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Shadow Monetary Policy Committee

July 2012

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IEA's Shadow Monetary Policy Committee votes by narrow five to four margin to hold Bank Rate in July

In its most recent monthly e-mail poll, completed on 27th June, the Shadow Monetary Policy Committee (SMPC) decided by a narrow five votes to four that UK Bank Rate should be held at ½% when the official rate setters meet on Thursday 5th July. Two of the dissenters on the shadow committee wanted to raise Bank Rate by ½%, while another pair desired an increase of ¼%. There was also a divergence with respect to the desirability of further quantitative easing (QE). One shadow committee member wanted an immediate injection of a further £75bn and another asked for a £50bn increase. However, most SMPC members were content to leave the QE stock where it was for the time being – except for one who wanted a phased programme of withdrawal – but there was general acceptance that QE should be used aggressively if the Bank of England again found itself in a lender of last resort situation, perhaps as a result of events in the Eurozone.

There was a near unanimous view on the SMPC that there remained a serious policy inconsistency between financial regulators' desire to gold-plate capital requirements and other restrictions on the size of commercial bank balance sheets and the official desire to get credit flowing again, especially to smaller enterprises. Some committee members thought that easing the regulatory push, while raising Bank Rate to a more neutral level, would represent a more coherent policy stance and bring increased credit growth and private-sector activity. The two big unknowns identified by the SMPC were the likely consequences of developments in the Eurozone and how far to trust the weak official growth numbers, as compared to the more buoyant labour market and survey data.

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 exactly 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 consequence, the nine independent analyses should be regarded as more significant than the precise vote. The next SMPC gathering will be held on Tuesday 10th July, with its minutes to be published on Sunday 29th July. The next two e-mail polls will be released on the Sundays of 2nd and 30th September, respectively.

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Comment by Tim Congdon

(International Monetary Research)
Vote: Hold Bank Rate.
Bias: To hold for the time being.

Disappointing money growth

Money growth trends in the so-called 'leading' nations have remained disappointing in the first half of 2012. In all the nations that have participated in the Basle III regulatory initiative, commercial banks have been obliged to restrict balance-sheet growth, or even to shrink balance sheets, in order to boost their ratios of capital to risk assets. Banks' capital/asset ratios today are far higher in the USA than in the 1980s or 1990s, and – although the situation elsewhere is less clear-cut – banks in the Eurozone and the UK also seem to be operating with much higher capital buffers than in the years leading up to the Great Financial Crisis of 2007. The result of these developments is that the quantity of money, broadly-defined, has stagnated for the last three to four years. In extreme cases, such as the Eurozone periphery, the quantity of money has actually fallen at annualized rates of 10% or more last seen in the USA's Great Depression of the 1930s.

Feeble and unconvincing recoveries

The money stagnation/contraction has in turn been associated with feeble and unconvincing recoveries from the 2008/9 downturn or even with double-dip recessions (most notably in the Eurozone periphery where the banking traumas and money contraction have been most severe). In other words, the latest cyclical episode – like so many before it – confirms the validity of the monetary theory of national income determination.

Regulatory demands are constricting bank balance sheets and the money supply

In the UK, the banks have to cope with the regulatory demands of the Vickers Commission, which has gold-plated the international rules. Lloyd's and RBS have said publicly that they are still trimming their balance sheets. So the growth of $M4^{ex}$ (i.e., broad money excluding the troublesome intermediate 'other financial corporations') has been weak for several quarters, despite the deliberate creation of money balances in two QE exercises. Happily, the inflation prospect for late 2012 is improving, which will make the policy environment more congenial for another round of QE. The aim remains that $M4^{ex}$ growth should run at about 3% to 5% a year. In conjunction with virtually zero short-term interest rates, that sort of money growth rate ought to be associated with a reasonable rate of domestic demand growth over the next few quarters.

Growth would be enhanced if Basle III and Vickers report were dumped

It is dismaying that the artificial 'funding for lending' scheme should now be thought necessary by officialdom. Have not the UK's regulators, central bankers etc. understood that the reason for banks' hesitation in expanding their balance sheet is that they are under the cosh of the Vickers Report? If the Vickers Report and Basle III could be dumped or given five years or a decade to implement, UK banks would assuredly want to lend more to the UK private sector. Further, with such low interest rates, the private sector would assuredly want to borrow.

Keep $M4^{ex}$ growth at 3% to 5%

As far as this month's vote specifically is concerned, I am in favour of no change in interest rates. Another round of QE should be implemented only to the extent required to ensure that the growth of $M4^{ex}$ runs at an annualised rate of 3% to 5%.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate; expand QE by £50bn.
Bias: To increase QE further.

Need for additional monetary stimulus

The case for additional monetary stimulus in the UK remains strong. The recovery in real activity is close to stalling – if the current generation of data from the Office for National Statistics (ONS) is to be believed, the economy has already tipped back into recession. Nominal spending growth remains too weak to sustain a solid rebound in output. Since the recovery started in 2009 Q3, nominal Gross Domestic Product (GDP) has grown at a rate 1½ percentage points below the average recorded between 1992 and 2007. Pay growth remains moderate, and there is little sign that elevated headline inflation has passed through into wage settlements. Commodity prices have fallen markedly over the last year, particularly since the spring. Spot oil prices in sterling terms are down by over 20% since late March, for instance. This should reduce the risk that persistently above-target inflation becomes entrenched in inflation expectations. Most importantly, a 'dark cloud of uncertainty' continues to hover over the Eurozone. Even though a centrist coalition has been formed in Greece and European funds are on the way to recapitalise Spanish banks, we remain some distance from a resolution of the zone's problems.

But poor growth figures may be misleading

Business surveys suggest the British economy is still growing. The GDP-weighted composite Purchasing Managers Index (PMI) averaged 52.6 in April and May, for instance. A similar figure was registered for the composite new orders balance as well. However, prospective output growth could be very limited. The one-off distortions due to the Queen's Diamond Jubilee could cause the headline GDP data to show another decline in the second quarter. This is all the more likely because of what appears to be a very sharp drop in April construction activity. Given the extreme volatility in some official monthly data, it is unusually difficult to assess the *underlying* pace of growth in the UK. Certainly, the 2011 Q4 and 2012 Q1 real GDP figures do look surprisingly weak. At best, one might say that the British economy is expanding gradually, but is close to stalling.

Inflation is down and…

Consumer Price Index (CPI) inflation, at 2.8% in May, remains above the 2% target, but it has fallen significantly over the last six months. Most of this decline has been due to base effects, as higher energy prices and VAT fall out of the annual calculation. More recently, though, it has been driven by an outright decline in 'non-core' components of the CPI. Petrol prices, for instance, dropped by over 3% in May. The twelve-month change in the 'core' CPI index was still above target in May, at 2.2%. However, there is evidence that the weakness of underlying price pressures is becoming apparent in the CPI numbers. The three-month (seasonally-adjusted) annualised change in 'core' consumer prices was 1.7% in May, the slowest rate of expansion in eighteen months. These trends are set to continue. UK food and energy price inflation should fall noticeably over the second half of this year, as movements in global commodity prices feed through to the domestic market. CPI inflation should end 2012 below the 2% target and should remain there next year as well.

…inflationary expectations remain tethered

Any worries of an upward creep in inflation expectations because of persistently above-target headline inflation should now be dispelled. There remains considerable disagreement about the UK's disappointing productivity performance, and its implications for future inflation. While there are good reasons for believing that the

financial crisis will have done some damage to Britain's supply capacity, it is not convincing that the vast bulk of the shortfall in output represents a permanent loss of aggregate supply. The argument that there is spare capacity that would come back on stream if demand were to pick-up is relatively convincing. It follows from this that there is a major risk of hysteresis-like effects, if demand weakness is allowed to persist.

How the UK authorities can improve things

The authorities need to do more. There are three main levers that could be pulled to achieve this. The pace of fiscal tightening could be slowed. This is neither likely nor desirable, however. The political reality is that the Coalition cannot deviate from Plan A. Moreover, government spending was the main source of excess demand before the crisis. There would seem to be strong grounds for reducing the share of government spending in GDP. Nevertheless, one can question the *balance* of spending cuts being proposed. For example, too little is being trimmed from current spending, particularly social benefits, at the same time as public investment is being cut too rapidly. Macro-prudential policies could be used to enhance the transmission mechanism of monetary policy. To an extent, this is already being done. In his Mansion House speech, the governor announced that the Bank would create a 'funding for lending' scheme, which provides subsidised financing to banks for a period of several years, collateralised by loans to the 'real economy'. This could potentially be very beneficial in the current environment if the terms are sufficiently easy. Unconfirmed reports suggest banks will be able to borrow at a spread of 25 to125 basis points above sterling London Inter-Bank Offered Rate (LIBOR) – the greater the increase in their net lending, the greater the subsidy that lenders will enjoy. Elevated bank funding costs, which should be alleviated by the scheme, are a major impediment to the UK recovery. The governor also announced plans to activate the Bank's Extended Collateral Term Repos (ECTRs), which provide six-month sterling loans at a small spread over Bank Rate against a wide array of securities and loans. It has recently become clear that the tightening of liquidity regulation may be constraining the lending of some banks. The activation of ECTRs should help in this regard.

£50bn more QE needed

How far these facilities go in easing credit conditions is unclear at this stage. We do not yet have full details of the 'funding for lending' scheme, for instance. To the extent that these changes enhance the effects of the Bank's past gilt purchases, one might want to hold off on any additional monetary stimulus. However, given on-going financial dislocation in the Eurozone, the weakness of output growth in the UK and the large fall in global commodity prices, there is still a strong case for additional asset purchases. My vote is for another £50bn to be bought over the next three months. Further stimulus may well become necessary as the year progresses.

Comment by Anthony J Evans

(ESCAP Europe)
Vote: Raise Bank Rate by ¼ %.
Bias: No additional QE but the Bank should be on standby with other monetary tools.

Inflation overshoot is an enduring and serious catastrophe

On the surface, the UK economy is in a delicate state but not in a slump. $M4^{ex}$ is growing at a reasonable rate and nominal GDP is not forecast to contract. Inflation remains well above target, with almost 10% of the internal value of the pound being shred since November 2009. This is an enduring and serious catastrophe. Even though inflation has dropped to under 3%, this is due predominantly to falling commodity prices and not to a tight monetary policy. Indeed, inflation expectations

remain anchored close to target. Survey data suggests that GDP is stronger than official figures suggest.

Eurozone uncertainties

The Greek election paralysed decision making as people waited to see the outcome, and for some there was disappointment that there is no real change on that score – instead, bailouts, debt, and the political inability to confront reality. Of course, the Eurozone constitutes a large part of the UK's export market. However, more important immediately is the unpredictable consequences of an abrupt change in expectations. Nevertheless, if UK policymakers are waiting for the situation with the Euro to be resolved, then they are implicitly committed to permanent crisis. If, or when, the Euro collapses, the Bank of England will have a job to do. Even so, there are risks involved in acting too quickly. If anything, special resolution schemes should be introduced to speed up this process and contain the fallout. Such crises present opportunities for the Bank to get interest rates back towards their natural rates without it being seen as the cause of the turmoil.

Bank of England needs to improve its communications

One useful thing that the Bank of England should be doing is improving on its communication regime. In October 2008, the Federal Reserve wanted the authority to pay interest on reserves and it utilised that authority immediately in order to do so. This led to a predictable contraction of credit – exacerbating the crisis – but it was believed that using the tool too early was better than not being able to use it in future. The Governor and Chancellor's Mansion House speeches sought to lay down a framework for further monetary tools. Furthermore, it is conceivable that the confidence-building effects of such an announcement would make it unnecessary to use them. However, the proposed changes also generate regime uncertainty. Credit easing gives even more discretion to the Bank of England and will almost certainly be conducted in an arbitrary way. It pays little attention to the type of credit being supported, since it moves us from a free-market to a centrally-planned volume of credit. The lender of last resort should only lend at a premium, and greater care needs to be taken in terms of distinguishing between liquidity and solvency problems. The lack of bank failures is a sign of the economy's fragility, not strength.

Moody's downgrade of British banks

The surprise downgrade of fifteen banks by the rating agency Moody's in mid-June threatens to take control of interest rates even further from the Bank, and lending costs will almost certainly rise. It is possible that the Bank has missed its opportunity to re-couple Bank Rate with the market. It remains to be seen whether this downgrading represents an isolated opinion or whether Moody's are simply the first of a number of news items pointing to a continuing deterioration. The Bank of England should keep a keen eye on developments. However, and if some of the more pessimistic scenarios transpire, further cuts to Bank Rate as discussed at the last Monetary Policy Committee (MPC) meeting or, indeed, further QE will not be sufficient.

Bank of England still has viable tools for maintaining nominal GDP stability

Those who feel that the Bank of England was slow to act in mid-2008 may want to atone for this with pre-emptive action now. Nevertheless, past mistakes need to be factored into the new reality. Much of the output loss since then is a permanent destruction of wealth and cannot be recovered through stimulating aggregate demand. It is commonly believed that the Bank's decisions are largely irrelevant on account of its impotence. In actual fact, there is a significant array of tools that the central bank can use to maintain nominal GDP stability should the need arise. This is all the more reason to take a cautious approach and curb the temptation to act too early.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate; implement £50bn more QE.

Encouraging May CPI

The latest CPI inflation data were encouraging. The annual rate fell from 3.0% in April to 2.8% in May, which was better than financial-market expectations. The Bank of England's upward revisions to the inflation forecasts, included in the May *Inflation Report*, now look to be on the pessimistic side, if anything, and this was conceded in the June MPC minutes. The Bank may even hit its 2% target by the end of 2012.

Inflationary pressures continuing to abate

Inflationary pressures are undoubtedly easing and commodity prices have declined over both the past month and the past year. The *Economist's* 'all items' index for 19th June 2012 was down 1.5% in sterling terms on the month and 12.0% lower on the year. In addition, the decline in oil prices has been marked especially since the spring of 2012. Brent crude oil was priced at around US$93 per barrel on 26th June compared with US$125 per barrel in the March and April period. Producer prices inflation is also on a downward trajectory, while earnings growth remains extraordinarily weak. Inflationary pressures should not be a concern.

Eurozone doom and gloom

Sir Mervyn King's Mansion House speech (14th June) radiated gloom. He referred to the *"black cloud of uncertainty and higher bank funding costs brought about by the Euro-area crisis".* Suffice it to say that the Eurozone crisis is nowhere nearer to resolution after the recent Greek elections than before. Europe's politicians, having already frittered away two and a half years in which they could have built the foundations for a sustainable solution to the currency area's inherent flaws, apparently remain in denial and seem to be transfixed by the horrors unfolding before their eyes. If Eurozone political union is not forthcoming, and there are no signs that either German or French politicians are prepared to completely submit the fates of their countries to Eurozone-wide institutions, then a break-up (partial or complete) is ultimately the only alternative.

British economy needs further stimulus

In the meantime, Britain's economy requires further stimulus. Real activity continues to disappoint, though the labour market seems, paradoxically, to be in more robust form. The proposed £80bn 'funding for lending' programme, in which the Bank will provide low cost funds to the commercial banks for them to lend on to businesses and households, is welcome. Details are, apparently, still being worked out. However, the announced proposals to date are encouraging. Small businesses, in particular, have been reporting increased difficulty in obtaining bank funds at affordable rates, not least of all because higher bank funding costs have led to higher lending rates.

More QE on the cards

More QE is also on the cards. June's MPC minutes reported that the committee had agreed that *"asset purchases remained an effective tool for lowering a range of market interest rates, supporting asset prices and so nominal demand"* even if the impact may be dampened with gilt-yields as low as they are. Three MPC members voted for an extra £50bn of QE in June (the Governor, David Miles and Adam Posen) and Paul Fisher voted for £25bn. The remaining five favoured no more expansion at this stage.

Faltering growth

Growth in the UK is faltering, stagnating at best. Meanwhile the Eurozone's economies continue to deteriorate, whilst there appears to be a marked slowdown in the US – our other major trading partner. There remains a strong case for a very

accommodative monetary policy. Bank Rate should be left at ½%. There is little point in cutting it further and the time is ripe for a further £50bn of asset purchases.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no more QE but no withdrawal of QE.
Bias: To raise Bank Rate.

Three key issues

There are three key issues facing the UK at present. One is that the underlying growth rate may be only about 1% over the medium term. For this, an interest rate of ½% is damaging. A second is the threat of banking sector collapse if the Eurozone disintegrates. For this, low interest rates and QE will not prevent it, and if it happens QE will be an insufficient instrument. A third is that regulation has attempted to force a large and artificial rise in capital ratios for banks, inducing unnecessarily low broad money growth. For this, regulatory reform, not monetary looseness, is the correct policy response.

Artificially low interest rates damage future growth and…

As regards the medium-term issue, economies do not grow at their fastest rate over the medium term with the lowest interest rate. Instead, they grow fastest when interest rates are at their natural rate. This has been known since the time of Wicksell, and is a standard prediction of most orthodox models as used by international authorities such as the Bank of International Settlements (BIS). The BIS itself has noted recently that artificially low interest rates might be damaging medium-term UK growth. From a policy perspective, holding interest rates below the natural rate requires the justification that circumstances are temporary and can be alleviated by temporarily low rates. With interest rates having been at their current emergency level now for more than three years, it has long ceased to be credible that circumstances are temporary or that low rates are an emergency measure.

…the UK policy rate is well below the economy's natural rate

It is difficult to observe the natural rate directly, but it can be reasonably estimated as the sum of the sustainable growth rate and either inflation expectations or the policy target – so if the UK sustainable growth is now between zero and 1% and inflation expectations are 2% to 3%, that implies a sustainable growth rate of between 2% and 4%. If the sustainable growth rate can be raised or is not quite as bad as this, that implies a higher sustainable growth rate. To claim that the natural rate is anywhere close to 0.5% at present would require the belief either that expected inflation is negative or that the sustainable growth rate is considerably negative (say, even worse than *minus* 1.5%). Given that neither of these is plausible, it is clear that the natural rate is well above the current policy rate – damaging medium-term growth. Rates should be raised back closer to the natural rate, at least to the point at which they re-connect Bank Rate to the monetary policy transmission mechanism.

Dark scenarios if Eurozone collapses

As regards Eurozone collapse, if that occurs and leads to some of the darker scenarios – which might include 20% contractions in Eurozone GDP and the collapse of much of the Western banking sector – QE (i.e. purchasing of second-hand government bonds) will probably be inadequate as a policy measure. Instead, the Bank of England will need to purchase government bonds directly or even simply print money to fund government spending, with all the attendant risk that entails. That bridge should be crossed if and when we come to it. For now, one merely observes that QE cannot stop the Eurozone collapsing and will be inadequate as a response to

its doing so. QE is now irrelevant and no more should be contemplated for the moment.

Perverse regulatory interventions are strangling credit creation

The third issue is the unnecessary contraction in lending induced by regulatory capital ratios. This is part of the overall deeply misguided approach to the banking sector's problems. The Bank of England seems, mercifully, intent on treating capital ratios as indicative rather than mandatory. The use of QE to offset a monetary contraction induced by regulatory policy is a case of the policymaker's left hand fighting the right. It is not monetary policy's job to do this. What we should be doing is to raise rates, just a little, and prepare our plans for the event that the Eurozone collapses. Raise Bank Rate by ½% for starters.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate, while reducing regulatory burden on banks.

Bureaucratic abomination

The debate over QE has finally become meaningful: first, with the intervention of Paul Tucker detailing some worries over the effects of regulation on bank lending; second, with the announcements in the Mansion House speeches that the Bank and government would reduce the marginal cost of lending to the banks, in a way related to extra lending. Frankly, this sort of bureaucratic 'incentive' is an abomination – reminiscent of the 'corset' device invented in the late 1970s to persuade banks to limit the former M3 broad money definition, which was the officially preferred measure at the time. Such interventions breed evasion and what is known as 'fungibility'- i.e., you do what you planned anyway but dress it up as the necessary 'increase'.

Cameron and Osborn 'Sir Humphreyed' by Bank officials and regulators

Far better to have had a *'mea culpa'* from these bureaucrats with respect to their ridiculous plans for regulating the banks. Maybe the new intervention will be a cover for a quiet retreat from these plans. Who knows? However, we should not hold our breath. When the Kings, Vickers and Turners of this world are allowed sway over our affairs, they will not relinquish it with much speed. Unfortunately, Messrs Cameron and Osborne are like innocents abroad, ignorant and led by the nose on these matters. Their ignorance is not helped by their quasi-religious views on 'debt'. The monetary intelligence of Alistair Darling, and even Gordon Brown, was of a far higher order.

Credit drought facing SMEs

Nevertheless, it is plain that there is a credit drought for Small and Medium Enterprises (SMEs). This part of our economy would be searching for new business opportunities otherwise, instead of just trying to survive. QE has not affected the supply of credit, it is plain. Some say the counterfactual is that credit could have declined further. This is pure invention. It is highly unusual for credit to keep on dropping after the end of recession (this is using general indicators, not the ONS's suspect first estimates, as a guide to the pattern of activity). Furthermore, if one looks at the 'events' of QE injection, it is clear they had no effect on credit growth. No doubt, as my SMPC colleague Tim Congdon says, QE has added to M4 broad money. Arithmetically, it must; the money is printed and deposited; it then has been held in bankers' balances. Thus, it is added to deposits; and also to M0 base money. However, the problem is that the ratio of broad to base money – the M0 multiplier - has collapsed because of banks' unwillingness to lend. So the rise in M4 is small. Indeed it is hardly growing.

Gilt yields are dominated by world bond yields, not QE

The only sort of QE that would add to SME lending in these circumstances would be direct use of the QE to buy SME assets or give them loans. However, this would be a bridge too far for the Bank. Indeed, even the US Federal Reserve which has bought all sorts of unorthodox assets, including corporate bonds and mortgages, has balked at doing this. Furthermore, it is not a good idea for the state to lend directly to business, as it lacks the monitoring capacity that commercial banks bring to this task. The Bank of England could buy mortgages, instead. This would get it nearer to the credit problem than buying gilts as it now does. The latter simply allows the government to print money to meet its deficit. Some argue that it drives down the yields on gilts. This argument relies on the 'preferred habitat' theory of interest rates by which there is a special demand for gilts for defined purposes; then to induce those demanding gilts to give them up one needs to bid up the price and so lower the yield. However, with the massive supplies of gilts on world markets, many of those holding gilts will be representative world bond portfolio holders. For them, the yield on gilts is set by the rate on competing international bonds such as US Treasuries plus any special UK risk premium. Gilt yields have fallen in line with the world appetite for safe havens. There is no discernible impact from QE 'events' on them. I would support QE purchasing of mortgages and any other unorthodox assets; their purchase could help the credit market to fire up again. However, there is no suggestion the Bank will do this.

Three arguments against QE

As for QE purchase of gilts, it should be opposed on three grounds. First, it is of no use for the problem at hand: viz. the stimulation of credit and, except trivially, money. Second, it allows the bureaucratic classes to maintain the fiction that they are somehow 'offsetting' their disastrous regulative policies; this relieves the pressures on them to reverse those policies. Third, it substitutes money for bonds in the government's financing, laying up risks long-term for the future control of money and making government dangerously dependent on money printing; in practical terms, when this has to be unwound, the government will face a sharp rise in its funding costs which will create unpopular pressure for further cuts – this will make reversal of QE difficult when it is necessary for monetary control.

Bank of England needs to regain control of the interest rate environment

Clearly, the endless crisis in the Eurozone continues to create monetary uncertainty. Nevertheless, there is evidence that the UK economy is managing to grow if only weakly in spite of the Eurozone recession. UK exports to non-euro destinations have grown 30% since 2007. While it may seem harsh in current circumstances to argue for a rise in interest rates, we must face the prospect that the Eurozone crisis will continue indefinitely. In my view, it is time for the Bank to regain control of the interest rate environment. The commercial banks' marginal cost of funds is now just below 4%, which is way above Bank Rate. The Bank of England has recognised this divergence in its new scheme to subsidise the banks' cost of funds in return for new lending. What the Bank should now do is raise Bank Rate (i.e., what it charges on direct lending to the banks) more into line with market rates, and simultaneously reduce the costs the banks face in terms of liquidity and capital regulations. By such moves, it could reduce the banks' cost of funds while also getting its own lending rate to a more normal level at which its adjustment up and down would be meaningful again. It would also signal an end to the Bank of England's hostility to the banking system and the beginning of a new regime that would liberate the banks to lend again, knowing they had the support of the key state player.

Raise Bank Rate but ease regulation

Therefore, no further QE is recommended, with a bias to its reversal; and a rise in Bank Rate to 1% with a bias to raise further. All this to be accompanied by a

strengthening of the announced plans to reduce the banks' cost of funds, but via a rollback of regulations and liquidity ratios, and without lending conditionality, which is a feature of planned, not market, economies.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate; no immediate increase in QE.
Bias: To raise Bank Rate; keep more QE on standby.

Sunbeams amongst the gloom

Several chinks of sunlight have recently appeared in the dark clouds overhanging the British economy. These include the better than expected May inflation data and the signs of a more buoyant private-sector jobs market in the most recent ONS Labour Market Statistics. This mildly favourable labour-market development is slightly surprising because the UK is a small, open and trade-dependent economy heavily influenced by overseas developments. Much of the recent news from abroad has been disappointing where the strength of global activity is concerned. Nevertheless, the fall in the price of oil from a monthly average of US$124.5 in March 2012 to US$93 on 26th June should prove disinflationary quite soon and expansionary in the medium term, once the positive output effects have worked through next year. The common view is that the lower price of oil reflects slowing global activity. However, it is conceivable that Saudi-Arabia is trying to achieve a permanently lower oil price for commercial and geo-political reasons. Cheaper oil reduces the incentives to develop technologies, such as 'fracking' which have the potential to knock the bottom out of the energy market in the long run. In addition, a reduced oil price cuts the financial resources available for Iran to develop its nuclear weapons capacity.

European Monetary Union was rendered non-viable by the fiscal profligacy of the Continent's politicians

The current model of European Monetary Union (EMU) now looks beyond salvation, even if the Continent's elites are likely to fight this development tooth and nail in a Verdun-style battle of attrition. Smith's four rules of forecasting almost certainly apply here: 1) if economic logic says something has to happen, it will happen; 2) the 'dead start' before the event occurs will be longer than one expects; 3) when the event happens, it will be more sudden than anticipated, and 4) the size of the shock will exceed initial expectations. The pity of it is that EMU might well have worked if Continental politicians had not driven a coach and horses through the Maastricht fiscal convergence criteria. These were not just pious intentions but a necessary condition for EMU to hold together in the long run. In addition, the Eurozone seems to have suffered from a form of the 'Walters' critique' – named after the late Sir Alan Walters, who was an early SMPC member – in that the move to a single rate of interest had the perverse effect of cutting real interest rates in high inflation economies – such as Ireland and Spain; hence, their credit booms – and raising them in low inflation economies, such as Germany. Several prominent German officials appear to have left the European Central Bank (ECB) recently. This suggests that the Euro is now considered either as a lost cause or, even worse, a charter for open-ended fiscal profligacy, the monetisation of public debt, high inflation and the imposition of open-ended future liabilities on the German taxpayer.

Previous currency unions have broken up but life went on

Numerous previous currency unions have broken up, of course, often because of the collapse of imperial powers such as the British Empire or Austro-Hungary, without the world coming to an end. As Sir Dennis Robertson amusingly commented in his 1928 *Money* describing the situation in the early 1920s: *"Sometimes a wholly new monetary unit was invented: thus the European Zoo is now enriched by a number of species –*

the Lit and the Lat, the Polish Zloty and the Hungarian Pengő – which were unknown to our ancestors. In other cases, such as France and Italy the old unit was retained, but the weight of gold to whose value its value was to be kept equal was fixed afresh, in the former instance at about a fifth, in the latter at rather more than a quarter of the pre-war weight" (page127 in the Routledge re-print published in 2000). Rather than have a fit of the vapours, the useful thing to do now is to study earlier episodes of currency zone dissolution in order to minimise the collateral damage when EMU eventually joins previous currency unions in the waste bin of history.

Mr Cameron's damaging rhetoric

Meanwhile, it would be a good idea if Mr Cameron stopped lecturing Germany from the side lines on why the German people should accept open-ended financial commitments in order to hold the Eurozone together. Not only do the numbers not add up – there are simply not enough Germans to support the rest of the population of Eurozone – but such actions give rise to serious moral hazard where the political classes of the non-Teutonic members of EMU are concerned and lead to the constitutional abomination of taxation without representation where the citizens of Germany are involved. Furthermore, it is hard to see why it is in Britain's geo-political interest to have the Continent of Europe dominated by one large centralised power, if Eurozone banking, fiscal and political union ultimately emerge from the present debacle. One of the main aims of British diplomacy for at least the past four centuries has been to prevent Continental Europe consolidating in a way that might prove inimical to our economic or other national interests at some stage.

The Mansion House measures

The banking measures announced in the 14th June Mansion House speeches appear to have three main aims. The first, and valid, psychological aim, was to steady financial market nerves by showing that the stock of monetary weapons available to the authorities had not been exhausted. The second was to ease pressures in the money markets and three-month money-market rates seem to have eased by some 9 to 11 basis points since the scheme was announced. The third was to encourage credit creation to industrial and commercial companies, especially to the SME sector. The problem here, as has been repeated endlessly in previous SMPC reports, has been the lunatic policy inconsistency between the regulatory overkill that the authorities have been trying to impose on the banking sector and the banks' ability to maintain even the existing size of their balance sheets, let alone expand them by granting new credit. The point has been reached where new interventions are being employed to offset the adverse effects of earlier ones. It all makes work for bureaucrats to do but it is of strongly negative benefit to the wider society.

A radical market-based alternative

It would be more sensible to tackle the 'too big to fail' and perverse incentive structures within banking by four simple measures. First, break up the large publically-supported banking groups into several smaller banks, which can be sold off piecemeal. Second, use normal anti-monopoly legislation to break up privately owned banks that are too big to fail. Third, restrict deposit insurance to, say, 90% or 95% of the value of the deposits concerned, so depositors have an incentive to seek out the most prudent organisations. Finally, senior bank executives – say, those earning more than a million pounds a year – should have uncapped personal financial liability if their banking groups have to be bailed out by the state. Furthermore, such liability should remain on a diminishing scale for a period of, say, five years after the executive involved has left the financial organisation concerned. This last would be to ensure a prudent choice of successor and to prevent failed bankers walking away with undeserved 'shedloads' of money.

This month's rate decision

As far as the July Bank Rate decision is concerned, the continuing uncertainties in Continental Europe warrant a tactical hold. However, the medium-term aim should be to get Bank Rate into the 2% to 3% range at which point it will start to re-engage with the money market rates that determine borrowing costs, while stopping the more ill-considered financial regulatory initiatives, or pre-announcing that they will be phased in over a very long period. Unfortunately, the current SMPC poll had to be frozen before the release of the new 2009 chained national accounts on 28th June. When the ONS introduced the current 2008 based data last year there were growth revisions of more than 1 percentage points to previous ONS estimates for some years. The re-worked national accounts might reduce some of the discrepancies between the GDP figures and the survey data and labour market statistics when they appear on 28th June. However, extreme cynicism is the only appropriate response to the ONS data. Moving on, it is widely expected that the authorities will announce a further batch of QE either on 5th July or 2nd August. The latter would be just ahead of the August *Inflation Report*, whose forecasts would be available to the MPC. However, the 3.8% annual rise in $M4^{ex}$ broad money in the year to April, the 3.3% annual increase in the double-core retail price index in May and the 320,000 increase in the number of private sector jobs over the latest four quarters are among a number of indicators suggesting that there is no case for further QE immediately. Additional QE should be kept on standby in case there is a renewed threat of a banking meltdown caused by events in Continental Europe. However, QE should be reserved for lender of last resort purposes and not employed as an instrument of day to day monetary policy.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%; no extension of QE; await impact of new credit initiatives.
Bias: To raise Bank Rate.

The new Extended Collateral Term Repo (ECTR) scheme

Since the escalation of the European financial instability threat last October, we have advanced the argument that the Bank of England, in the abruptness of its withdrawal of the £185bn Special Liquidity Scheme (SLS), was primarily responsible for aborting the nascent economic recovery in 2010. While the reintroduction of QE last year has improved liquidity conditions in financial markets, the flow of credit to the non-bank private sector barely has a pulse. Sir Mervyn King appears to have backtracked on his objections to the reintroduction of a similar facility, in the recent announcement of the activation of the Extended Collateral Term Repo (ECTR). Additionally, a new initiative, 'funding for lending', builds on the existing credit easing measures. The details have yet to be released, but his Mansion House speech stated that *"the Bank would lend, as in its existing facilities, against a much greater value of collateral comprising loans to the real economy, to protect taxpayers"*. Fundamental to the Governor's support for the scheme is the approval and underwriting provided by the government.

Commercial banks cannot cope with complex schemes

While it appears that the ECTR, first activated on 20th June with a £5bn allotment, is reminiscent of the SLS programme, the 'funding for lending' is much closer to the unsuccessful National Loan Guarantee Scheme (NLGS), launched in March this year. Basically, the commercial banks have not yet figured out how the NLGS is meant to work! It is to be hoped that 'funding for lending' will not suffer from the same drawbacks. It is of the utmost importance that these initiatives lift credit constraints to

the SME sector. There are obvious concerns that elevated European economic uncertainty will hold back credit demand quite independently.

Bank Rate a sideshow, disconnected from market rates

As argued on numerous previous occasions, Bank Rate is a sideshow in current circumstances, disconnected from a market structure of interest rates that is drifting higher. To reiterate, a sensible plan would be to raise Bank Rate under the cover of these European interest rate stresses. In all probability, once the fuss surrounding the first rate increase dies down, there would be virtually no impact on the overall structure of customer interest rates, with mortgage tracker accounts making small transfers to saving tracker accounts. The sooner that Bank Rate is reconnected to the market structure, the better.

'Zombie' loans from before the crash constraining new lending

One of the common misperceptions regarding credit is that government policy should seek to lower the stock of private sector debt. In other words, to force an overall contraction in the amount of debt held in private hands. In a credit-driven economy, this would be a foolhardy policy. The analysis above argues that there were vintages of mortgages and business loans – most notably, those extended between 2003 and 2007 – which suffered from bad underwriting practices. The failure to either write down or quarantine these bad loans stands in the way of a meaningful private credit recovery. The credit losses that the banks are taking year by year relate primarily to these old loan vintages. By implication, an expansion of new lending, based on tighter criteria and lower loan-to-value ratios, does not present a threat to future financial stability. If these new initiatives allow poorer quality bank assets to be offered as collateral against net new credit to the private sector, then it is possible to become more enthusiastic about the economic outlook.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)
Vote: Hold Bank Rate; extend QE by £75bn; purchase wider range of securities.
Bias: To ease further, if required.

Increasing fragility of world recovery

The fragility of the world recovery has been heightened over the last week by the economic news emerging from the US and Europe. Meanwhile, the latest economic news in the UK suggests that the economy is at risk of another quarter of negative growth in 2012 Q2. The PMIs for manufacturing and construction and the April falls in manufacturing and industrial production, which fell by 0.7%, all point to the risk of a further GDP decline in the third quarter – making three consecutive quarters of negative growth. These risks are clearly forefront in the minds of Bank of England officials. The minutes of the last meeting of the MPC show that, though the vote was to maintain the existing programme of QE at £325bn, it was on a knife edge – just five votes to four in favour.

Further easing now required

Interestingly, amongst the four who voted for further QE was the Governor himself. What the minutes suggest is that an increase in QE is almost inevitable in July's vote, as the five who voted to maintain the status quo on this occasion, did so on the basis that they wanted to be sure that inflation remained weak and that there was greater clarity around the direction of the economy. Well, we now have more clarity and it is not of the kind that would prevent further easing, unfortunately. So, an additional £50bn is almost pre-ordained. Price inflation has fallen further, helped by lower petrol prices and the economy is showing renewed signs of weakness. Although core year-

on-year inflation rose from 2.1% to 2.2% in May, this was mainly down to distortions to the May 2011 base. Meanwhile, the rise in the volume of retail sales in May masked real weaknesses. So, the real question is whether the additional QE in July should be as much as £75bn.

Enhancing the monetary toolkit

The Bank of England has also embarked on a programme of allowing institutions to borrow from it using a broader range of collateral. The new ECTR offers six-month loans, with a minimum borrowing value of £5bn. In his Mansion House speech, the Governor suggested that the Bank would also consider an effective revival of the Special Liquidity Scheme and a swap facility comparable to the European LTRO. He also implied that Bank would accept credit risk through taking on mortgage-backed securities and bundles of corporate loans; the Treasury effectively has indemnified the monetary authority to do so. This means that the Bank has added another batch of instruments to the toolkit that it can use to ease policy. It may well be that they will be required in the weeks and months ahead as the turmoil in Europe persists and events unfold in an unpredictable manner.

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), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), 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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