC, for instance, recently revised down its expectations for UK growth in the medium-term and argued that underlying productivity, which has been extraordinarily weak in recent years, would only expand slowly in the years ahead. This is a notable admission – the Monetary Policy Committee (MPC) not only believes that the crisis has had a large one-off effect on potential output, but also that it will constrain potential output growth over the medium-term.

Undue policy defeatism

Yet, the MPC also places weight by the view that demand and potential output will move together over the years ahead; i.e., that the weakness of productivity is in large part due to effective supply failures and sluggish demand. If so, a failure to stimulate demand sufficiently today will cause lasting and avoidable supply-side damage. MPC members are right to acknowledge the limits of asset purchases, and monetary policy more generally – monetary action cannot bring about the necessary real adjustments in the UK economy and elsewhere. However, the MPC, and other UK policymakers, are increasingly being gripped by policy defeatism. In the aftermath of a severe banking crisis, the feedback loops between demand and potential output are likely to

be much more powerful than in normal times. Overall macroeconomic policy must err on the side of doing too much in the current environment. In light of the planned fiscal tightening, the heavy-lifting must be done by the Central Bank. Ideally, this would be supported by an easing of capital and liquidity restrictions on UK banks, which although desirable in the long-term, are counterproductive in the current environment. The transfer of accumulated coupon payments on the BoE's gilt holdings to HM Treasury represents an additional degree of monetary accommodation. As the funds are transferred, the government's need to issue gilts to fund the budget deficit will be reduced – this should boost broad money by an equivalent amount and work in a similar manner to Bank of England asset purchases. The benefits of the Funding for Lending Scheme (FLS) should also filter through to overall monetary conditions in the months ahead. It is worth waiting to see how much support the scheme provides. Monetary policy will also have to respond quickly if conditions in the Eurozone worsen. On balance, however, additional monetary ease is likely to be needed, even if the Euro area muddle-through continues.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold Bank Rate.

Bias: Maintain asset purchases at £375bn; only increase the total to offset declines in M4^{ex}.

Monetary 'magneto failure'

We live in a world where the monetary transmission mechanism works well most of the time, but at certain times it fails. Keynes called this problem 'magneto failure' (i.e., comparable to the failure of the electrical system in a car). What Keynes meant was that in a modern economy broad money is created mainly by commercial banks making loans, not by central banks creating bank reserves. In normal times, the rate of growth of broad money is a good guide to the rate of growth of nominal spending. However, when households or firms or financial institutions are reluctant to borrow – as they tend to be after a bubble has burst, and when, in addition, banks are reluctant to lend, then the monetary transmission mechanism does not work. Under these conditions, no matter how low interest rates fall, the reluctance to borrow and lend may frustrate the authorities' wish to maintain adequate rates of money growth to ensure full employment GDP.

Monetary policy à outrance

In Keynes' 1930 *Treatise on Money* he argued for extreme measures of monetary expansion ("monetary policy à outrance"), or QE as we would say today. "These extraordinary methods are, in fact, no more than an intensification of the normal procedure of open-market operations. I do not know of any case in which the method of open-market operations has been carried out à outrance." However, he had concluded by his 1936 *General Theory* that the authorities would either not do this ("Central Banks have always been too nervous hitherto") or that the economy could remain far below full employment for extended periods even with such measures. Consequently Keynes came to the view that the economy should fall back on government borrowing and spending to ensure adequate aggregate demand at such times of 'magneto failure'.

Keynesian dilemma has returned

Central banks and government Treasuries face exactly the same dilemmas today. On the one hand, the Bank of England, the US Federal Reserve and the European Central Bank (ECB) have all been expanding their balance sheets. The Bank of England and the Fed have done this mainly by adding to their holdings of securities,

while the ECB has done it mainly by making loans, and yet real GDP growth in each area remains far below desired growth rates and levels, while unemployment remains disappointingly high. In general, central bankers are nervous about going to extremes and flooding their economies with excess money as this would arouse fears of inflation. Similarly, and on the other hand, governments have been increasing their borrowing and spending in order directly to boost incomes, output and employment. Yet they, too, are acutely nervous of excessively increasing their indebtedness beyond some undefined limit in case investors react by rejecting their debt offerings, driving up government bond yields, and having knock-on effects on other public and private borrowing costs.

Which Keynes to follow?

If this is the intellectual backdrop to the debates on QE and austerity in Britain today, what should policy makers do – follow the Keynes of 1930 or the Keynes of 1936?

Divergence between M4 and M4^{ex} broad money clouds the picture

On the monetary side the key question is: what is the appropriate rate of growth of broad money? If Keynes were alive today he would surely say that ‘animal spirits’ were depressed and the reluctance of households and financial institutions to borrow and the reluctance of banks and others to lend was inhibiting the rate of money growth as a consequence. On the face of it, this means that there is a strong case for continued asset purchases by the central bank. However, the problem here is that while M4 declined by 3.5% in September compared with a year earlier, M4^{ex} (which excludes intermediate other financial corporations’ holdings) increased by 4.1% over the same period and by over 7% p.a. on a three month annualised basis. This was probably, in part, due to the £50 billion asset purchase programme initiated in July.

Higher inflation in October suggests that the Bank should err on the side of caution

Since CPI inflation has recently increased to 2.7% in October, the Bank should probably err on the side of caution for a while. Having made the serious error of presiding over excessive monetary growth between 2004 and 2009 (with M4 growth mostly in the range 8% to 14% p.a.), the Bank of England should now be much more careful to maintain broad money growth below 8% for the foreseeable future. In my view, therefore, the Bank was probably correct to suspend asset purchases in November. Nevertheless, this question should be reviewed if money growth shows signs of weakening in future. Against this background, the Bank of England should hold rates stable at ½%, but be prepared to undertake additional asset purchases if M4^{ex} growth falls abruptly.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%; gradually withdraw QE.

Bias: To steadily raise Bank Rate to 2%, then pause to review.

Time to normalise Bank Rate

The economy will grow faster over the medium term if interest rates are closer to the natural rate – which probably sits at around 3.5% at present and hopefully will rise to about 5% over the next five years. With positive GDP growth last quarter, the MPC has another window of opportunity to raise rates. With inflation rising again, it should find that straightforward to explain in terms of the inflation target, insofar as that is still a relevant determinant of policy – i.e., very little. A rise of ½% initially then increments of ¼% to ½% each month until 2% is reached would provide an initial phase of normalisation.

How to withdraw QE

QE was originally envisaged as gradually phasing itself out as coupon payments came in and bonds were redeemed. With the Treasury's decision to take £37bn in interest payments as a notional 'profit' on QE - notwithstanding the fact that the scheme currently stands to lose £48bn on a hold-to-maturity basis - the Bank of England faces a situation in which its original intention to withdraw £37bn of QE automatically next year will not be realised, unless there is an explicit decision to do so. Without such a decision, QE would only be withdrawn as bonds are redeemed or, alternatively, if bonds are sold into the market. However, the latter course would surely result in a significant fall in bond prices. There has already been too much QE. Nevertheless, it would shake confidence to explicitly withdraw QE at this stage by selling bonds. It would be better to allow QE to be phased out gradually by retiring the money of coupons as they are paid and for the Treasury then simply to make its standard claim on the profits of the Bank. This should be done.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE.

Monetary policy and regulatory policy are now one

Unfortunately, it is difficult to talk about monetary policy today without referring to regulatory policy. These two branches of policy will now be put under one roof, with the new Governor of the Bank of England in charge of both. It is hard to feel much confidence in the future conduct of either branch.

Bank has confused relative price shocks with general inflation

Looking over recent events, we observe that inflation has been above its target for several years. It was forecast to come back below 2% by the end of this year, but it now looks as if it will rise again towards 3% or more over the next twelve months. The Bank's response to this further failure of control is to blame 'individual price rises' yet again; this time it is university tuition fees besides the old favourite of utility prices. Of course any month's inflation figure is bound to be the result of some individual price rises but the point about higher inflation is that this is the way it always presents itself. The Bank has again taken no action in the face of this deteriorating inflation outlook. True, it has not done any further QE but neither has it ruled out more QE. As it has noted, the ceding to the Treasury of the debt interest on the gilts it has acquired represents a monetary loosening in the sense that it allows the Treasury to issue less gilts to private lenders than otherwise – it is as if the Bank had done this much QE and bought gilts issues to this amount.

Bank of England subservient to HM Treasury and politicians

It is now hard to see the Bank as independent of the Treasury and this government. The implicit 'deal' had been that: a) there would be fiscal tightening; b) this would be 'offset' as far as possible by monetary loosening, regardless of the inflation developments; and c) there would be extensive regulative tightening of the banking system. The Bank is a wholly-owned subsidiary of the Treasury so none of this is new. What is new is the subservience over the one part of the Bank's remit where it was supposed to have 'instrumental independence' – viz. the targeting of inflation. The Bank was to be the outward manifestation of the de-politicisation of inflation, the keeper of the new anti-inflation consensus, much like the Bundesbank once was in Germany. Instead, it has neglected its credibility and inflation is adrift in a potentially dangerous way.

Regulatory attack on banks

The one thing that is holding inflation down is the other major failure of this policy: the regulatory attack on the banking system that has resulted in the collapse of lending, especially to small companies. The UK's ramping up of the Basel III requirements for capital and other tiers has made lending highly expensive, particularly for borrowers with high risk status. The point has repeatedly been made by Per Kurowski that Basel biases lending heavily away from risky borrowers anyway, since at the margin banks must not only suffer the extra risk of these loans but also load on the extra tier-capital costs the loans imply. Thus banks are incentivised only to lend to 'low-risk' parties – viz. certain governments and at a pinch top corporate borrowers.

Worst of all worlds

So we have the worst of all worlds: a paralysed banking system awash with liquidity which it is unwilling to lend, so holding back growth in the economy. However, the fears aroused by this liquidity are undermining the inflation target's credibility. It is said that we need all this regulation to stop future crises. But the evidence we have been able to gather in our recent research on the US, the UK and the Euro-area (see my academic page on www.patrickminford.net) suggests that crises will happen anyway and that if we have a banking system that is appropriately active in lending such crises will often involve the banks too. Furthermore, the UK as one of the great banking centres will necessarily have large foreign asset and liability positions: this has been its role through the ages and a major way the UK has earned its GDP. The liabilities are mainly deposits and the assets loan positions around the world. The Bank of England has been proud to be the overseer of this activity in the past. Now, and partly under orders from a government ignorant of such things, it is presiding over the ruin of this system in what can only be seen as a colossal loss of nerve.

Efficiency in banking

We need to remind ourselves that efficiency in banking suggests that the margins between deposits and loan rates be kept to the minimum. Individual risk is not social risk in lending; socially there is pooling of individual risks. Society is best off when lending is cheap and priced as competitively as possible – see recent papers on the role of banking and regulation by Anton Korinek of the University of Maryland. Recent regulatory action is driving us further and further away from this social objective. It is ironic that the UK government, which should be supporting its major industry, is helping to organise its destruction.

A British Glass-Steagall would not have prevented the banking crisis

It is said by the Vickers Commission that the investment banks must be deprived of access to deposits that are insured by the taxpayer; hence the proposed 'ring-fencing', a sort of bureaucratic Glass-Steagall arrangement. Yet the commercial banks used these deposits to make loans that went as badly wrong as did the investment banks with their more exotic loans. Deposit insurance is there to prevent runs on banks by making small depositors feel secure. Banks still lose money if they make poor loans, surely a powerful incentive against the 'moral hazard' of being secure about keeping their depositors. The main implication of the social optimum is that we need competition between banks, to drive down rates and encourage lending again. Bureaucratic schemes like 'Funding for Lending' cannot substitute for such incentives.

UK monetary policy badly adrift

When policy is so badly adrift, it is hard to know what advice to give for that branch of it that merely deals with monetary policy. Some SMPC colleagues have naturally been impressed by the banking paralysis and the slow growth in the economy of which this paralysis is an important cause; these have prompted them to recommend keeping rates low and open the QE taps more. Yet it is obvious that these actions have not led to any rise in lending nor have they produced (as a result of this failure to stimulate

lending) a healthy rise in the money supply. All that has been achieved is a very low cost of government borrowing and record low returns to savers on safe assets.

Better monetary policy would enable an improved regulatory approach

Getting monetary policy right, however, could lead to an improvement in regulatory policy, since then the government would realise that it could not rely on monetary ease to substitute for excess regulative enthusiasm. It would be forced to ease the regulative burden by the need to get lending and money supply growth and so growth in demand going up again against a backdrop of rising interest rates and reversed QE.

Raise Bank Rate and stop and reverse QE

It is for this reason that interest rates should be raised forthwith by ¼% with a bias to raise Bank Rate further in a steady manner. QE should be stopped and reversed steadily over the next twelve months. These actions should be taken to remove the future threat to inflation posed by the QE-induced liquidity overhang; and by the loss of Bank credibility over its inflation target. As monetary policy is returned gradually to normality, excess regulative burdens should be removed from the banking system and competition reintroduced in a manner mimicking the entry of building societies into the banking high street in the 1980s and foreign banks in the 1990s. To help this process on its way, the Treasury should dispose of its stakes in Lloyds and the Royal Bank of Scotland group by breaking these huge banks up into competing parts.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Raise Bank Rate by ¼%; hold QE.

Bias: Avoid regulatory shocks; break up state-dependent banking groups; raise Bank Rate, and maintain QE on standby.

World economy still treading water

It is increasingly likely that the 1% increase in UK GDP in the third quarter – which was confirmed by the revised estimate released on 27th November – was an aberration that largely reflected a catch-up from the negatively distorted second quarter figure. The very sketchy output and expenditure data for the fourth quarter suggest renewed weakness, although a lot will hang on the strength of household demand over Christmas. The UK is not alone in this fourth quarter faltering, however, and recent figures show a closeness of fit between the annual increases in UK real GDP and that in the wider OECD area which suggests that the British economy is to some degree being swamped by the turbulent events happening overseas. This is unfortunate because international indicators suggest that activity in the leading industrialised economies lost momentum in the fourth quarter. One example is the latest Munich based *CES Ifo* 'World Economic Climate Indicator', which continued to fall in 2012 Q4, albeit only slightly. The decline was due to less favourable assessments of the current situation and reduced expectations for the outlook over the next six months. The largest drop in the *CES Ifo* measure was recorded in Western Europe, and there was a more mixed picture in North America. However, even Asian respondents reported that current economic activity remained at an unsatisfactory level. The conclusion drawn by the *CES Ifo* economists was that the world economy was currently treading water. This seems to be as fair an assessment as any of the international background in which the UK economy is trying to operate.

Autumn Statement

Turning now to domestic matters, this commentary was prepared before the announcement of Mr Osborne's 5th December *Autumn Statement* and the release of an updated set of forecasts from the OBR – the first time that these will have been updated since the 21st March Budget. There is little point in speculating about the

details of the Autumn Statement, given that it will be announced only a few days after this note is released. However, it is clear that the March Budget forecasts for the public finances have proved overoptimistic and that the Chancellor's fiscal policy strategy is badly off course. The fundamental reason is that, in practice as distinct from rhetoric, Mr Osborne has been attempting a Type 2 fiscal retrenchment predominantly weighted towards tax increases, rather than a Type 1 strategy in which spending discipline takes priority and taxes are not raised. This explains the sogginess of national output – although the situation has clearly not been helped by the weakness of many of our trading partners – and the unfavourable nature of the current output/inflation trade off. Unfortunately, the Chancellor also appears to have failed to get a grip on departmental spending. In particular, civil servants appear to have been running rings around Mr Osborne when it comes to their reward packages by using all the re-grading and other tricks they first learnt during the incomes policies of the 1960s and 1970s. It is questionable whether this situation can be turned round in time to fight a successful election campaign in 2015. Fundamentally, the Conservatives wasted their thirteen years in opposition, when they should have been devising a market-based, pro-growth strategy. They have since been learning from their mistakes while on the job but have done so too slowly to get a grip on events.

The new Bank of England Governor and...

The contrast between the strong performance of the Canadian economy over the past five years and the worse performance of the British one may be one reason the Bank of Canada Governor, Mark Carney, has been appointed to follow Sir Mervyn King in June 2013. However, while the Bank of Canada clearly performed well in avoiding the worst excesses of the pre-2007 international credit boom and the subsequent crash, it was helped by a less highly-competitive and internationally-exposed banking system than Britain's and by a far more responsible fiscal policy background. The latest figures from the OECD indicate that General Government outlays amounted to 39.4% of Canadian GDP in 2007, compared with 43.9% in Britain. Government outlays then soared to 48.7% in Britain in 2012, according to the OECD, but were still only 41.8% in Canada. The Canadian government had enjoyed a financial surplus of 1.4% of GDP in 2007 and its General Government Financial Deficit appears to have been a modest 3.5% in 2012. In contrast, Britain had already suffered a General Government Financial Deficit of 2.8% of national output in 2007 when it should have been running a substantial surplus on normal Keynesian demand management grounds. This deficit figure was still 6.6% in 2012, the ratio having peaked at not quite 11% in 2009. Fortunately, the strong international reputation of the new Governor will add to the credibility of UK macroeconomic policy. This is important given the poor outlook for fiscal consolidation and the need to avoid a collapse in overseas confidence ahead of the next general election. However, Mr Carney may have to undertake a major institutional re-building of the 'old' parts of the Bank, which failed badly in 2007 and 2008, as well as having to integrate its new regulatory responsibilities.

...new Bank of England forecasting model

Meanwhile, it has been revealed by the independent Stockton review into the forecasting capability of the MPC, mounted on the Bank's website on 2nd November, that the *Inflation Report* forecasts have been largely generated by a new macroeconomic model – known as 'Compass' – since November 2011. This has replaced the previous Bank of England Quarterly Model (BEQM) that had underpinned the Bank's forecasting efforts for many years and was heavily criticised in the author's May 2007 Economic Research Council paper *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence* (www.ercouncil.org). One of the main criticisms of BEQM in 2007 was

that it contained a highly simplistic model of monetary policy in which only one short-term rate of interest was included and that there was no representation of other traditional monetary tools such as funding policy. According to the Stockton review, Compass represents an even more parsimonious Dynamic Stochastic General Equilibrium (DSGE) approach than BEQM, with only sixteen variables at its core. As far as one is aware, a detailed technical account of the new model has yet to appear in the public domain. However, it is unlikely that any of the so-called unconventional monetary policy tools, such as QE, now being employed by the Bank can be represented in the context of such a small model.

Reforming the banking system

Another issue that probably cannot be encompassed in the new Bank model is the effects of negative regulatory shocks to the supplies of money and credit which have caused so much concern on the SMPC. Here one can only express agreement with Patrick Minford's comments in this note and add four minor points. First, the payment of state-backed deposit insurance should be limited to a number of say 90% rather than the present 100% up to £85,000. This would encourage prudence on the part of depositors. Second, the most senior bank executives should have unlimited personal financial liability. There is ample historic evidence that this would remove a major source of moral hazard where the behaviour of senior executives is concerned. Third, because all the major banking groups are the product of numerous mergers over many years, the simplest approach to the 'too big to fail' problem would be to break them up into their original constituents using normal anti-monopoly legislation. Finally, some arrangement would have to be made to allow the demerged banks to share their computer systems for cheque clearing etc. on a fair basis until they have time to develop their own. This could probably be done by voluntary agreement. However, there might have to be an official arbiter on standby for cases of disagreement.

Mr Osborne's gilt interest grab

The more one thinks about the Chancellor's 9th November decision to transfer gilt coupon payments received by the Asset Purchase Facility (APF) to HM Treasury, the harder it becomes to understand the political thinking involved. What may have happened is that the internal briefings on the forthcoming 5th December Autumn Statement indicated that the public finances are not coming right and this was a book cooking attempt to bring cash receipts forward – at the risk of an offsetting or larger reverse flow in future – in order to make the figures look better or, alternatively, too complex for anyone to understand. However, that means less cash flow in future, which is odd if one is thinking in terms of a 2015 election. The PSNB was already being pushed down by the once-and-for all £28bn receipts from the Post-Office pension fund in the present financial year. Even before the 9th November announcement, there was the likelihood of a sharp borrowing rebound in fiscal 2013-14 given the lack of progress in reducing the underlying deficit. The fact that the Post Office and APF announcements have artificially reduced borrowing by a total of £65bn in 2012-13 at the cost of large extra financial commitments in later years has substantially increased the likelihood that the government will go into a May 2015 general election with the PSNB way off track. Under these circumstances, massaging down this year's borrowing at the expense of even worse figures in the run up to the election seems political suicide.

Recent inflation trends

Meanwhile, the latest inflation figures show that the target CPI increased by 2.7% in the year to October, compared with 2.2% in September, while the all-items RPI and the old RPIX target measure increased by 3.2% and 3.1%, respectively. The 'double-core' retail price index – which excludes mortgage rates and housing depreciation and

is the most historically consistent inflation measure – rose by 3.2% over the same period, compared with the 2.7% recorded in September. Producer output prices, which some people consider an early indicator of consumer prices, showed an unchanged year-on-year inflation rate of 2.5% in October, while the yearly rise in producer output prices excluding food, beverages, tobacco, and petroleum products accelerated slightly to a still modest 1.4%, compared with 1.2% in September. With the annual increase in economy-wide earnings a modest 1.8% in the year to the third quarter, there seems to be little risk of UK inflation accelerating too far in the immediate future, as long as confidence in sterling holds up, whatever one fears about the longer term inflation risks associated with current fiscal and monetary policies.

December Bank Rate decision

As far as the December Bank Rate decision is concerned, the temporarily reduced uncertainties in Continental Europe suggest that there is a window of opportunity to raise rates and that it is now time to introduce a modest $\frac{1}{4}$ % hike in Bank Rate. The medium-term aim should be to get Bank Rate into the 2% to 3% range at which it re-engages with the money market rates that determine borrowing costs. The 4.2% annual rise in M4^{ex} broad money in the years to both August and September, and the signs that broad money growth is accelerating, suggests that there is now a much weaker case for holding Bank Rate at the low emergency levels appropriate when the authorities were acting as a lender of last resort. Mr Osborne's recent grab for the interest savings generated by QE has confirmed that such free funding has generated political moral hazard and allowed the Chancellor to avoid the hard public spending decisions required to stabilise the official finances. QE should be strictly reserved for lender of last resort purposes from now on and not employed as an instrument of day to day monetary policy.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Hold Bank Rate; diversify existing QE into non-gilt assets.

Bias: To raise Bank Rate.

Weak corporation tax receipts suggest recovery is stalling

The weakness of corporation tax receipts is a warning not to read too much into the 1% rebound in third quarter GDP. The fiscal outlook for the economy has worsened appreciably this year, not so much because of weak growth as the legacy of the latest inflationary lapse. Indeed, public sector services made a chunky contribution to economic growth in the third quarter. The evidence is accumulating that more can readily be achieved with less (fewer employees) in the public sector, which can hardly come as a surprise. Unfortunately, productivity has been weakening in a number of other private sectors, including financial services.

Firms reluctant to invest

Of even greater concern is that the impetus behind corporate investment has faltered again. This partly reflects the depressing messages from the Eurozone economies, but possibly a more general perception that the developed world is locked into a low-growth phase. The downgrading of future capital expenditure requirements may help to explain why asset lives are lengthening throughout the developed world and why so many global corporations are willing to return cash to shareholders. What does all this mean for the conduct of monetary policy?

Bank should normalise short rates

The Bank of England must not lose sight of its goal of normalising short-term interest rates. Running policy on the basis of a permanent emergency is sending a progressively negative message to the entrepreneurial sector. The more reckless the

policy, the greater is the risk to the real return on capital spending. If there is a role for 'forward guidance', it is to reassure of the Bank's determination to take rates back to the region of 2% to 2.5% over the next two years. For now, the economy could do without any more tinkering. QE has reached the end of the road.

Comment by Mike Wickens

(University of York and Cardiff Business School)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate.

British economy remains flat and public debt is rising

The immediate background to the next monetary policy decision is Mr Osborne's December statement on fiscal policy. This will be for a British economy that remains flat and has a high and still rising level of debt – the latter constrains any scope for a fiscal stimulus. The only good news for monetary policy is that smoothed inflation has fallen somewhat, despite the uptick in October, due to energy price rises a year ago now dropping out of the year-on-year CPI.

Main problem is lack of demand

The main problem for the UK economy is a lack of demand. Household expenditures are still suffering from the sharp rise in the savings rate in 2008 as households tried to reduce debt. This has been sustained by households saving for big ticket items rather than borrowing as previously. Investment expenditures and house building also remain depressed. These are both significant constraints on the effectiveness of monetary policy and QE. Historically low interest rates and plentiful bank reserves have failed to offset rock-bottom household and business confidence. To make matters worse, exports have fallen in 2012 due to recession in the EU – a main export market – and imports have risen. A steady appreciation of sterling during 2012, reflecting in part the perception that the UK is a safe-haven, has contributed to this worsening of the current account.

'Primary' budget deficit has increased

Falling government expenditures have added to stagnant aggregate demand. Even so, it is worth noting that in 2011/2012, as a proportion of GDP, the primary deficit has continued to increase as revenues have fallen more than expenditures. The consequent continuing rise in government debt – when combined with the fear of having to pay much higher interest rates as a result – remain a major constraint on the government's willingness to borrow more to finance a substantial fiscal stimulus.

Bank officials believe that monetary policy has shot its bolt

To make matters worse, according to recent public statements made by various members of the MPC, including the current Governor, there is little that monetary policy can do to provide a stimulus. Interest rates are already close to their lower bound and bank lending is no longer liquidity constrained. Furthermore, a flatter term structure due to further QE is highly unlikely to induce more private sector borrowing for business investment or for household expenditure. Significantly, QE is not much different from new government borrowing and therefore has done little more than offset the negative effects on the economy of this additional borrowing. It is worth noting that the lower-bound constraint on interest rates shows up in simulations of macroeconomic models as a negative monetary policy shock, implying that monetary policy is tighter than it would be if unconstrained.

HM Treasury's £37bn interest receipts grab

A recent announcement is that £37bn in interest payments to the Bank of England arising from its purchases of government debt from the market will be returned to the Treasury. How to interpret this in terms of its effects on monetary and fiscal policy

depends on how the ONS decides to incorporate it into the national accounts. Assuming that the interest payments are still included in the government budget constraint, then this is an increase in the money supply which will reduce the deficit and hence new debt issuance. The consolidated government budget constraint, which combines the government and the Bank budget constraints, is unaffected, however.

Helicopter drops of money

With monetary policy ineffective at present, there has been mention of an even more unconventional monetary policy: i.e., making a so-called 'helicopter' drop of money. This is a theoretical concept associated with Milton Friedman and the printing of money. The attraction is that it puts immediate spending power into the hands of income- and credit-constrained households who should then spend it, in theory. In practice, this could be achieved by a one-off cut in taxes or increase in benefits that is money, and not debt, financed. The apparent objection of the Bank of England is that it would be inflationary and would destroy the hard-earned credibility of the inflation anchor, probably the most important achievement of monetary policy since 1992. Although it would be expected to raise inflation temporarily, this fear would only be justified if the expansion of money growth were permanent and not one off. It may, therefore, be worth giving this serious consideration in order to get more growth. Such a policy would not, of course, be pure monetary policy; rather, it would remove the separation of fiscal and monetary policy of recent years.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)

Vote: Hold Bank Rate.

Bias: Neutral.

Will the new Governor mean a new approach?

In the minutes of the November meeting, the MPC highlighted the continued fragility of UK economic recovery. Whilst overall policy remained unchanged this month, the MPC is clearly watching domestic and global events carefully and is poised to react as and when necessary. However, the first question that arises is which way are the current economic trends pointing? In summary, they seem to be pointing lower where activity is concerned. However, there then comes the follow-up question of how to ease most effectively? A new approach may arrive with the new Bank of England governor, Mark Carney or, perhaps, not.

£37bn QE net interest transfer to HM Treasury has precluded need for further QE

The MPC meeting saw only one vote for a further £25bn increase in QE, which was largely in line with market expectations. The 8 to 1 majority in favour of maintaining QE at its current levels was undoubtedly influenced by the early November announcements that the £37bn accumulated net interest on gilts that the Bank already held was to be transferred to HM Treasury. The effect of this was deemed to be akin to QE, negating the need for further monetary easing, according to the minutes of the MPC November meeting. However, that does not mean that further QE is completely off the agenda. The MPC did not rule it out. Instead, the monetary authorities were willing to assess the impact of programmes like the Government's Funding for Lending Scheme, which appears to be finding some traction in particular in household borrowing.

Steadying the ship and inflation

Following wide consultation with a number of financial bodies, the MPC was explicit in ruling out any reduction in the bank rate from the current ½%, which was widely expected. It noted that a cut would hit the profitability of financial firms, further undermining confidence and future economic recovery. Regarding inflation, the effects

of increases in household energy costs, rising fuel duty and higher tuition fees led the MPC to anticipate that the rate of inflation will remain above target over the coming year. Nevertheless, they project a return to around the 2% target once these pressures subside.

Bank's watchful eye

On that basis and considering the potential for a slowdown in output in the UK and the Eurozone in the final quarter of this year, the MPC acknowledged that there may be a case for further monetary easing in 2013. Despite the higher near-term inflation profile, the MPC noted that 'a case could be made for a further easing in monetary conditions'. The minutes said that undertaking further stimulus could help to discourage 'any further appreciation of sterling' and 'might help to avoid lasting damage to the supply capacity of the economy'.

Low rates may be here for some time

My recommendation is that policy stays on hold, but if inflation were to approach last year's levels of 5%, rates might have to be increased, given the damage that inflation has done to real growth. Nevertheless, this outcome seems highly unlikely as weak growth in Europe – and only a modest recovery elsewhere – do not suggest that we are on the cusp on an inflation surge. The question of what is damaging UK growth cannot be addressed by monetary policy alone. Also, the question of balance sheet adjustment – whether it is a supply of credit problem or a demand for debt problem or neither – cannot be addressed by interest rate policy. Hence, low rates may be here for some time.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (University of Derby and Beacon Economic Forecasting). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Wholesale Markets). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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Pellipar House, 9 Cloak Lane, London EC4R 2RU
www.lombardstreetresearch.com