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Shadow Monetary Policy Committee

January 2014

Embargo: Not for publication before 00:01am Monday 6th January

Shadow Monetary Policy Committee votes six/three to raise Bank Rate in January

In its most recent e-mail poll, finalised on 2nd January, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 9th January. Four shadow committee members wanted a ½% increase and two SMPC members voted for a rise of ¼%, while three wished to leave rates unaltered. This pattern of votes would deliver an increase of ¼% on the usual Bank of England voting procedures.

Despite the split vote, there was considerable agreement amongst the SMPC members that the British economy had picked itself up off the floor at last and that growth prospects for the next year or so were reasonable. Several individuals mentioned the upwards revisions to UK national output published just before Christmas. These suggest that the economy expanded by 1.9% on average last year, rather than the 1.4% which had previously seemed likely. However, there was also concern that the dismal third quarter balance of payments figures released alongside the GDP figures indicated that home demand was running ahead of potential supply. Nevertheless, the immediate inflation outlook seemed reasonable, with some prospect of a further easing during 2014. The essential splits between Hawks and Doves were over the margin of spare capacity still available and how far it was urgent to commence the process of normalising real interest rates. There was also concern that forward guidance made it difficult for the Bank to act pre-emptively when the economic situation suddenly changed. Several committee members independently warned about the risks to the recovery posed by potentially over-zealous financial regulation.

The SMPC is a group of economists who have gathered quarterly at the 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 elsewhere. 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. As a result, the nine independent analyses should be regarded as more significant than the exact vote. The next quarterly SMPC gathering will take place on Tuesday 14th January and its minutes will be published on Sunday 2nd February. The next two SMPC e-mail polls will be released on the Sundays 2nd March and 6th April, respectively.

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Comment by Tim Congdon

(International Monetary Research Ltd)
Vote: Hold Bank Rate.
Bias: Hold Bank Rate for next few months, while remaining open to another round of QE if demand weakens.

Relatively benign economic conditions

The UK is enjoying a relatively benign macroeconomic situation at present, certainly compared to some of its European neighbours. 2014 will see necessary and overdue measures to curb public expenditure. Easy money conditions (i.e., a positive rate of money growth as well as zero interest rates) are therefore appropriate to ensure that, for the public and private sectors combined, demand, output and employment keep on rising. Inflation is in line with target and underlying upward pressures on labour costs are very weak.

Obtuse officials

The main features of the monetary landscape are similar to those since the start of the Great Recession in 2007, including officialdom's obtuseness about the causes of the economic and financial *malaise* from which we continue to suffer. Central bankers and financial regulators still believe that an increase in banks' capital/asset ratios contributes to the health, wealth and happiness of nations, when in fact the result of the move to higher capital/asset ratios has been an intense squeeze on bank credit to the private sector. That squeeze has in turn restrained the growth of banks' deposit liabilities (i.e., 'the quantity of money', as usually understood) and so been the dominant explanation for the prolonged weakness of nominal GDP.

Inflation could drop below target in 2014

However, UK inflation is under better control now than for most of the period since the start of the semi-recovery in late 2009. The consumer price index rose by 2.1% in the year to November, almost bang in line with target. According to the December survey from the Confederation of British Industry (CBI), a net balance of only 11% of companies plan to raise prices in the next three months, lower than a year ago, while upward pressures on costs are much weaker than – say – three years ago. Inflation could drop beneath target in early 2014.

Monetary policy must be forward looking

Monetary policy must be forward-looking. The current better news on inflation therefore does not necessarily invalidate calls for a tightening of monetary policy. The argument against monetary tightening can be presented on quite different grounds, that the rate of money growth may be about to decelerate in the main countries, including the UK. 2013 saw positive money growth in the USA, the Eurozone, Japan and the UK, but not at high rates, and in three of these jurisdictions (the USA, the UK and Japan) the main force behind the expansion of banks' deposit liabilities was the increase in their cash reserves due to so-called Quantitative Easing (QE). This has now been halted in the UK and is being 'tapered' in the US. Amazingly (and foolishly), regulators in the Eurozone are about to have another go at 'tidying-up bank balance sheets', meaning that credit and money growth will be negligible there in early 2014. With the possible exception of Japan (where broad money growth is now running about 1% to 2% a year higher – *and only 1% to 2% a year higher* – than in the Great Recession), the prospect is for a fall in the rate of money growth and perhaps even a return to money stagnation. As at the end of 2010, I favour "keeping base rates at zero at least for the next few months, while remaining open to the need for another round of quantitative easing if demand is weaker than expected".

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: Neutral.

The upwards revisions to third quarter GDP figures

As we head into 2014, the UK economy is growing solidly. The latest figures from the Office for National Statistics (ONS) left output growth in the third quarter of last year unchanged, but past data were revised up. Real GDP is now estimated to have expanded by 1.9% over the last four quarters, up from 1.5% in the previous ONS National Accounts release. Equivalent figures for non-oil output are 2.1% and 1.6% (for current and previously published data). On the demand-side, higher consumer spending explains the majority of the upwards revisions. Business investment, disappointingly, remains weak, however; although it is now thought to have increased by 3.5% in the third quarter, it is still more than 2% off its end-2012 level.

Business surveys suggest economy has heated up subsequently

Business surveys suggest the economy heated up over the autumn. Output growth in excess of 1% in the current and coming quarter is possible, although other indicators suggest a more modest pace of growth. For instance, retail sales volumes in October and November were actually below their third quarter average. On balance, though, above-trend growth is likely to persist in the near-term.

Inflation backdrop remains benign

The inflation back-drop is benign. Headline CPI inflation, at 2.1% in November, would in fact be slightly below the Bank's 2% target were it not for the entirely artificial effect of higher university tuition fees. 'Core' inflation is currently around 1½%. Although the recent decline in petrol prices has played a role in capping inflation, underlying price pressures remain limited in the UK, a reflection of the spare capacity that exists primarily in the labour market but also within firms themselves.

However, this is not a normal business cycle

Were this a normal cycle, a strong case could be made for a withdrawal of monetary stimulus at this point. Indeed, the exceptional monetary measures currently in place would need to be unwound quickly. However, this is not a normal cycle, either domestically or globally. The major financial imbalances that led to the 2008/9 banking crash have not been fully resolved. It could be some while before the world economy returns to solid, sustainable growth, and en-route much could still go wrong, most obviously in Britain's main trading partner, the Euro area.

Domestic recovery is not assured

Domestically, the recovery is not assured. For the moment, it is unduly dependent on consumption – both household and government – and a rapid upswing in house prices. Business sentiment is improving, but global events could easily reverse this trend and stymie the necessary rebalancing of activity towards tradable sectors.

And there remains significant spare capacity

Most importantly, the UK economy has plenty of scope to operate at growth rates above historic norms before slack is used up. Although spare capacity within companies is less obvious than that in the labour market, it seems highly unlikely that it has disappeared entirely, as some surveys would seem to imply. Persistently sluggish demand is likely to have impinged, most probably temporarily, firms' effective supply capacity, giving another reason for monetary policy to err on the side of doing too much. As a cross-check, moderate rates of broad money growth – and still disappointing nominal GDP growth – do not suggest that monetary activism has done its job and should be scaled back.

Comment by Anthony J Evans

(ESCP Europe)
Vote: Raise Bank Rate by ½%.
Bias: Further rises in Bank Rate.

Bank needs a clear strategy for getting rates back to normal

The UK economy continues to grow at a rate that divides commentators. Some believe that this is a long overdue recovery, whilst others are concerned that it is unsustainable. Either way, there is a case for the Bank of England to raise interest rates now. If the economy is as strong as the headline GDP figures suggest, and given the fact that inflation is above target, the case for rate rises is obvious. In fact, the main reason against is a fear of the unknown brought about by a dangerously long commitment to low interest rates. Even if the economy is unbalanced, a rate rise may be sensible. Low interest rates can inhibit growth as well as stimulate it, and generate misallocations of capital. If capital remains in underproductive uses, then rate rises are a normal part of the adjustment process. The Bank of England have provided some worrying projections about how higher rates would affect mortgage costs for typical UK households. One of the key reasons against low rates is that it incentivises borrowers to take on unserviceable debts. Undoubtedly, rate rises will cause pressure on over extended firms and households, especially if they run ahead of increases in real incomes. However, this is a reason for having a clear strategy of getting rates back to normal levels, rather than kicking the can down the road.

Forward guidance can worsen uncertainty if employed in a discretionary way

Forward guidance is intended to reduce uncertainty. The fact that it contains specified thresholds gives the appearance of a clear rule that binds the central bank. On the other hand, it also has the potential to increase uncertainty if it is deployed in a discretionary way. The UK growth rate continues to run at an above-expected rate, with real GDP for the third quarter being revised up from 1.5% to 1.9% (compared to the same quarter of the previous year). When the Bank of England chose 7% as the unemployment threshold that would need to be breached prior to interest rates being raised, they forecast that this would occur in 2016. In a matter of months, this has been brought forward to 2014 with some commentators predicting it to be imminent. However, instead of forward guidance being a way for markets to anticipate interest rate rises, the Bank seem more likely to simply shift the goalposts. Instead of being used to communicate the conditions under which a rate rise would be necessary, it is being used as a tool to convince markets that rates will be kept lower for longer than current expectations.

Inflation close to target but this may prove temporary

Inflation has finally returned close to target, but inflation expectations and various forecasts suggest that this will be temporary. The conditions within the economy have changed from sluggish growth and above target inflation (which, incidentally, suggests that the problems are supply side rather than a result of inadequate monetary stimulus), to quite rapid growth and declining inflation. This is another problem with forward guidance, because it was implemented and designed for different economic conditions to the present.

Demand shortfall no longer a major concern

Broad money remains consistently above 4% growth, when compared to the previous year, and narrow money has spiked in recent months, with some measures showing a rise from a steady rate of 7% to 8% since April 2013, to 13% in October. This supports the idea that a shortfall of aggregate demand may have contributed to the 2009 recession, but is no longer a major problem. Bank rate is too low at present, and the

current conditions offer an opportunity to start the process of raising rates. It would be very dangerous to leave this until it is too late.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate further and to hold QE.

Monetarist versus creditist prognostications

We are in the midst of an interesting monetarist/creditist experiment. Broad money has been ticking along at an annual pace of around 4½% for around a year on the Bank of England's preferred $M4^{ex}$ measure. This is probably around 1.5% to 2% faster than is compatible with a 2% inflation target over the medium term if the sustainable growth rate of GDP is 1.5% to 2%. Simplifying, one would expect that monetary excess initially to drive above-trend growth and then, with a lag, a rise in inflation to 3.5% to 4% on a monetarist account. In contrast, the equivalent broad measure of bank lending has been in annual contraction for the past year, having been growing modestly in 2011 and 2012. Again over-simplifying, one would expect such a contraction in lending growth to be associated with a slowdown in GDP growth or even further recession on a creditist account.

Faster bank lending is not a necessary condition for recovery but likely to accompany it with a lag

It can now be said with confidence that no material acceleration in lending growth was required for healthy UK GDP growth to return. However, that does not mean that there will not be an eventual pick-up in lending as GDP continues to grow. As bank balance sheets appear healthier, at least temporarily, with faster income and wage growth, banks will become more willing to lend. A more rapid rate of lending growth should be anticipated as a second-round effect of faster GDP growth, feeding a further phase of yet faster broad money growth. Similarly, as GDP growth becomes embedded, investment projects foregone during the extended depression will be delayed no longer – the fact that investment has not accelerated that much yet does not bode ill for future growth prospects; quite the reverse. Indeed, we can expect a second-round effect upon investment, also, as faster monetary growth creates a greater likelihood of inflation down the line, driving investors out of fixed income assets – which offer poor inflation protection – and into real assets such as shares and machines. Thus, GDP growth becomes self-feeding for a time.

Potential international headwinds

It is plausible that such a self-feeding cycle could even persist in the face of significant international headwinds. Perhaps the Syrian situation will deteriorate further, putting pressure on oil prices. Perhaps Greece will default on official sector creditors and Portugal default on private sector creditors. Such scenarios remain significant possibilities. Nevertheless, the UK's internal monetary momentum is now sufficient that, short of major further Eurozone problems, such as a material risk of Italy or Germany leaving the Euro, we should expect the internal UK scenario to play out largely independently of international events. Solid GDP growth should drive a further phase of lending and investment growth, followed by rapid wage growth, overheating, and a spike in inflation in 2015 to 2017.

Monetary policy's evolution from moral hazard to fool's errand

The Bank of England has clearly set its face against any attempt to curtail inflation until UK GDP growth allows us comfortably to achieve escape velocity from the Great Recession. The MPC will not raise interest rates until households and banks have experienced sufficient income and wage growth for an interest rate rise not to cause the liquidation of bad debts accumulated in the years from 2000 to 2007. Survey

evidence now suggests more than a million households might default with only modest interest rate rises. If six years of depression have not been sufficient for such households to correct their finances, will they ever really do so? Policy has evolved from moral hazard to fool's errand. Clearly, policymakers are now willing to tolerate inflation rising again, and all that entails. It is already far too late. However, one can only recommend making the best of a bad lot from the present position. From where we are placed now, raising interest rates by ½%, and quite rapidly returning them to 2% before pausing to take stock, continues to be the sensible option.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼%.
Bias: To steadily raise Bank Rate; QE to be cut back at the rate of £25bn per quarter.

Bring back Bagehot!

Credit has at last started to flow again. So far, it is just the mortgage market but confidence is likely to spread to business investment soon, which so far has been held back by uncertainty and a shortage of credit. The politics of growth has taken hold, with an election soon and a new Governor of the Bank who is a much-needed pragmatic realist. For the new banking era, we need a new philosophy of regulation that is concerned; administered by Bank experts, and harks back to an earlier age of competition and self-regulation. We have to update the vision of practical economists like Bagehot.

Huge risks from over-regulation

At present, there are still huge risks from over-regulation. The naïve politicised enthusiasm of the regulators has interacted with fears of the bankers to shrink bank balance sheets sharply. This must stop. Nevertheless it is clear from the new Governor's statements that the 'Taliban tendency' has been put to flight within the Bank. The need is now for monetary policy to take over the heavy counter-cyclical regulation of credit conditions; money supply and credit growth must be paid attention to again.

Nevertheless, it is possible to be reasonably optimistic

Looking at the outlook against this background, it is at last possible to be reasonably optimistic. We may now start to see credit flowing to business and Small and Medium Enterprises (SMEs) in particular, as the banks respond to the greater certainty in the environment. Large businesses are flush with cash and should now start to look at investment plans for the growth ahead. Small firms may do their necessary cheeky work of snatching victory from in front of their lethargic paws. Entrepreneurial Britain may be waking up again.

Lower commodity prices should boost UK real incomes

With world commodity prices falling – and oil prices steady under the impact of shale oil and gas, reflecting the slowing of the emerging countries as well as new technology and discovery – the background for some growth in real disposable income is there too. It has been growing slowly; it should gather speed, as real wages start to pick up with a tightening labour market. The stage is also set for some tightening of monetary policy once credit growth picks up; interest rates should be raised and QE start to be reversed. My vote is to raise Bank Rate by ¼% in December, with a bias to raise it steadily thereafter. The existing stock of QE should also be cut back in a steady phased manner, at a rate of £25bn per quarter.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)
Vote: Raise Bank Rate by ¼%; hold QE.
Bias: Avoid regulatory shocks; aggressively break up state-dependent banks; raise Bank Rate to 2% to 2½%, and gradually run off QE.

Upwards revisions to UK GDP and poor net exports suggest that supply constraints are more important than a lack of demand

The upwards revisions to the UK GDP data released on 20th December – together with the accompanying poor balance of payments figures for 2013 Q3 – have altered substantially the accepted view of the British economic situation. In particular, UK economic activity is now known to have been stronger than was previously believed, while the £10bn deficit on net exports recorded in the third quarter – and £20.7bn overall current account deficit during the same period – suggest that home demand is running well ahead of potential supply. None of this will surprise people who can recall previous UK boom/bust business cycles. Almost without exception, the underlying strength of activity in previous upswings became manifest in the form of upwards revisions rather than in the initial official data and excess home demand became apparent in a worsening in net trade well before its inflationary consequences appeared. However, it strengthens the argument that the Bank of England is 'behind the curve' where UK interest rates are concerned. The late Lord George once commented that "a stitch in time saves nine", by which he meant a 9% Bank Rate. Nobody is anticipating such an eventuality currently. However, the principal involved, that it is better to make rate adjustments early and pre-emptively rather than late and reactively is the antithesis of the forward guidance approach. Forward guiders believe that a commitment to hold rates encourages a strong recovery. However, that begs the question of what happens when the strength of the recovery catches the authorities unaware, perhaps because it appears in the form of data revisions.

UK economic growth prospects, following the pre-Christmas data revisions

In the light of the revised GDP data, which introduced revisions back to 2012 Q1 and added 0.6 percentage points to the level of activity in the third quarter of last year – i.e., significantly narrowing the output gap, for those who believe in that concept – it now looks as if market-price UK GDP grew by 1.9% in 2013, rather than the 1.4% previously expected as the consensus figure. However, upgrading the base does not necessarily imply faster growth in future, because of the reduced scope for 'catch up' growth as activity closes in on its underlying trend. Furthermore, the fact that the deterioration in real net exports reduced real GDP by 1.3 percentage points between the second and third quarters suggests that the country still faces acute supply-side limitations. In addition, Britain's small and open economy means that the growth of UK GDP moves closely with that of the Organisation for Economic Co-operation and Development (OECD) as a whole. As a consequence, it is unlikely that the UK can flourish if the outside world faces difficulties. The latest Beacon Economic Forecasting (BEF) projections, which incorporate the various pre-Christmas ONS data releases, suggest that UK growth will average 2.4% this year, before reaching a peak of 2.8% in the election year of 2015, and the decelerating into the 2% to 2.5% range from 2016 onwards (the forecast horizon terminates in 2024). The anticipated rundown of North Sea oil and gas production means that the non-oil basic price measure of UK GDP is expected to grow by 2.6% this year, 2.9% next year, and 2.5% in 2016, compared with the 2% believed to have been recorded in 2013.

Political risks

These forecasts imply that the lost output (compared to previous trends) of the post-2008 'Great Recession' is a bygone and will never be reclaimed. Nevertheless, the

immediate prospects do not look too bad for a mature industrial economy provided that the September Scottish referendum does not produce a vote for independence and current policies are maintained after the May 2015 general election. Mr Miliband's commitment to 1970s style interventionist policies, apparent indifference to private property rights and populist anti-business rhetoric suggest that the financial markets would not give any benefit of the doubt to a new Labour government, or a putative big-spending Lib/Lab coalition. This could prove a major problem for a government which would probably be facing twin deficits on the current account balance of payments and Public Sector Net Borrowing (PSNB) of the order of 4½% of GDP in 2015. As a result, a 1969 or 1976 style fiscal stabilisation crisis cannot be ruled out next year, even if the prospects for 2014 are more favourable than they have been for some time.

Rosy scenario and the Autumn Statement

One reason for concern about the prospects after May 2015 is that Mr Osborne has done sufficient to keep the government spending juggernaut on the road but has chickened out of the bold supply-side measures and tax-reforms required to give Britain a reasonable growth of productive potential in the long run, albeit for comprehensible political reasons. Furthermore, while the Chancellor's delivery of his December *Autumn Statement* represented a minor political triumph, the detailed numbers given in the Annex tables on the Office for Budget Responsibility (OBR) website suggest that the politicians' old favourite 'Rosy Scenario' is back on the scene with a vengeance. Between 2013 Q4, when the OBR forecasts commence, and 2019 Q1 (when they end), the official forecasts show the volume of general government consumption – which accounts for roughly one half of total general government expenditure – falling by a total of 5.3% and its cost easing by 1.3% during a period in which the volume of tax-rich household consumption is forecast to rise by 13% and its price by 11.2%. During the same period, the volume of general government investment is expected to rise by 7.1%, according to the OBR, while real business investment is projected to rise by 50.2% and private dwellings by 59.9%. Likewise, the cost of general government investment is forecast to decline by a total of 2% between 2013 Q4 and 2019 Q1, while the price deflator for all fixed investment (including by government) is forecast to rise by 8.3%. Some of these trends, which may reflect the implementation of tighter administrative controls since 2010, are present in the latest BEF projections. However, the longer term outlook for the public finances is dependent on the compounding effects of these OBR forecasts over the next half decade. It is surprising that there has not been more questioning of the Chancellor's *Autumn Statement* forecasts for public borrowing as a consequence.

Benign inflation prospects

However, the recovery in the external value of sterling, when combined with a reasonably benign outlook for international inflation, suggests that there is scope for the annual increase in the CPI to ease further from the 2.1% recorded in the year to November to, perhaps, 1.5% in the final quarter of this year, before picking up to 2% in late 2015 and 2.2% in late 2016. This sort of inflation performance would also be consistent with the unchanged 4.4% annual rise in $M4^{ex}$ broad money in the year to November. Other inflation indicators, such as 'core' producer output prices, which increased by 0.7% in the year to November, and average earnings (where total pay rose by 0.9% in the four quarters ending in August to October) confirm that the immediate inflation outlook remains benign. Also, there may be a self-reinforcing element. Reduced inflation in the UK means that the real interest rate gap between Britain and the rest of the world is less negative than it was. This is likely to add to the attractions of holding sterling assets and possibly strengthen the pound slightly further, which should further help the disinflation process.

But 'second pillar' considerations suggest that rates should still rise

Against this inflation outlook, it is reasonable to ask why a rate increase is still needed. One reason is that, in terms of the European Central Bank's 'second pillar' approach, there are already signs that a monetary tightening is required to maintain longer run financial stability. One such indicator is house prices, where the ONS measure increased by 5.5% in the year to October. Another is the Divisia money measure, which rose by 8.4% in the year to November (or 9.4% excluding other financial corporations). Further reasons for wanting to raise Bank Rate include: a simple desire to normalise rates now that the immediate crisis has passed; the continued tightening in the demand for labour; the continued leakage of excess home demand into the trade deficit, and the 13.4% increase in the Financial Times All Share Index in the year to December – which acts as a longer leading indicator of activity, arguably. Finally, there is the likelihood that economic distortions will continue to build up in the real economy while current policies persist, leading to a cumulative supply-sapping misallocation of the factors of production. The main reasons for not being even more pro-active by advocating a Bank Rate hike of ½%, or more, in January are twofold. First, for the authorities to go back on forward guidance so soon might inflict a needlessly damaging blow to confidence. Second, there has been the recent strength of sterling, with the trade-weighted index standing at 85.0 (January 2005=100) on 2nd January. My vote is for Bank Rate to be raised by ¼% in January 2014 and then to be raised cautiously in a pre-announced fashion, by ¼% increases every second month or so until it is in the 2% to 2½% range, after which a pause for re-consideration might be desirable. Likewise, the appropriate approach to QE is to allow it to gradually unwind as stocks mature, through a process of partial re-placement, but not to attempt anything too aggressive.

Avoid negative regulatory shocks to the monetary sector

Finally, it cannot be emphasised too often that excessively onerous financial regulation can have major adverse consequences for the monetary aggregates, the supply of bank credit and the wider economy. For the recovery to continue and mature, it is essential that it is not derailed by imperialistic regulatory officials attempting to gold-plate financial regulation to the point where the recent recovery in monetary growth is put into reverse.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ½%; rebalance QE from gilts to securitised private sector assets.
Bias: To raise Bank Rate.

Forward guidance has divided the MPC

Forward guidance, far from unifying policy committees, leaves them more divided. Within a short while, it has become clear that there were disagreements among members of the MPC over the choice of threshold variables (unemployment rate, inflation rate forecast and inflation expectations) and the extent to which the breaching of thresholds should be regarded as a trigger for policy change. All that remains of Bank of England monetary policy is a form of calendar guidance, whereby the MPC influences Sterling interest rate markets through its indications that Bank Rate will not be raised for some considerable period, regardless of the real GDP growth rate, the unemployment rate, the inflation rate, or measures of inflation expectations.

Pressure to tighten will soon become unbearable

A succession of strong readings for UK economic activity has culminated in near-term expectations of a 4% annualised growth rate for GDP. On most definitions, this would qualify as 'escape velocity', and would signal to the market an unwinding of extremely

easy monetary conditions. While no UK policymaker has explicitly advocated a 'lower for longer' interest rate strategy – unlike in the US – this is the implicit message that governor Carney has conveyed. Data-dependence is a fig leaf for 'lower-for-longer'. However, my expectation is that the pressures on the Bank of England to tighten will soon become unbearable. It is probable that the Labour Force Survey (LFS) unemployment rate will drop to, or below, 7% by July 2014 and that the first Bank Rate rise will occur in August 2014.

MPC has not acted responsibly concerning its mandate

This rate rise would have already occurred if the MPC had been acting responsibly in relation to its mandate. The compound annual inflation rate over the past five years has been 3%, not 2%. The recovery of monetary growth, house prices and economic activity in recent months has provided all the evidence necessary for the Bank to begin the withdrawal from ½% Bank Rate. Remarkably, a recent public opinion survey (YouGov) found a majority of respondents agreeing that their personal finances would be favoured by a rise in interest rates.

Time to sweep aside the interest rate taboo

It is high time for the interest rate rise taboo to be swept away. A rise in Bank Rate would not inflict severe damage on consumer, much less business, confidence. Nor would it countermand the assistance to homebuyers that has been provided by the mortgage guarantee. The access to and cost of the best value mortgages would be undisturbed. The delay in raising rates means that my vote is to increase Bank Rate by ½% in January, with a target rate of 2% by end-2014. Regarding QE, it is time for the Bank of England to announce a schedule of gilt sales from its hoard, beginning with issues where it holds more than 40% of the total amount. Initially, the proceeds could be used to purchase private sector assets, such as securitised infrastructure or commercial property assets.

Comment by Mike Wickens

(University of York and Cardiff Business School)
Vote: Raise Bank Rate by ½% and decrease QE to £250bn.
Bias: Start to unwind QE and slowly raise interest rates as the economy grows.

With recovery established, it is time to consider future monetary policy

With the recovery of the UK now an accepted fact - and not just a prediction by economists supporting 'Plan A' - the time has come to consider the likely future path of monetary policy. Given the Bank's recent conversion to greater transparency in its monetary policy stance, it should provide more information about how it proposes to return monetary policy closer to normal and to unwind QE. The urgency is all the greater as the US Federal Reserve has recently announced a taper to its asset purchases, and UK monetary policy tends not to be far behind that of the US.

The Governor's evidence

In his evidence to the House of Lords Economic Affairs Committee in the week before Christmas, the Governor gave a glimpse of what may lie ahead for the UK. This is different from what the Fed appears to be planning. The Governor stated that before QE was unwound interest rates would be raised. Conventional economics would expect the reverse: first, start to unwind unconventional monetary policy – i.e., previous asset purchases.

And the term structure of interest rates

Inspection of the term structure of interest rates in recent years provides valuable insight into the issue. The MPC has argued throughout the financial crisis that asset purchases, which have been almost entirely of long-dated government bonds, have stimulated the economy by flattening the yield curve. This implies a segmented bond

market, or a preferred habitat in bonds. This is contrary to the standard theory of the term structure in which, risk-adjusted, the price of bonds is based on the absence of arbitrage opportunities. The simplest such theory is the expectations hypothesis of the term structure, which assumes no risk.

Steepening of yield curve inconsistent with Mr Carney's evidence

Data on the term structure since 2000 shows that its shape changed dramatically after the financial crisis, becoming much steeper rather than flatter as claimed by the Governor. Throughout this period the yield curve has been roughly anchored at the long end. This includes the years before and after the financial crisis. In contrast, the short end fell sharply with the cut in Bank Rate in 2008. As a result, the yield curve has sloped upwards ever since, and is not flatter. Even if the Governor was correct, and QE did flatten the yield curve, then this effect appears to be so small that it is completely swamped by the impact of a much lower Bank Rate.

Bank could start to unwind QE now

This has implications for how to return monetary policy to a more normal stance. One might expect that, as purchases of long bonds had little or no effect on the term structure, selling them back on the market would also have little effect on its shape and hence would not provide a major monetary stimulus to the economy just when inflation was likely to pick up due to a higher rate of economic growth. This suggests that the Bank of England could start to unwind QE now. Raising interest rates first, as the Governor proposes, is much more likely to affect the economy. The justification for this should be solely in terms of the use of conventional monetary policy to control inflation and not as part of unwinding QE.

A possible caveat

A possible caveat to this argument, and a possible reason why QE has had such a small effect on the yield curve, is that for much of the time asset purchases matched the government deficit, implying little net increase in bond holdings by the private sector. This suggests that, ideally, unwinding QE should coincide with cuts in the deficit.

Limits of official transparency

One further observation on the transparency of current monetary policy is of interest. The MPC has tried (successfully) to persuade the public (but economists less successfully) that interest rates will not rise until late 2014 at the earliest. Yet in the latest *Inflation Report* the MPC states that it has based its forecasts on the forward curve which is rising. (Recall the yield curve is sloping upwards.) The MPC is therefore using a different set of interest rate assumptions from what it wants the public to believe. Clearly, transparency has its limits.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking and University of Derby)
Vote: Hold Bank Rate.
Bias: Neutral; hold QE but gilts should be eventually run off.

Strong end to 2013

If the latest economic indicators are anything to go by, UK GDP growth looks set to end 2013 on a firm note. The consensus forecast is for fourth quarter GDP to rise by 0.8%, although the sharp rise in the purchasing managers' indices and the Lloyds Bank business confidence survey raise the possibility of an even stronger outturn. If realised, this would leave calendar year growth for 2013 as a whole at 1.9%, or even 2%, compared with a revised 0.2% in 2012.

And 2014 is starting with significant momentum

Looking ahead, it does look as if the momentum will be maintained in the early part of 2014. Rising house prices, the resilience of the labour market, a more favourable inflation outlook and the surge in confidence point to a continuation of the recovery. In response to recent developments, forecasts for GDP growth for 2014 have been increased from an average of 2.3% in the last consensus poll to 2.6%. However, while the outlook has improved, the recovery is likely to remain very unbalanced, with net external trade expected to deteriorate further.

But challenges remain and growth may slow in 2015

Further out, optimism should be tempered by the substantial challenges that remain. The process of balance sheet adjustment is ongoing; the fiscal squeeze is set to intensify, while real income growth is likely to remain historically weak. As the recovery progresses, the pace of growth is likely to fade, with GDP growth in 2015 forecast to slow towards 2% or so.

Inflation is abating

In addition, inflation is falling faster than expected. Following the recent drop, CPI inflation is now expected to fall below the 2% CPI inflation target in early 2014, and to remain at or below that rate over much of 2014 and 2015. Although firms may seek to raise profit margins, inflation is likely to be constrained by the lagged impact of sterling's strength, the weakness of global commodity prices and by the subdued growth in unit labour costs.

And monetary policy should remain accommodative

The more favourable inflation backdrop is likely to underscore the MPC's desire to keep policy extremely accommodative. Although the Bank of England expects the unemployment rate to reach the 7% forward guidance threshold earlier than previously thought, ample spare capacity and the sensitivity of income gearing to higher rates argue for maintaining the status quo. Bank Rate should remain on hold until recovery is well entrenched and with real GDP at least above the 2008 high. Moreover, asset purchases should be only run-off via redemptions. In short, the UK recovery is still vulnerable, not least because the fall in global inflation is telling us that there is deficient demand and no price inflation threat.

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 (Beacon Economic Forecasting and University of Derby). 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), Graeme Leach (Institute of Directors), 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 Commercial Banking and University of Derby). 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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