



# Shadow Monetary Policy Committee

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July 2013

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## IEA's Shadow Monetary Policy Committee votes by five to four to raise Bank Rate by ¼% in July

In its most recent e-mail poll, which was finalised on 25th June, the Shadow Monetary Policy Committee (SMPC) decided by five votes to four that Bank Rate should be raised on Thursday 4th July. Four members of the shadow committee wanted an increase of ½%, while one advocated a rise of ¼%. This split vote for a rate hike would imply a rise of ¼% on normal Bank of England voting procedures. However, four SMPC members believed that Bank Rate should be held at its present ½% for the time being. Most members of the shadow committee saw no immediate justification for adding to the stock of Quantitative Easing (QE). Nonetheless, it was felt that the international economy was not yet out of the woods and that all monetary tools needed to be kept available on a standby basis.

Most SMPC members thought that the UK economy was showing signs of a modest recovery and that growth probably accelerated in the second quarter. However, there was less agreement as to whether recovery would continue or, alternatively, peter out in the second half of this year. One reason for wanting to raise Bank Rate in July was the belief that it was less disruptive to make the necessary rate hikes early and in a number of small increments than to leave it late and then possibly be forced to make a more abrupt move. There was a strong concern that ill-considered financial regulation was impeding money creation and credit extension to the private sector. However, current UK broad money growth was sufficient to sustain a non-inflationary recovery. The SMPC poll was completed before the 26<sup>th</sup> June Comprehensive Spending Review and a major re-working of the UK national accounts to be published on the 27<sup>th</sup>, which might introduce substantial revisions to the current 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 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. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 9th July and its minutes will be published on Sunday 28th July. The next two SMPC e-mail polls will be released on the Sundays of 1st September and 6th October, respectively.

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## Comment by Tim Congdon

(International Monetary Research Ltd)

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

**Bias: Hold Bank Rate for next three months and use rate setting and QE to achieve growth in broad money of 3% to 5%.**

### Regulatory blight has hindered broad money creation process

My last note for the SMPC opened with the sentence, ‘The regulatory blight on banking systems continues in all the world’s so-called “advanced” economies, which means for these purposes all nations that belong to the Bank for International Settlements.’ As I explained in the next sentence, the growth of banks’ risk assets is constrained by official demands for more capital relative to assets, for more liquid and low-risk assets in asset totals, and for less reliance on supposedly unstable funding (i.e., wholesale/inter-bank funding). The slow growth of bank assets has inevitably meant, on the other side of the balance sheet, slow growth of the bank deposits that constitute most of the quantity of money, broadly-defined. Indeed, there have even been periods of a few quarters in more than one country since 2007 in which the assets of banks, and hence the quantity of money, have contracted.

### This, in turn, explains sluggish growth of money GDP

The equilibrium levels of national income and wealth are functions of the quantity of money. The regulatory blight in banking systems has therefore been the dominant cause of the sluggish growth rates of nominal gross domestic products, across the advanced-country world, that have characterised the Great Recession and the immediately subsequent years. Indeed, the five years to the end of 2012 saw the lowest increases – and in the Japanese and Italian cases actual decreases – in nominal GDP in the G-7 leading industrialised countries for any half-decade since the 1930s.

### Dog and Frisbee

It is almost beyond imagination that – after the experience of recent years – officialdom should still be experimenting with different approaches to bank regulation and indeed contemplating an intensification of such regulation. Nevertheless, that is what is happening. The source of the trouble seems to be a paper given at the Jackson Hole conference of central bankers, in August 2012, by Andy Haldane, executive director for financial stability at the Bank of England. The paper, called *The Dog and the Frisbee*, argued that a simple leverage ratio (i.e., the ratio of banks’ assets to capital, without any adjustment for the different risks of different assets) had been a better pointer to bank failure than risk-weighted capital calculations of the kind blessed by the Basle rules. The suggestion is therefore that the Basle methods of calculating capital adequacy should be replaced by, or complemented by, a simple leverage ratio.

### Infuriating regulatory behaviour

For banks that have spent the last five years increasing the ratio of safe assets to total assets, or that have always had a high proportion of safe assets to total assets, the potential introduction of a leverage ratio is infuriating. A number of banks have been told in recent weeks that they must raise yet more capital. Because it is subject to the new leverage ratio, Nationwide Building Society has been deemed to be £2 billion short of capital. That has upset its corporate plans, to say the least of the matter, and put the kibosh on significant expansion of its mortgage assets. And what does one say about George Osborne’s ‘Help to Buy’ scheme, announced with such fanfare in the last Budget and supposed to turbocharge the UK housing finance market?

### Mervyn King's 'last hurrah'

The leverage ratio has been called Mervyn King's 'last hurrah', since there can be little doubt that King has been the prime mover in the regulatory tightening that has hit British banking since mid-2007. He is soon to be replaced by Mark Carney, who may or may not have a different attitude. Carney has been publicly critical of Haldane and his 'Dog and Frisbee' paper, but that does not guarantee an early shift in the official stance. Indeed, it is striking that – of the bank's top team under King – only Paul Tucker, generally (and correctly) regarded as more bank-friendly than King or Haldane, has announced that he is leaving the Bank once Carney has taken over.

### Over-regulation of banks is key factor holding back recovery

My verdict is that the regulatory blight on UK banking is very much still at work. Further, without QE, the quantity of money would be more or less static. As before, I am in favour of no change in sterling interest rates and the continuation of QE at a sufficiently high level to ensure that broad money growth (on the M4<sup>ex</sup> measures) runs at an annual rate of between 3% and 5%. My bias – at least for the next three months – is for 'no change'. It is plausible that I will be advocating higher interest rates in 2014. However, much depends on a realisation in official quarters that overregulation of the banks is, almost everywhere in the advanced world, the dominant explanation for the sluggishness of money supply growth and, hence, the key factor holding back a stronger recovery. Major changes in personnel may be in prospect at the Bank of England now that Mervyn King is leaving, but the Treasury – which I understand from private information will be glad to see the back of him – has failed to prevent the growth of a regulatory bureaucracy led by King appointees.

### Comment by Jamie Dannhauser

(Lombard Street Research)

**Vote: Hold Bank Rate and QE.**

**Bias: Additional QE and a rebalancing towards non-gilt assets.**

### Improved near-term outlook

The near-term outlook for UK growth has improved somewhat. The composite UK Purchasing Managers Index (PMI), based on monthly reports covering the manufacturing, construction and private service sectors, has climbed to its highest level since March 2012. Sub-indices covering new orders across the three main parts of the economy have picked up even more sharply – the composite balance is at a three-year high. Little hard data for the second quarter has yet been published but there are early signs of relatively solid growth. The momentum going into the second quarter is marked, with activity in April already some way above the first quarter average. The strong retail sales and new car registrations in May suggest that consumers continue to show some resilience, despite very sluggish wage growth. The labour market continues to firm. Robust growth in vacancies in the three months to May better represents recent developments than the flat-lining of employment volumes.

### Arguments for continued monetary ease

A moderate recovery in UK output is emerging. This could amount to an argument for laying the foundations for a withdrawal of monetary accommodation. The persistence of above-target inflation into 2014 supports a more hawkish stance. There are, however, several arguments for keeping the monetary stance unchanged and also maintaining a bias towards additional ease. First, the UK recovery is not assured. Private domestic demand – although growing and supported by rising house prices – will be held back for some time by several factors, including insufficient broad money growth, fiscal tightening and balance sheet repair. External threats, meanwhile, remain considerable, as evidenced by the recent shake-out in financial markets on the back

of, arguably, grossly exaggerated fears about the tapering off of QE by the US Federal Reserve. Major global imbalances continue to restrain the recovery in world demand. In 'debtor' economies, there has been very little reduction of excessive private and government sector debts. 'Creditor' nations show little willingness to undertake the policies necessary to boost domestic demand. Although output in the Euro area may stabilise in the months ahead, sustained growth is a way off. A dip back into recession may still occur. More broadly, the Eurozone crisis is far from resolved.

**Balance of risks remains firmly on the downside**

Risks to growth are still firmly on the downside. Inflation risks are more balanced but the recent data flow has pointed to greater disinflationary pressures than previously thought, if anything. Regular wages have barely grown over the last year – with average hours worked up by around ½% over the same period, nominal hourly pay has effectively been stagnant. Near-term and medium-term household inflation expectations are now at their lowest point in a year. Even the actual inflation data themselves have surprised on the downside. Excluding the effects of the 2012 tuition fee hike, 'core' inflation has been below 2% since last December. Consistent with this, UK retailers' price expectations (for the next three months) have dropped to their lowest level since November 2009.

**Additional monetary stimulus would still boost activity**

Additional monetary stimulus at this stage would incur costs but there are good reasons to believe that it would provide a boost to demand and asset prices. The benefits of QE still outweigh the costs in my mind. There remains a case for switching towards non-gilt assets, if additional stimulus is needed. That time has not arrived. However, it may yet do so.

## **Comment by Graeme Leach**

**(Institute of Directors)**

**Vote: Hold Bank Rate and QE.**

**Bias: Neutral.**

**Monetary tightening is now back on the agenda**

For the first time in five years, the possibility of a tightening in monetary policy is being seriously mooted. This is being driven by a number of factors. First, there is the potential tapering off later in 2013 and ultimately the ending, possibly in the first half of 2014, of central bank purchases by the US Federal Reserve. Second, there is the prospect of an improved UK GDP performance, which is probably better than at any time since recovery began; this has been signalled by the recent pick up in the growth of M4<sup>ex</sup> broad money to around 4.5% to 5% year-on-year. Third, there is the combination of an improved growth outlook with above target inflation. The May Consumer Price Index (CPI) was up 2.7% on the year with the prospect of a higher figure in June. Finally, minds are turning towards the potential 'normalisation' of monetary policy and what that means for the Bank Rate and gilt yields.

**Two questions**

This leads to two questions. Will there be a tightening in monetary policy? Should there be a tightening in monetary policy, and if so how?

**New Governor likely to trigger internal debate within the Bank**

With regard to the first question, the immediate prospect of a tightening appears slim. The outgoing Governor was outvoted in each of his last five meetings. However, this was a vote against a further expansion in QE, not for a reversal in policy. Moreover, with the arrival of a new Governor, inclined towards explicit forward guidance, some form of internal debate within the Bank of England is likely to ensue. Admittedly, the Governor is a member of the MPC, not the MPC, but some attempt at forward

guidance is likely to occur. In addition, given that CPI inflation has exceeded the 2% target for eighty one of the past ninety-six months, the current excess is unlikely to alarm the Monetary Policy Committee (MPC).

### Need to clarify how monetary tightening would be implemented

With regard to the second question, one can remain sceptical that any immediate tightening in policy is required. The new Prudential Regulation Authority (PRA) is signalling that the banks need to raise a further £27 billion of capital, with the attendant consequences for the money supply. But possibly of greater significance is the lack of debate thus far as to exactly how any future tightening should occur. Should it start at the short or the long end? Are there circumstances in which it could involve competing effects, such as a tightening at the short end combined with further expansion in QE? At present, there is not sufficient clarity on these issues and so a neutral bias seems appropriate. Furthermore, the recovery has within it, moderating effects, due to the recent global jump in bond yields – stemming from speculation about and the prospective reality of the withdrawal of asset purchases. The jump in yields also threatens a resurrection of the Euro crisis.

## Comment by Andrew Lilico

(Europe Economics)

**Vote: Raise Bank Rate by ½%; no additional QE.**

**Bias: To raise Bank Rate.**

### Things are looking up

Things are definitely looking up for the UK economy in the short term in internal terms. Multiple surveys indicate a pick-up in growth. At the time of writing, ten-year gilt yields have risen by around 100 basis points from their early May trough, reflecting the stronger growth outlook and diminishing expectations of further rounds of QE. The government has finally got around to starting serious spending cuts – though these will have to go on for many years and more will yet need to be announced. There is an underlying back-log of private sector investment projects delayed or foregone during the Depression of recent years. A mere reduction in the risk of things getting worse should be sufficient to release some of that investment potential and spur short-term growth.

### But the situation remains fragile

However, circumstances are still very fragile, and could easily be derailed by external events. The worsening of the credit crunch in China; escalating war in Syria; the Greek coalition collapsing and precipitating early elections and a Euro exit; the collapse of other UK banks – any or all of these could be sufficient to further retard the flowering of that investment potential. Nothing can be guaranteed. So there will not be a ‘convenient moment’ to tighten policy for many years. To wait for such a moment is to doom the economy to excessively low interest rates and chronic above-target inflation for the foreseeable future, with the consequence being a lower-than-necessary average growth rate.

### Loose monetary policy cannot accelerate growth in the medium term

As noted in the recent Bank for International Settlements annual report, all that an accommodative monetary policy can do is to buy time for households and governments to deleverage and for structural reforms to be made that protect and increase the average growth rate of the economy. Loose monetary policy itself cannot make economies grow faster over the medium term – it can only, if done to excess, make them grow slower. Nonetheless, the UK government and households have used very low interest rates as an excuse for delay, not a means to smooth transition. They still hope that ‘something will turn up’ rather than their needing to bite

the bullet on serious deleveraging. Slightly higher interest rates would give households slightly less temptation to delay, encouraging slightly faster deleveraging. Let us start with a half-point rise and take it from there.

## 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; unwind QE.**

**Official obsession with inflation targets caused the recession more than 'greedy bankers'**

When the history of the Great Recession comes to be written, it will be clear that it was only to a minor extent the fault of 'greedy bankers'. Yes, of course there were plenty of those but since when have people not been greedy? 'Greed and fear' goes the weary summary of business and market behaviour; what is new? The fault will be seen to lie with monetary policy's obsession with inflation targeting, to the exclusion of maintaining general monetary stability, which had been the traditional task of policy. It was the failure to keep monetary conditions stable – for which read 'keep the money supply on a reasonable growth track' – that allowed the great credit boom of the 2000s to take hold. Inflation targeting was so successful in stabilising inflation expectations that inflation hardly moved however much or little interest rates were moved. As a result, interest rates and bank reserve injection were given latitude to ignore monetary excesses – because inflation was so well controlled.

**The Great Regulatory Backlash**

Out of that failure, there came the Great Regulatory Backlash that followed the crisis when the credit boom crashed. This backlash produced a massive tightening of monetary conditions via the sledgehammer of excess regulation hitting the nut of weakened banks. It has proved impossible to loosen monetary conditions sufficiently to generate a proper recovery, against the contraction engineered by this regulative excess. Official interest rates have been lowered to the zero bound and QE has injected fabulous quantities of excess reserves into the banks, with no perceptible effect on credit growth and a collapse of the money multiplier.

**A recession was unavoidable but recovery would have been stronger with correct policies**

When we have the right models to analyse these events, we will be able to simulate a counterfactual world in which monetary policy targeted money growth and a credit boom was avoided in the 2000s. Then when the slowdown occurred due to global productivity growth slowing (for this read 'the world hitting a raw material shortage, forcing commodity prices skywards'), the banks would not have been exposed as badly as they were, nor would households have overbought houses. Yes, we would have still had a bad recession but it would have been possible to have a normal recovery, absent any regulative mania developing. Commodity prices would have fallen back, against a background of a lower cumulative level of GDP at the time of slowdown, and recovery would have been brought about by monetary loosening — falls in interest rates accompanied by injections of bank reserves.

**Poor advice from economists was to blame**

Ultimately, we should blame us economists not the politicians, because it is we who failed to have these models in time. As Keynes said, the policymakers are merely echoes of the researchers who taught them. We had models in which there was no money, only (official) interest rates being used to target inflation; they also contained no interest rates on credit to small businesses and households, the key channel the banks give us. The crisis has taught us now to allow for the imperfection of the monetary channel system; there are channels and they do not communicate perfectly

with each other. Money growth is an indicator of what is going on in the credit channel and what is therefore happening to credit rates to small businesses (which we observe very poorly due to the mass of accompanying charges and conditions, such as arrangement fees and collateral requests) and households. We also lost sight of the damage that can be done by monetary instability.

### **Gains from a money growth target**

If we add a money growth target to the inflation target, then we have two key features of the economy being ensured by the central bank: a) the long run inflation environment, and b) the stability of the monetary environment. In the process, output growth should also be stabilised, since output growth will be reflected in money supply growth. A natural pairing of instruments with targets would be for interest rates to react to inflation while the monetary base reacts to the money supply, which it directly affects.

### **No justification for macro-prudential regulation**

Where does this leave 'macro-prudential' policy? Regulations have the effect of raising the cost of credit – and so the 'credit frictions' in the economy. This is damaging to economic welfare – the only rationale for enhanced regulation is that it reduces the chances of a future banking crisis. However, if monetary policy were reset as above, this need would be met in that way, at no cost to the economy: one can think of monetary stability as ensuring that the cost of credit is kept at the socially optimal level, allowing for the desired underlying credit friction. Thus, in booms it would stop the credit cost falling unnaturally low; and vice versa in slumps. In these circumstances all that regulation should do is set a 'basic' level of regulative constraint on grounds of social 'bank safety' factors – this in turn would supply the underlying desired credit friction. There is no need for regulation to vary 'macro-prudentially'; and this basic level of regulation would be the minimal one required to offset the moral hazard created by deposit insurance. It should not discriminate against 'risky' lending to small businesses. Rather it should be set in relation to the whole bank portfolio's diversified risk level; a minimum capital ratio should be set that would prevail for a band of risk around some normal level on the whole portfolio. In this way, we should get away from the cost of funds for loans to SMEs attracting a much higher cost because their individually higher risk causes extra capital to be raised.

### **Official regulatory actions have blocked the credit channel**

As through a glass darkly, the coalition and their civil servants in Whitehall and Threadneedle Street have begun to realise that their regulatory actions have blocked the credit channel; so more recently we have had Funding for Lending (FLS) schemes 1 and 2, followed by the Mortgage subsidy for first time buyers. These do appear at last to be having an effect on the housing market and on lending conditions for small businesses – the ice blocking the credit channel appears to be cracking slightly. The economy appears to be picking up towards moderate growth. This has been helped by less grasping policies towards North Sea oil and gas producers, so that now we are seeing North Sea oil output bottoming out in line with banking and construction, the latter two aided by this credit channel thaw.

### **Regulative U-turn**

It is messy to have regulation combined with policies deliberately offsetting the regulation. Nevertheless, systems cannot turn on a dime and so we must be grateful for the easing we have in the regulative backlash. The implications of this regulative 'U-turn' for monetary policy are that we now need to worry about the return to more normal banking behaviour.



### Massive overhang of bank reserves

First, we have a massive overhang of bank reserves: the UK monetary base, as measured by Bank liabilities, has expanded to about eight times its level of 2007. This implies that banks have massive liquidity available for lending should they choose to use it. QE simply must be unwound as soon as practicable, although this should be done in a way that does not upset markets unduly. Thus as regulation is eased, the QE that was injected in a failed attempt to offset it needs to be unwound.

### Official interventions have crowded out interbank market

Second, what of official interest rates at the zero bound? Ronald Mackinnon in persuasive recent work has shown that if central banks swamp the banks with bank reserves at next to zero interest rates, then banks will not use the interbank market for very short term financing; rather they have all they need held with the Bank. QE at super-low rates has thus crowded out the interbank market, which indeed has fallen into relative disuse. The result has been that the banks' 'cost of funds' has borne no relation to Bank Rate; banks have borrowed on deposit, including longer term deposits from other financial intermediaries, to finance their lending – besides the effect of regulation in forcing expensive extra capital into the funding mix, now being offset by the new FLS and Mortgage subsidy schemes.

### Unwind QE and raise Bank Rate

Thus, as QE is unwound, Bank Rate should be raised to restore the interbank market and reinsert it into the funding mix. This will not tighten monetary conditions as measured by the cost of funds; it will substitute interbank borrowing for bankers' balances at the Bank. It will restore a normal banking market and drain off bank liquidity that is now dangerously excessive.

### Need to get credit and money growth back on track

These are transitional measures needed to bring monetary policy back on track as the effects of regulation on the credit channel are eased off. In the longer term, we need to get credit and money growth back on track; once that is achieved interest rates will be back at normal and QE unwound so that the monetary base too is back at a normal level of bank reserves. We must hope too that regulation has been cut back to a much less intrusive level. To conclude, the action needed today is to unwind QE and to move Bank Rate up in small steps, initially by ½%.

## Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)

**Vote: Raise Bank Rate by ½%; hold QE.**

**Bias: Avoid regulatory shocks; break up and fully privatise state-dependent banking groups; raise Bank Rate to 2½%, and maintain QE on standby.**

### Britain's economic openness limits its policy discretion and effectiveness

Britain's small open and trade-dependent economy means that it generally behaves like a small boat bobbing around on the turbulent seas of international economic developments. This can be easily verified from charts comparing British growth, inflation and real interest rates with their equivalents in the Organisation of Economic Co-operation and Development (OECD) area as a whole over the past five decades. This makes it impossible for the domestic authorities to fine tune the course of the UK economy, as politicians like to pretend and media commentary tends to assume. The government can improve Britain's long-term growth performance relative to the rest of the world if it maintains fiscal discipline – which probably means a share of total government expenditure in national output of no more than 35% to 40% – and refrains from ill-considered interventions in the markets for labour, products and finance. However, the global business cycle still tends to pre-dominate in the short term and apparently has been doing so for far longer than is recognised generally.

**Bank of England imports real interest rate from overseas**

Likewise, the Bank of England can improve Britain's relative inflation performance by pursuing policies that pull up the exchange rate and vice versa. However, international inflation is the main influence on the domestic rate of price increase in the short run, not the domestic output gap. In its rate setting, also, the Bank has tended to import the foreign real rate of interest much of the time. If it does not, then sterling tends to adjust to a possibly uncomfortable extent, especially as foreign exchange markets are notoriously prone to speculative overshooting in the short term.

**Britain's performance undermined by regulatory overkill**

No one who has looked at UK fiscal and regulatory policies since 2000 in the light of the literature on international growth performance can be happy with the massive increase in economic socialisation and regulatory overkill that marked the tenure of the previous government. The present Coalition's attempt to maintain so much of Gordon Brown's gigantic state power grab – because it has lacked the moral fibre to do otherwise – means that we are back on the treadmill of relative economic decline that marked the pre-Thatcher years, even when compared to an OECD area whose growth has slowed dramatically. There has been considerable debate as to why ultra-low interest rates and £375bn of QE have not yet had more of a stimulatory effect on UK economic activity. One reason has been the weak international background. Another has been misguided and excessive financial regulation which has been applied at exactly the wrong point in the business cycle and has led to an unduly sluggish growth in real broad money balances and total bank credit. This issue remains of supreme importance but is well covered elsewhere in this document.

**Large differences in socialisation between UK regions mean that effectiveness of monetary stimulus varies regionally**

However, there is a third, structural, reason that has had less attention than it deserves. In theory, a lax monetary policy can only stimulate activity in the private sector of the economy, which accounted for 51.5% of UK GDP last year, according to the June 2013 OECD *Economic Outlook* Annexe Tables. This is because the government can always create money at will. However, the size of the private sector in regional GDP in fiscal 2009-10 varied from only around one quarter in Northern Ireland to over two thirds in London, using data for the twelve 'NUTS1' regions into which the UK is officially divided. If all twelve NUTS1 regions were separate political entities, London's general government spending ratio of 31.7% would be the second lowest in the entire OECD after South Korea (30.2% in 2012), while the South East of England's government spending ratio of 37.9% would then be the fifth lowest OECD figure after Switzerland (34.1%) and Australia (36.1%). In contrast, the North East (66.5%), Wales (71.4%) and Northern Ireland (74.8%) all have noticeably higher spending ratios than Denmark (59.5%), which tops the OECD socialisation scales. The degree of state-dependence in these UK regions approximates to that in the former Eastern European satellites of Soviet Russia and means that such areas are probably incapable of reacting to monetary stimuli as a result.

**London is already showing incipient signs of overheating**

Certainly, the pattern of regional response to the Bank of England's aggressive monetary ease have been pretty much what one would expect from the relative degree of economic freedom. London is already showing nascent signs of economic overheating, especially in its property market. However, the heavily socialised former industrial heartlands have shown a far weaker response, except where the more competitive exchange rate and foreign-management initiated structural reforms within specific trades, such as the motor industry and steel, have been unusually helpful. The conclusion is that monetary policy will not work equally across the national domain until the former East German style structural rigidities of the more heavily socialised regions are tackled through aggressive liberal-market reforms.

**The same problem can be observed in the Eurozone as a result of post-EMU public spending sprees in the peripheral economies**

Incidentally, this is also one of the key issues facing the Eurozone. Germany has by-and-large maintained its general government expenditure ratio at its 2000 level but a number of peripheral economies went on Gordon Brown style spending binges after they had squeezed themselves into the fiscal corset demanded by the Maastricht convergence criteria – apart from Greece, which simply lied about meeting the criteria. The result is that a lax monetary policy at the level of the Eurozone as a whole may well prove an inflationary threat to Germany without providing a stimulus to the more highly socialised fringe members of the Eurozone. This has been pointed out by several German members of the European Central Bank, who have left the institution because they feel that it is no longer acting in the best traditions of the old Bundesbank. The problem now is that restoring the lower government spending burdens that allowed countries such as Spain to qualify for Eurozone membership in the first place would require such a large fiscal retrenchment – which would of necessity be in the form of spending cuts because they have overshot the limits of taxable capacity – that it could cause a massive political upheaval. When discussing rate setting the tendency is to concentrate on the finer points of the latest monthly economic indicators. However, these are virtually irrelevant sometimes and the important issues are almost geo-political in nature.

**Both UK and OECD broad money growth are satisfactory**

As it is, the latest figures for the M4<sup>ex</sup> definition of the UK broad money stock showed a rise of 4.8% in the year to April, while broad money in the aggregate OECD area was up by 5.5% in the year to March. Current monetary growth rates might be regarded as being appropriate on a medium-term perspective to achieve low and stable inflation given the rather subdued outlook for the growth of potential supply. However, there is an interesting difference between the 7.1% growth in US broad money in the year to April reported by the OECD and the increases of 2.6% and 2.7% reported for the Eurozone and Japan, respectively, over the same period. The main concern is that governments are hogging the money creation process and lending to the productive private sector is being crowded out, largely because of the financial repression caused by excessively onerous regulations. The international financial markets strong negative response to Mr Bernanke's suggestion that US QE will be approaching its end in the foreseeable future suggests that the UK boat could be hit by another wave of turbulence from monetary policy decisions overseas. This risk, together with the continuing uncertainties in the Eurozone, suggests that it may be hard for the UK monetary authorities to maintain a steady course under their new captain Mr Carney.

**Recent economic indicators**

The rise in the annual CPI inflation rate from 2.4% in April to 2.7% in May suggests that the more favourable April figure was an aberration and takes the year-on-year inflation rate back to the 2.7% to 2.8% range that has prevailed since October 2012. Core producer price inflation accelerated from 0.7% to 0.8% between the same two months, but remains well down on the CPI rate where much of the inflation appears concentrated in the service sector. Annual house price inflation on the ONS measure eased slightly from 2.7% to 2.6% between March and April. However, there are substantial differences between the various UK regions with house prices in London up 6% on the year but down 1.3% in the North East. The most recent labour market statistics have shown some signs of weakness in the very short-term comparisons. However, the employment rate was 0.7 percentage points up on the year in February-April; the labour force survey (LFS) measure of joblessness declined from 8.1% to 7.8% over the same period, and the claimant count measure of unemployment eased by 8,600 in May to a level 87,600 down on a year earlier. The reduction in the top rate of income tax at the start of the new fiscal year appears to have induced a surge in

bonus payments in April. Nevertheless, overall wage pressures remain weak and economy-wide earnings in February/April were only 1.3% up on the corresponding three months of 2012. Overall, a Bank Rate increase of ½% seems appropriate at the July MPC meeting with no further increase in QE for the foreseeable future. British interest rates will have to be normalised at some point. It is less disruptive to start the process early, and in small steps, rather than leave it too late and then have to slam on the brakes.

## Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

**Vote: Raise Bank Rate by ½%; no additional QE.**

**Bias: To raise Bank Rate.**

**Developed economies remain weak but there are signs of recovery**

The economy of the advanced countries is still weak, five years into the Great Recession. Nonetheless, there are signs of recovery. In particular, the US is expanding at around 2% per annum at the moment, and the second quarter growth rate in the Eurozone is expected to be better than the weak first quarter. The British economy is also showing some limited signs of recovery. UK economic growth is still weak, at only 0.3% in the first quarter, which is just enough to avoid falling back into recession again. However, service industries have been growing relatively strongly. In addition, house prices are picking up, which is usually a good predictor that consumption will strengthen. Overall, the British economy remains weak but it is showing some positive signs. However, the annual increase in national output is still far away from the 2% to 2.5% annual growth, which is considered a healthy long-run average.

**Monetary policy has now done all that it can to stimulate the economy**

Monetary policy has run its course. It could do only so much towards lifting the economy. Low interest rates and QE were needed during the worst part of the financial crisis, in order to calm markets and stabilise the financial sector. The loose monetary stance also helped to avoid an even larger decline in output in the first phase of the recession. However, low policy rates do not help the economy return to a healthy 2% to 2.5% growth rate. In particular, low interest rates can buy time for adjustment during a financial crisis, but they can also create perverse incentives if kept low for too long. Firms that borrowed prior to the crises have adjusted more slowly than desirable because of the low interest rates. At the same time, banks are reluctant to lend to new firms until their existing loan portfolio improves. As a consequence, the recovery is slow. To escape from this trap, the central bank needs to raise cautiously its policy rate.

**Inflation expectations under control but can change rapidly**

Inflation seems to be under control and inflation expectations are well anchored in the US, the Euro area and in Britain. Expectations can change fast if the recovery speeds up. In particular, CPI inflation has been above the 2% target since November 2009. Although it fell from its 5.2% peak in September 2011 to below 3% by mid-2012, it has been hovering above 2% ever since. It is important to note that the large drop in inflation was primarily due to a drop in the rate of goods price increase, while service inflation has been fluctuating around 3.5% since mid-2010. Overall, there are signs that inflationary pressure is slowly building up in the service industries, which make up the bulk of the British economy. The need to signal the readiness of the authorities to control inflation when necessary, also calls for a rise in interest rates.

## Comment by Peter Warburton

(Economic Perspectives Ltd)

**Vote: Raise Bank Rate by ¼%; diversify existing QE into non-gilt assets.**

**Bias: To raise Bank Rate.**

### Bernanke's clumsy interventions

In an unusual turn of events, the chairman of the US Federal Reserve Ben Bernanke's clumsy interventions have amplified nervousness in the US bond market with adverse implications for the UK rate curve. The upward shift in ten-year gilt yields of 50 basis points in the past month has also dragged up short rates and brought forward the implied date of the first rate increase to mid-2015 from late-2016. The significance of this market move is twofold. First, it casts even more doubt on the desirability and efficacy of QE programmes. Second, it has reinstated scope for a UK policy of calendar-based forward guidance on interest rates, specifically Bank Rate. These issues have pertinence in the context of Mark Carney's imminent assumption of the governorship of the Bank of England.

### MPC more likely to vote for extended QE under the new Governor

MPC members may also be more inclined to supplement QE (in the form of gilt purchases) after the rout in the gilt market, overturning the six to three votes that marked the final months of Lord King's tenure. Ironically, the MPC may be ready to grant Carney a majority for more QE, if he wants it. The twist would come if Carney were willing to advocate a broadening of asset purchases to embrace securitised infrastructure, property or small and medium-sized enterprise loans.

### Carney likely to push for US Fed style forward guidance

Every shade of opinion has been expressed regarding the ability of the new governor to change course. An ex-MPC member recently confided that he thought the MPC was 'stuck in 2009'. Mark Carney has been recruited surely with a view to dragging the MPC out of its rut and the question remains what impact he will seek to have on arrival. Market events suggest that he will push for the adoption of Fed-style forward guidance from the start.

### UK economy has perked up

Meanwhile, the UK economy has perked up since the end of the cold and wet spring with the possibility of a strong reading for 2013 Q2 on 25th July. After a 0.3% quarterly increase in 2013 Q1, the second quarter should see a gain of between 0.6% and 1%. The combination of the FLS and the 'Help to Buy' scheme has set a positive tone in the housing market and revived gross mortgage lending (up 17% from a year earlier). Retail sales and consumer confidence are both improving more than widely expected.

### Signs of normalisation in the banking sector

There have been other indications of normalisation in the banking sector as the Chancellor has committed to the return of Lloyds Bank plc. to private ownership and a final reckoning seems to have been reached in terms of additional capital requirements for other banks and building societies. The prospect of private sector credit expansion is rather more credible now than even six months ago.

### Broad money growth inflated by large public sector contribution

M4 growth, excluding intermediate OFCs, is running close to 5% on a year earlier, although this remains inflated by a large public sector contribution to the money supply. If QE is not extended in any form, then private credit growth would need to strengthen in order to sustain M4<sup>ex</sup> growth.

### Unblock credit transmission

However, as previously argued, Mark Carney's most pressing task as incoming Bank governor is to unblock the credit transmission not to construct an elaborate set of conditions under which Bank Rate may one day be raised. Indeed, if there is a role for

'forward guidance', it is to reassure markets of the Bank's determination to take rates back to the region of 2% to 2½% over the next two years. An immediate move to ¾% is my preference with no early commitment to additional QE.

## Comment by Trevor Williams

(Lloyds Bank Commercial Banking)

**Vote: Hold Bank Rate and keep QE at £375bn.**

**Bias: Neutral.**

### Bond markets have over-reacted to Fed's statements on QE

At the time of writing, financial markets are currently in the process of pricing for the end of asset purchases under the QE programme in the US. For background, the Federal Reserve buys \$85 billion of bonds a month, comprised of \$45 billion of treasury bills and \$40 billion of mortgage backed securities (MBS). The result has been a rise in the ten-year Treasury yield to 2.60% from a low of 1.63% in early May. UK ten-year gilt yields have responded to this by rising from 1.62% to 2.56% in the same period. This is without anything economically fundamental changing in the UK and, as such, seems overdone. It might not of course be overdone for the US economy, where growth is clearly moving towards its trend rate – albeit not above and maybe not at the rate that the financial markets are expecting. Even there though, it could be argued that the move seems excessive, as the Fed was careful in its recent press conference to point out that any tapering was data dependent and that that the Fed fund short term rate would not be raised for a considerable time after QE ended.

### Will Bernanke stay on after February 2014?

In saying any tapering was data dependent, the Fed suggested that it was not hell bent on raising rates come what may but would only do so if the economy continued on its current trajectory. Moreover, the messages were clear that QEIII would end only when unemployment hit 7% and rates would only rise if it hit 6.5%. On this basis, the data are not 100% clear about the timing of the tapering move (or the amount), unemployment edged up 0.1% to 7.6% in May, and inflation fell back, with wage pressure and core inflation very low. On top of that, Bernanke might not be around when QE ends next year, if he leaves as Fed Chairman when his current term terminates in February 2014.

### MPC's view of the UK economy

As for the MPC view of the UK economy, it remained divided in June but voted to maintain the status quo 6:3. It was the fifth consecutive month the committee was divided on the need for further stimulus, with the departing Governor, Fisher and Miles arguing for a further £25bn of QE, and the fifth month that Lord King was outvoted (and at his last meeting). The tone of the minutes was broadly unchanged to slightly more upbeat than last month's. While the committee acknowledged the economic data had shown a 'moderate' improvement, the recovery was evolving broadly in line with the projections outlined in the May *Inflation Report*. As such, there was no pressing need for members to change their positions.

### Stimulus versus inflation risk

MPC concern remained fixated on the debate about the case for further stimulus and continued to centre on the potential damage that weak demand could inflict on the supply base of the economy versus the potential risk to inflation of keeping policy too loose for too long. For the majority of members, the persistent overshoot of inflation, 'moderate' signs of economic recovery, and the effect of the previous rounds of QE and the FLS argued for no change. By contrast, the dissenters maintained that the

high degree of spare capacity, the importance of rebalancing growth and the substantial risks still posed by the Euro area justified further stimulus.

**UK likely to adopt conditional forward guidance**

Positions on further QE are now firmly entrenched, for some the recent correction in asset prices had highlighted the role further QE could play in helping to address financial market volatility and to help shape future policy expectations. Given the extent to which market expectations of UK interest rates have increased over the past month, this suggests some members could vote in favour of QE as a means of managing down bond yields and interest rate expectations if required. However, there must be a big question mark over whether that would work now, given the rise in global yields triggered by the words from the Fed. That said, it is likely that the MPC will adopt some form of conditional forward guidance, possibly after the report into its efficacy for the UK in August.

**Strong growth likely in Q2 but a slowdown thereafter**

With regards to recent data releases, the PMIs continue to suggest that growth in the second quarter will be close to ½%. However, the pace in the second half of 2013 will depend on Europe, the US and the rest of the world. On that score, the pace of growth in the rest of the world seems to have slowed, the US economy has exhibited some easing in its progress towards trend growth and Europe seems to be stabilising and no longer declining as quickly (though not yet in recovery mode).

**Inflation concerns**

On inflation, annual UK CPI inflation rose to 2.7% in May, unwinding some of the previous month's decline. May's price increases saw acceleration in both goods and services inflation. Goods inflation accelerated to 2.0% at an annual rate from 1.7% to reach the top end of the range seen over the last year. Service sector inflation also accelerated to 3.6% year on year in May. Although this rate remains more subdued than recorded over the last six months, service sector inflation is showing few signs of responding to the large amounts of spare capacity in the UK economy and is likely being kept elevated by relatively high unit labour costs. A further rise in June when the inflation numbers are released seems inevitable.

**Mr Carney could adopt US Fed tactics**

All in all, these figures and the volatility we are seeing argue for leaving rates where they are and QE on hold. However, if the economy firms further in the second half of the year, talk of QE will be all but banished and attention will turn to what would trigger a tighter policy stance from the Bank of England, with Mark Carney possibly using the approach adopted by the Fed.

## 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). 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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