



Shadow Monetary Policy Committee

June 2012

Embargo: Not for publication before 00:01am Monday 4th June 2012

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

In its latest monthly e-mail poll, completed on 29th May, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that UK Bank Rate should be held at ½% in June. Two dissenters wanted a rise of ¼%, while one argued for an increase of ½%. There was a divergence of view with respect to the desirability of further quantitative easing (QE). Two members wanted an additional £50 billion of QE in the near future; another called for an extra £100 billion. At the other extreme, one member believed that a start should be made on clawing back the current stock of QE and that this should be fully unwound over the next few years. Most SMPC members were more agnostic, however. It was accepted that QE was a useful implement when the central bank had to act as a lender of last resort, but less confidence that it would act as a major stimulus to the real economy. It was also felt that it was better for the authorities to avoid excessive regulation of the banking system in the first place than to try to offset the negative monetary and credit consequences through QE.

However, there were also areas where there was significant consensus. One was that the slightly more buoyant labour market statistics were probably a better guide to the true strength of the economy than the weaker GDP growth figures. Another was that many of Britain's economic difficulties reflected a poor supply-side performance that could not be cured by expansionary demand-side measures alone. A third area of agreement was that the difficulties within the Euro-zone had reached the point where a break up would be less damaging than a continuing war of attrition against the centrifugal forces involved.

The SMPC is a group of economists who have met quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers to debate the deeper 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 change the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses are correspondingly more significant than the precise vote. The latter is not a forecast of what the Bank of England will do but a declaration of what the SMPC believes it should do. The next SMPC gathering will be on Tuesday 10th July and its minutes will be published on Sunday 29th July. The next two SMPC e-mail polls will be released on the Sundays of 1st July and 2nd September, respectively.

For Further Information Please Contact:

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

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

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

For Distribution Enquiries Please Contact:

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

Comment by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate.

Bias: To hold for the time being.

Strange start to 2012

From a macroeconomic perspective, early 2012 is proving every bit as strange as the five rather odd years which preceded it. Not the least of the puzzles is the evident inconsistency between official statistical information and business survey results. According to releases from the Office for National Statistics (ONS), real gross domestic product (GDP) fell by 0.3% in the first quarter and the UK is back in a recession. By contrast, business surveys are satisfactory and indicate reasonable growth, perhaps at a trend rate, despite a rather gloomy European backdrop. As is well-known, data on employment are among the most reliable pointers to current economic trends. The figures in fact show employment rising in the early months of 2012. Even though the rise is concentrated in temporary and part-time work, they do suggest that the business surveys – and not the official GDP figures – are ‘the truth’.

Official data may not be picking up newly-established businesses

The first quarter drop in GDP may prove wholly illusory, when all the statistics are in and the ONS has conducted the ‘triangulation’ exercise which is necessary to reconcile different measures of GDP. The trouble may arise from the difficulty of incorporating output and employment in newly-established businesses, particularly in new types of economic activity (such as in information technology and its offshoots, including online-based and ‘app’ products and services). If moderate employment growth is taken as a fairly clear and positive sign of improving macroeconomic conditions, the state of the economy itself does not provide a rationale for extra monetary stimulus by, for example, another round of quantitative easing (QE).

Mixed monetary messages

Superficially, the money supply trends themselves are also satisfactory at present. Over the year to March $M4^{ex}$ moved ahead by 2.7%, while in the three months to March the annualised rate of increase was 6.4%. Closer inspection of the credit counterparts is more worrying. The six months to March saw banks shedding their loans to the private sector with greater intensity than at any time so far in the Great Financial Crisis. The good news is that much of this asset shrinkage may have reflected the unwinding of offsetting balance-sheet entries created by ‘conduits’, special investment vehicles and such like; the bad news is that banks are not as yet expanding their loan portfolios, despite continuing official pressure in that direction.

Hold Bank Rate and see how events unfold

It is possible that – with the latest round of QE now over – $M4^{ex}$ growth will come to a halt, as banks and their customers respond to the Vickers Commission proposals to operate on a sounder, more capital-intensive basis. If so, policy-makers must have their eyes open to the possible need for another round of QE. That conclusion would be reinforced if yet another Euro-zone trauma (such as Greek and Cypriot withdrawal from the Euro-zone) were to hit the UK somehow. Nevertheless, my preference is for no change in interest rates, while I have no bias in my view of the direction of monetary policy over the next six months or so.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate; expand asset purchase programme by £50 billion.

Bias: To increase QE further, unless Euro-zone situation improves materially.

Deepening Euro-zone crisis has led to growing pressure on the UK banking system

For some months, my bias has been to ease monetary policy further if the Euro-zone crisis were to deepen. The time for additional stimulus has now arrived. Since my last vote in March, financial markets have woken up to the desperate political situation in Greece, even though it has been clear for some months that the two centrist, pro-austerity parties had lost significant amounts of support. For much of this year, it was apparent that they would have difficulty forming a coalition and that the majority of the electorate would vote for political parties opposed to the Troika's demands. Over the last two months, stock markets have fallen sharply and risk premia have spiked. Conditions in bank funding markets, which improved markedly after the European Central Bank's (ECB's) long-term repo operations (LTROs), have deteriorated recently. Bond issuance by Euro-zone banks has slumped. No bank in Europe's periphery has managed a sizeable deal in the last few weeks, and there has been a sharp rise in the usage of national central banks 'Emergency Lending Assistance' (ELA) schemes. The major UK banks have not been left unscathed. Bond issuance all but dried up in May. Unsurprisingly, we have also seen a marked rise in CDS premia on UK banks' debt. A proxy for the marginal cost of new sterling loans is heading back to the highs of last autumn and is already 150 basis points (bps) above the level of the first half of last year, having risen by 50bps in recent weeks. Broad money growth was relatively strong in the first quarter, but this has much to do with erratic movements in the money balances of the non-bank financial sector. Over the last six months, M4^{ex} has grown at an annual equivalent rate of only 2.5%. This is despite the additional £105 billion of gilts purchased by the Bank of England during that time. Outstanding lending to UK households and non-financial companies has continued to shrink, in part because of reduced credit supply.

Recent UK GDP figures

The official GDP figures suggest the economy has tipped back into recession. There was much head-scratching when the preliminary figures showed activity dropping by 0.2% in 2012 Q1. It now turns out that decline in output was slightly larger than that, although there remain good reasons for placing only a limited amount of weight by these numbers. Survey evidence – the monthly Purchasing Manager Index (PMI) reports for instance – suggests the economy is growing, albeit slowly. There is a particularly puzzling discrepancy between official construction data and recent PMI reports, which point to robust growth in new orders and activity. On balance, the underlying pace of output growth in recent months has been stronger than the ONS figures would suggest. The expenditure breakdown of first quarter GDP would seem to confirm this: a significant negative contribution from stock-building offset the most rapid expansion in real domestic demand in two years.

'Big picture' is economic weakness

Even if the economy turns out to have been stronger than the current vintage of ONS data would suggest, the big picture will not be materially altered. Economic activity has barely grown over the last year. Business investment has been far weaker than expected. Had it not been for strong demand for UK exports from outside Europe, conditions could have been materially weaker. Most worryingly, nominal spending growth remains feeble. Had the 1995-2005 trend continued, nominal GDP would be 15% higher than it is today. To put this in perspective, this is exactly the same shortfall

that Japan faced, relative to its pre-crisis trend, at an equivalent point after its asset bubble burst.

There is spare capacity available in the UK economy, despite claims to the contrary

Some might argue that the 'stickiness' of UK inflation is evidence that the bulk of this shortfall in spending is matched by a reduction in potential output, i.e. that the output gap is relatively limited. This argument is not convincing for two reasons. First, it is not obvious that underlying inflation is actually high at all. Several different measures of domestically-generated inflation suggest slack in the economy is bearing down on price pressures significantly, most notably in the labour market. A measure of output prices in the private sector – the market sector gross value added deflator – shows inflation running at only 0.7% over the last two years, less than half the 1992-2007 average. Second, there is scant evidence that Britain's supply capacity has been permanently damaged to the extent that inflation hawks are suggesting. Pervasive credit constraints may mean that firms cannot utilise capacity they temporarily mothballed during the recession. They may also be encouraging firms to prioritise cash flow, and short-term balance sheet health, over longer-term profitability. In this sense, it is not so much that the output gap is relatively small, but that the effect of slack on price pressures is more limited than might be the case, i.e. that the Phillips curve is flatter than in 'normal' times.

Weak activity feeds on itself through hysteresis effects and Bank of England should purchase wider range of assets

The question is whether it is appropriate to use monetary policy in this instance to stimulate demand and output, and bring inflation back towards the 2% target over a period of time. There is a broader question of whether solely targeting CPI inflation is desirable in this environment; but even if we ignore this issue for the moment, there are strong grounds for additional ease. There is a growing risk that the persistence of weak demand causes an erosion of supply capacity à la Japan. The welfare costs associated with this could be substantial, as David Miles, an external MPC member, recently made clear. Hysteresis effects may not be material after a 'normal' recession, but in the current environment the path of demand may have a much larger effect on potential output. This is all the more true given the extreme uncertainty surrounding the euro area crisis. In my view, an additional £50 billion of QE is warranted. Given the sizeable downside growth and inflation risks going forward, further stimulus may become necessary. There is a growing question mark around how much benefit might be derived from additional gilt purchases in isolation. As such, the Bank should give serious thought to taking credit risk directly onto its balance sheet in order to enhance the stimulatory effects of injecting additional money balances into the economy. Alongside gilt purchases which boost broad money directly, the Bank of England (or government) should contemplate other measures, including direct purchases of bank bonds, securitised debt and even equities.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold Bank Rate.

Bias: Expand asset purchases by a further £50 billion to offset weakness in broad money.

Protracted weakness of UK economy

The UK economy continues to exhibit the protracted weakness characteristic of economies undergoing balance sheet recessions. While 'soft' survey data has been modestly positive in recent months, real GDP based on 'hard' official data from the ONS recorded a revised decline in of 0.3% in 2012 Q1, following a 0.3% decline in

2011 Q4. Since this was the second successive quarterly fall in real GDP, the six month period from October 2011 to March 2012 now constitutes a recession on the basis of the standard, crude definition. The level of real GDP is currently 4.4% below its pre-crisis peak in 2008 Q3, and only 2.8% above its trough in 2009 Q2.

Failure of macroeconomics

The failure of official policy to generate a recovery is a strong indictment of modern macro-economics. The economics profession has generally followed JM Keynes rather than Irving Fisher in concentrating excessively on flow variables in recent decades, ignoring the stock variables – in this case the balance sheets – that underlie them. Two broad channels for generating economic recovery have signally failed – the monetary transmission mechanism and fiscal expansion.

Monetary policy has failed to stimulate the economy

First, the results of monetary policy have disappointed those who predicted a strong recovery based on the abnormally low rates of interest rates or faster money growth. Economists of this persuasion argued that their macro-economic models showed a strong relationship between lower interest rates and faster economic growth. In reality, however, even the extraordinary monetary measures by the Bank of England have failed to fire up the animal spirits of the business world, leading to weak business investment and even cash hoarding by non-financial companies. Moreover, the expansion of the Bank of England's balance sheet by means of asset purchases or QE has not yet led to any expansion of commercial banks' balance sheets or the broad money supply as the money multiplier has collapsed. The best that can be said of QE is that it may have prevented the economy from becoming even weaker.

Advocates of fiscal stimulus are false prophets

Similarly, those who have argued for ever more government spending or bigger budget deficits are false prophets. In their case the errors have been twofold. First, far from being 'cut', UK government expenditure has continued to grow at an alarming rate (3.8% year-on-year overall in April, comprising 2.5% for departmental spending, 5.4% for welfare payments, and 9% for interest payments). To argue for more government spending in these circumstances is to make the same error the Japanese made through most of the 1990s – when the authorities relied primarily on fiscal spending for economic recovery – and to risk burdening the UK economy with ratios of government spending to GDP of 55%, 60% or 70 %, and even higher debt ratios. Second, it is misleading to claim that continued fiscal expansion in the United States has restored growth there and therefore the same strategy should be followed in the UK. The reason for the US recovery is to be found elsewhere (see below).

Weak recovery reflects over-indebted balance sheets

The question that now arises is why is the recovery proving so intractable? The basic reason why the economy is not recovering is that two of the largest sectors in the economy – households and the banking sector – are struggling with over-indebted balance sheets, and balance sheet repair in these two sectors invariably takes much longer than it does in the non-financial corporate sector. Fundamentally, there are only three ways to repair a balance sheet. First, a company or bank can raise equity capital, but this route is obviously not open to households. Second, assets can be sold, and the proceeds used to pay down debt. Banks are indeed following this path, selling non-core businesses, reducing customer loans and inter-bank or capital market activity. In the US, bank balance sheet repair is significantly more advanced than in the UK and therefore US bank balance sheets, money growth and credit growth are all much further ahead than in the UK. This is the basis of the stronger US recovery, not fiscal expansion. However, for British households that have borrowed mainly to finance their primary residence, selling assets is simply not realistic. Most will prefer to

cut consumption and/or increase savings in order to continue making payments on their mortgage. For other households that have borrowed to acquire second homes or buy-to-let properties, the selling prices will now be below the purchase prices in many cases, and therefore holders will procrastinate or not sell at all.

Households are increasing saving in order to pay down debt

That leaves the third option: assuming the householder can keep his or her job, the only way to reduce debt relative to income is to cut consumption, increase savings and pay down the interest or principal year by year. This is the main option facing most householders, and explains both why balance sheet repair takes so long and why consumer spending remains so weak. Against this backdrop, the authorities should concentrate first and foremost on measures to accelerate the repair of household and financial sector balance sheets. For its part, the Bank should keep base rates at their current low levels and continue to expand its asset purchases to ensure broad monetary growth remains positive.

Above target UK inflation mainly result of external shocks

In my view, fears about inflation should not deter the MPC from this course of action since: a) QE has not caused any rapid growth of broad money and credit, and b) consumer price index (CPI) inflation in the past three years has been mainly due to exogenous factors – such as commodity price increases, weak sterling and indirect tax increases – interacting with the pre-2010 excess money growth to generate specific episodes of inflation. The lack of any growth of money and credit over the past two years is likely to mean a distinct slowdown in inflation over the months ahead. In that sense, the surprise decline in April's year-on-year inflation rate to 3.0% from 3.5% was an early harbinger of the disinflation still to come.

Comment by Ruth Lea

(Arbuthnot Banking Group)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate; no more QE this month, but keep it in reserve.

Mildly encouraging April CPI data

The latest CPI inflation data were mildly encouraging. The annual rate fell from 3.5% in March to 3.0% in April. This was much as expected, partly reflecting the significant increases in April 2011 falling out of the annual comparison – this was partly associated with technical factors surrounding the timing of Easter. The 'core' inflation rate (defined to exclude the volatile items of energy, food, alcoholic beverages and tobacco) fell from 2.5% to 2.1%. The Bank of England's latest forecasts for inflation, which were revised up in the *May Inflation Report*, now look reasonably realistic having been previously over-optimistic. The Bank currently expects CPI inflation to decline to 2½% by end-2012 before meeting the 2% target in the first half of 2013.

And commodity prices are easing as well

Inflationary pressures do seem to be easing. Commodity prices have declined over the past month and past year. The *Economist's* 'all items' index measured in sterling terms for 22nd May 2012 was down 1.2% on the month and 12.6% on the year, whilst the decline in oil prices has been especially marked since spring 2012. Partly reflecting the weaker commodity prices, UK producer prices inflation has moderated for both output and input prices since mid-2011. In addition, the pound has strengthened, especially against the euro. Moreover, there are absolutely no signs of a 'wage-price spiral' taking hold. Year on year earnings growth in 2012 Q1 was only 1.6% excluding bonuses (i.e. regular pay). According to Income Data Services wage settlements are still modest, albeit marginally ticking up. In 2012 Q2 the median

settlement was 3.0%, a figure which can be interpreted as the current benchmark settlement level.

Failing and flawed Euro-zone project

Turning to GDP, the Bank of England reduced its forecast for 2012 from over 1% in February to around 0.7% in May. Sir Mervyn King warned of a “*storm heading our way from the Continent*”. As the Euro-zone crisis intensifies, Europe’s politicians are still ducking a permanent solution. Faced with hard choices, they have consistently shirked them. Most of the Euro-zone economies, with the exception of Germany, are struggling reflecting the failing and flawed euro project. If Europe’s politicians cannot stomach fiscal union, they should prepare for break-up; and the sooner the better.

UK GDP figures for the first quarter

The ONS duly downgraded the GDP decrease for 2012 Q1 from 0.2% to 0.3%, reflecting the (even) weaker construction numbers. The analysis of the expenditure components of GDP shows a big drag on growth from destocking (which contributed a 0.7% fall to GDP), only partly offset by a rise in General Government Final Consumption (GGFC), which contributed a 0.4% rise to GDP. The other components had little impact on growth in the quarter. The rise in GGFC in 2012 Q1 makes nonsense of the ‘savage cuts’ scenario so popular in political and media circles.

Feeble Queen’s Speech measures

The Government talks a great deal about growth. Nevertheless, the measures in the Queen’s Speech were feeble. There was a little help on employment tribunals, but the proposed measures on flexible parental leave could prove a nightmare for small businesses. The Energy Bill, committing us to yet more expensive and intermittent wind-generated electricity, could only be pursued by a government that is not really serious about business, competitiveness and growth. Even less encouragingly (if that is possible) the Business Secretary recently dismissed out of hand a key proposal of the Beecroft report concerned with limiting the right of employees to claim unfair dismissal on employment regulations as “*complete nonsense*”. At a time when the Government should be considering all avenues for stimulating employment and the economy, such a dismissal seemed peremptory at best.

Faltering growth

Mme Lagarde of the International Monetary Fund (IMF) has also been in on the growth debate recently. She sensibly suggested that the British Authorities should adopt growth boosting measures including more QE and the loosening of the capital requirements on banks which are restraining bank lending. Growth in the UK is faltering, stagnating at best. Given the headwinds, I continue to support a very accommodative monetary policy. Bank Rate should be left at ½%, I see little point in cutting it further, and QEIV should be kept in reserve.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%.

Bias: No additional QE.

Greek exit from Euro-zone is unavoidable

Matters have changed little over the past month, other than most commentary on Greece catching up with what was already obvious before – namely that Greece is very likely to default again, on official sector creditors this time, and then to exit the euro. This endgame has been obvious almost since the moment of the first bailout of May 2010, and indeed Greek euro exit will, if it occurs, be the direct and predicted consequence of the May 2010 bailouts. Be that as it may, the key uncertainties do not concern Greece but, rather, Spain and Italy. Italian euro exit would, in particular,

constitute the end of the project, bring about Italian sovereign default, and thus bankrupt much of the Western banking sector, again.

Germany is being reasonable in not underwriting other nations' debt

The Bank of England is unfortunately saddled with the British government's bizarre insistence that Germany is somehow unreasonable for not wanting to take responsibility for trillions of Italian debts accumulated long before the euro even existed. One wonders how keen the British taxpayer would be to take on such a burden. Insofar as it can distance itself from Her Majesty's government's increasingly strange position on this matter, the Bank should instead be urging: the accelerated introduction of special resolution regimes for Eurozone banks; the application of European Commission- and Basel Committee-recommended bail in (debt-equity swap) rules (particularly in Spain), and preparation to avoid further bailouts of UK banks if they become distressed as collateral damage from Eurozone events.

Immoral policy madness

The Bank should also be doing all it can to soften or reverse overly aggressive rises in regulatory capital ratios. In the current environment a more idiotically perverse policy would be hard to conceive (unless one could have conceived of almost all the rest of the immoral policy madness – trillions of bank bailouts, massive rises in public spending destroying medium term growth, huge rises in deficits impoverishing sovereigns – that have been pursued since 2007). In the meantime, the Bank should be seeking to raise interest rates. Rates that were justified as an extraordinary emergency measure in early 2009 have no such rationale more than three years later. Monetary policy has done all it can here. It is now time to raise rates.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%.

Bias: To raise Bank Rate and gradually withdraw QE.

The economic situation and dubious ONS data

The latest data from the ONS continues to defy other general indicators of the state of the economy. The first quarter outturn for GDP has now been revised downwards to *minus* 0.3% on the grounds that construction output fell by nearly 5%. The Bank of England is just one example of economic forecasters questioning the reliability of this construction estimate. However, we know that these preliminary estimates are virtually worthless, even in less turbulent times. My colleague Mike Wickens found the following result in work for the House of Lords Economic Committee.

“Over the period 1998 Q2 to 2004 Q1, nine of the nineteen preliminary estimates of growth were more than one standard deviation away from the final estimate, while only four out of eighteen of the previous quarter’s growth rates were more than one standard deviation away from the final estimate. The assumption of no change in the growth rate gave estimates that were twice as accurate as the worst interim estimate. In other words, over this period, using last period’s growth rate gave the best estimate of the current growth rate.”

We are still too far from the final estimates over the last few years to be able to do a similar exercise since the crisis. However, the early estimates for recession periods generally get revised up later. The reason is that there is substitution away from activities that are being depressed to newer activities that are less well reported initially.

Factors frustrating growth

So let us be guided by the employment statistics and by purchasing managers' surveys which suggest that there is no double-dip but rather that the economy is growing weakly. This is still a poor scenario for a government trying to reduce the public deficit, unless this weakness in growth improves. The factors frustrating growth here are the same as those frustrating growth in other western economies. Unfortunately, these factors will not suddenly go away. For this reason, policies need to be orientated towards alleviating their effects. One adverse factor is the tightness of commodity markets, which will remain until productivity in the use or creation of raw materials rises. This is what happened in the 1980s in response to the commodity crisis of the 1970s. During the 1980s the demand for commodities was reduced by substitution and additional supplies were found, also usually by new methods of extraction, such as in oil extraction in the North Sea. As a result, commodity prices in the 1990s dropped to low levels and this helped to fuel the long boom of the 1990s and 2000s. With commodity markets tight, there is a reduction in western living standards for those countries that are net importers of commodities. Thus, if a country imports commodities worth 5% of its expenditure, then if the cost of this inclusive of transportation rises by 100%, the loss of living standard is 5%. Real commodity prices roughly doubled between 2005 and 2011 so a number of this order looks about right.

Change in the structure of production caused by new relative prices

Second, there is also a change in the structure of production after such an upheaval in relative prices. For example, we are seeing substitution away from use of the car and from travel; housing demand is reduced because of the energy costs of larger houses. This is a process going on widely. We can gauge something of its importance from the calculations of 'excess capacity'. Were UK economic structure to be the same as it was pre-crisis, then we would have excess capacity of around 13% today. Actual estimates of excess capacity from surveys of businesses indicate a figure of around 3%. This is telling us that much capacity is now simply irrelevant as it will not ever be used. If we assume that over the coming decade technical progress in substituting away from these scarce commodities will be slow, then we can also gloomily note that if the West were to grow faster, this would put further upward pressure on commodity prices and hobble the attempt by reinforcing the factors we have just elaborated. We must hope that this is too gloomy and that technical progress will reduce our commodity dependence faster in the coming decade.

No prospect of cyclical rebound

What all this suggests is that, as is now obvious, there will not be a 'cyclical rebound' such as occurs when there is plenty of excess capacity which can quickly be brought on stream as demand recovers. Instead it implies that growth from here will be dependent on productivity growth making new capacity profitable. We need 'Enterprise Britain' to spur growth.

Regulative backlash against credit creators

At this point, we hit another problem. Our banking system has been tied up in knots by the regulative backlash against banking and finance. While preaching competition the Vickers Commission has proposed higher costs through a new raft of regulation; this is discouraging new entry (competition) and is even reducing credit creation by existing banks because of the high marginal cost of raising the extra capital to go with it when bank share prices are so low. By this regulative overkill, we are both curbing the growth of our major industry and curbing the growth of Small and Medium Enterprises (SMEs) who depend heavily on bank credit. In so doing we curb productivity growth.

Popular sentiment is now anti-business

Finally, we note another set of problems induced by the pain of the crisis. Popular opinion has turned anti-business and this is reflected in policies designed to please the populace. We have had the 50% top rate of income tax, the verbal bashing of bankers, windfall taxes on banks, and a climate of hostility to high pay and those dreaded bonuses. This has been further complicated by populism on the green agenda which has stopped proper infrastructure provision; thus, we have had a veto on the third Heathrow runway, the emphasis on wind farms that are costly and ineffective, and the proposal for HS2, which is a white elephant. One sympathises with politicians who have to deal with popular disquiets. Nevertheless, and in the end, if growth is to be achieved – which both we and these same politicians need, in order to get our economies working again – then these politicians must be willing to explain the pro-business and pro-growth case.

QE fails to reach the growth producing parts of the economy

Some economists say growth must be slow because ‘balance sheets are weak’. However, this is to confuse cause and effect: balance sheets are weak because growth prospects are poor; hence share prices discount weak growth and so the value of assets is low, and the incentive to invest low with it. We need policies that unlock growth potential and then balance sheets will automatically be strengthened. These same economists argue that balance sheets would be strengthened by printing more money – that is further QE. This will raise the prices of assets and increase the supply of credit, easing balance sheet problems. However, while it may be that QE does lower interest rates on government bonds, it does not reach the parts of the private sector that credit reaches. SMEs do not issue corporate debt and most do not issue shares either. Unfortunately, QE has not triggered any improvement in the supply of credit, essentially because the regulators are choking off this supply elsewhere by their new heavy-handed interventions. Increasing credit supply seems unattractive to banks if they are forced to raise extra capital at rock-bottom share prices. QE accordingly has made it easy for large firms and the government to finance themselves but that is where the benefit stops. The government has benefited from three years’ financing by printing money but is broke, while large corporations are awash with cash, have easy access to equity markets but see no opportunities for investment. The trouble is that QE has not removed the main roadblock to new activity by SMEs that hold the key to spurring productivity growth and competition.

Demand injections by government will fail

Then there are other economists, mostly on the left, who believe the situation can be resolved by ‘injecting demand’ through fiscal loosening. Unfortunately, and once again, the situation does not permit this to be done while maintaining government solvency. Just like private households, governments are limited by their budgetary flows. Most western governments now have reached the limits of their borrowing capacity in peacetime; to maintain confidence in their solvency they must show plans for rebalancing their books. In this situation, a government cannot achieve a good ‘multiplier’ from spending more; this is because the net effect will be to raise interest rates on its own debt and indirectly on the other debt in the country. The effects of these higher interest rates would dwarf any positive effect from the higher spending, producing a negative multiplier. Alas, when times are bad, governments are as constrained in their spending decisions as households are; when times are good, households are as free to spend strongly as are governments.

The Euro-zone crisis

Another excuse for inaction is the depressing crisis in the Euro-zone. Much ink has been spilt on this; many of us warned of the dire possible economic consequences of the euro, a half-baked scheme for monetary union created mainly for political reasons.

The world banking crisis has cruelly exposed the fault lines in this project, mainly derived from its lack of fiscal union. There is now a struggle within the Euro-zone between North and South about the allocation of the burdens for saving the euro. This struggle is condemning the zone to renewed recession. What we notice is that, in spite of all the rhetoric about the importance of saving the euro for the fate of the world order, the world is getting along quite well in spite of this endless struggle. Indeed the recession in the Euro-zone is weakening commodity prices, which is quite helpful for other western economies. Furthermore, other countries including the UK are increasingly shifting their trade away from the Euro-zone. The UK's exports to the zone are down 10% on their pre-crisis level while its exports to non-euro countries are up 30%. Of course the Euro-zone's weak demand does reduce demand elsewhere. However, this shift and the commodity price weakness are compensating factors. The UK is quite capable of growing if its supply-side forces were given the necessary boost, regardless of the problems in the Euro-zone, which will probably take at least a decade to sort out.

Gloomy conclusion

The gloomy conclusion from all this is that printing more money will not generate growth but instead will keep down the cost of budget deficits. Thus, in conjunction with repressive regulation, it creates what 'financial repression' does in developing countries: it enables the government to acquire all of society's savings cheaply. This depresses general welfare by reducing the return on savings and capital and so reducing growth. Already savers are protesting against the endless perpetuation of these policies. They allow the government to survive, even though its policies are anti-growth. The policy conclusion is that we need policies to address the factors stultifying growth. Bank regulation must be eased; other regulations on small businesses also need to be eased. Growth will only come from SMEs; as we see large businesses are just sitting on their cash, seeing no urgency to create new markets. Only SMEs have the hunger to drive competition and new technology.

High banking sector liquidity poses a serious inflation risk if the economy ever recovers

Assume for one optimistic moment that the coalition government started to do this. Then the mountain of liquidity in the banking system would prove a serious inflationary danger. Already the Bank's credibility on inflation is in danger of erosion from its persistent under-prediction of inflation. So far we have avoided these dangers in practice because the economy is failing. So we have monetary policy that fails to ignite inflation under economic failure but in the presence of success risks igniting a vigorous inflation. You might say: "*well at least monetary policy is not currently doing any damage*". But imagine a Governor who said:

"We will no longer subsidise government failure to cut deficits and produce growth. We will withdraw QE/excess liquidity; and we will progressively bring inflation under clear control by raising interest rates back towards normal, as is appropriate when demand is approximately equal to supply. Now let government help itself by introducing the right policies for business and so for bringing down its deficits. One of those policies is to loosen bank regulation – and we will take the lead in doing this".

This is the policy I would urge: a robust responsible bank getting in control again and urging good supply-side policies on this divided and failing coalition. Thus, I would now raise Bank Rate by a ¼% with a bias to raise further. For QE, I would start the process of withdrawing it - at the rate of say £25 billion per quarter for now; this would eliminate the £325 billion liquidity mountain in just over three years. So I would have a bias to speed this up after a year.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate, until the Euro-zone situation clarifies, but then to raise; keep further QE on standby only.

Euro-zone break up is inevitable and attempts to hold it together are doing more harm than good

The situation in the Euro-zone has now reached the equivalent position to the later stages of the unhappy marriage between the Prince of Wales and the late Princess Diana. In other words, the situation has become so bad that a break up is both inevitable and significantly less damaging than attempting to maintain the status quo, however much loss of face and political embarrassment is involved by accepting the need for divorce. The irony is that well before European Monetary Union (EMU) was proposed there had been a de facto movement towards currency convergence centred on the Deutschmark on Hayekian lines, with currencies such as the Dutch Guilder already effectively pegged to the Deutschmark for a decade or so. The experience of Denmark that has maintained its own currency since EMU, but effectively rigidly pegged it to the Euro, and currently has a ten year bond yield below Germany's (1.24% versus 1.37%) is another indicator of what might have been if informal monetary convergence with stably related but separate currencies – but no 'big bang' currency union – had been attempted. The EMU project partly came about because of French geo-political fears about the potentially excessive power of Germany after German Economic and Monetary Union (GEMU). However, it also represents a classic example of the overwhelming hubris of the political and bureaucratic classes not only in Continental Europe, but also in the Anglo-Saxon nations, in recent decades, which has done so much damage to the economic performance of the Western economies.

Time to plan for life after the EMU 'divorce'

There would probably have been more currency stability and greater economic prosperity across the European continent if monetary convergence had happened organically than that which is resulting from the present 'Bourbonist' model of EMU. Monetary union should have been modelled on the gradual international spread of the Gold Standard over two or three decades in the late nineteenth century, instead. Where the present British Coalition government is concerned, an early break up of monetary union would just about allow scope for some recovery in economic activity in our Continental trading partners, after an initial period of chaos, before the next general election. The nightmare scenario for Mr Cameron is that the Continental elites will fight the breakup of EMU in a long and costly war of attrition similar to the Great War's battle of Verdun, which caused 698,000 battlefield deaths. The emotional driving force of the founding fathers of the European Union in the 1950s was that there should be "*no more Verduns*". That remains an entirely legitimate and praiseworthy aim and one that the writer wholeheartedly shares. However, continuing EMU in its present form is neither a necessary or sufficient condition for achieving it. Instead, it is now time to plan for a happier and more stable life after the Euro-zone divorce.

Labour market statistics versus the GDP figures

Around a dozen years ago, the UK labour market statistics were compiled by the then Department of Employment (DoE), not the ONS, and the DoE used to give excellent quarterly briefings on its statistics to City analysts. One theme that emerged on several occasions was that, when the labour market data disagreed with the economic picture portrayed by the ONS national accounts, as they do at present, it was the national accounts data that tended to be revised in the direction of the trends shown

by the labour market statistics rather than vice versa. Other submissions to the current SMPC poll have also drawn attention to the stronger trend shown by the UK labour market data than is apparent from the first quarter GDP data, so it is not necessary to labour the point here. However, it is worth emphasising that the introduction of the new ESA 2010 national accounts by the ONS was badly botched, and that historic back runs of even the most important GDP components were not published until just before Christmas 2011, six months later than usual. The ONS will be issuing re-based national accounts in 2009 chained prices rather than the present 2008 price base on 28th June and it is difficult to know how far this will lead to extensive back revisions to the current estimates. It is impossible for macroeconomic model builders to maintain reasonable standards of statistical estimation when the national accounts are as unstable as they have been in recent years. This applies to the official model builders at the Bank of England and the Office for Budget Responsibility as well as those working in the private and academic sectors. One gets the impression that the ONS would rather undertake cutting-edge 'blue skies' research at the frontiers of statistical methodology than act as a boring utility that supplies reliable figures to policy makers and the citizenry. This may be a situation where firm political direction as to the ONS's appropriate priorities needs to be imposed.

European economies are weak because large government spending increases have debilitated their supply sides

Unfortunately, firm political direction seems to be beyond the capacity of the present coalition. There may well be demand side weaknesses affecting the UK economy but it is hard to avoid the conclusion that there are major shortfalls on the supply side involved after such a prolonged period of weak output performance, even if the 'true' economy may be stronger than the ONS figures suggest. The deep fundamental cause of this sluggish performance has been the massive rise in the public sector's share of national output between 2000 and 2010, and the fact that the Coalition have attempted to consolidate Gordon Brown's gigantic state power grab rather than reverse it. There is strong evidence that a large government sector not only reduces long-run economic growth but also crowds out private economic activity in the short run. People who attack fiscal 'austerity' rarely seem to define the term precisely. However, there appears to be a negative relationship between higher government spending and private economic activity even in the short run. Furthermore, this crowding out is especially marked in open economies with a floating exchange rate and a high public debt level such as the UK. GDP includes government spending by definition and this can mask the underlying impact of government spending increases on the residual private sector. However, the need now is to encourage private activity, both to generate real jobs and because this boosts the tax base. Furthermore, the crowding out effects of government borrowing and taxes appear to be very similar even in the short-term, so that the primary problem is the government spending burden, not taxes or borrowing considered separately. The European Central Bank has cogently argued that the ultimate reason that EMU has become unsustainable is the contrast between the relative fiscal discipline in Germany and the sharp increases in the government spending ratios in the peripheral Euro-zone members. Monetary policy is incapable of rectifying the imbalances that arise from such structural differences, and can only lead to stagflation if it is set too loosely.

Lower oil and other commodity prices will reduce inflation and boost activity next year

Fortunately, the recent reductions in the prices of oil and non-oil commodities should not only allow for some further easing in inflation over the next few quarters but should also provide some real economic stimulus, although the benefits will not be felt until 2013 because of the time lags involved. There are also welcome signs that some areas of the UK economy, such as motor manufacturing, are enjoying something of a

renaissance – possibly and partly because Mr Osborne’s cuts in the rate of corporation tax are starting to bear fruit. If one takes the latest GDP figures at face value and inserts them into the Beacon Economic Forecasting (BEF) model, economic growth this year would be predicted to average no more than 0.5%. However, the prospects for 2013 look significantly brighter, unless energy costs take off again. There is scope for quite a marked rebound in activity, provided the political and bureaucratic classes do nothing stupid in the way of additional misguided tax increases or excessive financial regulation. The uncertain situation in Continental Europe warrants a tactical hold where the June Bank Rate decision is concerned. 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. There is no immediate case for further QE at present. Furthermore, stopping the excessive regulatory push against the banking sector would be a far more effective method of shoring up the supplies of money and credit. However, QE should be kept on standby if there is the renewed threat of a banking sector meltdown but only for lender of last resort purposes.

Comment by Peter Warburton

**Comment by Peter Warburton
(Economic Perspectives Ltd)**

Vote: Raise Bank Rate by ¼%; no extension of QE; explore other policy options.

Bias: Raise Bank Rate.

Threats posed by European financial instability

The reassertion of the European financial instability threat in recent weeks is likely to have negative implications for the UK outlook even if the more extreme scenarios can be avoided. As market risk premiums rise, UK mortgage borrowers will face rate increases. As deposits are withdrawn, quite irrationally given the Europe-wide deposit guarantee scheme, from European banks operating in the UK, domestic mortgage supply is likely to be tightened again. Given the perceived lack of flexibility in the fiscal context and the multiple regulatory constraints on the banking system, the Bank of England is again thrust into the limelight.

Bank of England has been too cautious

At a time when other central banks, even the Bank of Japan, have shown imagination in the execution of monetary policy in order to bolster the collateral of the financial system and guard against discontinuous financial and economic outcomes, the Bank of England appears to have forsworn all but the vanilla options. The coalition government may have nailed its colours to the mast of fiscal virtue but the Bank is not similarly constrained. It is time to re-examine what more the Bank could be doing to relieve the external stresses on the UK economy and especially to stimulate domestic credit and monetary growth.

Commercial banks will only lend more if BoE is prepared to take greater risks with its own balance sheet

The risk equation is straightforward: for the commercial and investment banking sectors to commit more of their capital to new loans to the private sector requires the Bank of England to take more risk on its own balance sheet. It could decide to take capital risk (by acquiring mortgage securities or corporate bonds), liquidity risk (by purchasing hard-to-trade assets from the banks at suitable haircuts) or duration risk (by switching its shorter-dated gilts for longer-dated ones). Alternatively, it could copy the ECB and conduct a liquidity operation by relaxing its collateral eligibility conditions at the repo and relieve pressure on the re-capitalisation of the banks. The conservatism of the Bank’s approach, reemphasised in the latest *Inflation Report*, sits

uneasily with the other policy constraints and the external threat of European financial instability. The Bank needs a plan B and it will lose no face by having one.

IMF was wrong, Bank Rate should be raised

Contrary to the IMF's latest suggestion that the Bank should consider a cut in Bank Rate, from the current 0.5%, a better plan would be to raise it under the cover of these European interest stresses. In all probability, once the fuss surrounding the first 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. Other policies must be considered if the economic impasse is to be broken.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)

Vote: Hold Bank Rate; do an additional £100bn QE.

Bias: To change focus of QE to buy more corporate bonds, mortgage backed securities (residential and commercial) and a pool of small business loans from banks.

Six adverse factors constraining UK growth

The latest figures for GDP show that the British economy has either been in recession or flat lining for a year. True, and to some extent, this is not borne out by the employment and the unemployment data, nor by hours worked, which suggest a better growth profile. However, it is implausible that there would be much economic growth taking place, even if those factors were properly reflected in the GDP statistics. Nor do I think that the economy would be in a strong uptrend. So, what is happening here, or rather not going right? A number of factors can be pinpointed. The first is that the aftershock from the financial crisis means that: a) households are spending less out of their income; b) companies have increased their savings; c) the financial sector is repairing its balance sheet, and d) regulation has been ratcheted higher. The second adverse factor is that the UK exports markets have still not recovered from the earlier global downturn. The third is that the UK's poor infrastructure is damaging the recovery and business confidence and so holding back activity. Fourth, a decade of debt induced growth meant that swathes of industry have to relearn how to be more competitive as demand does not just increase year to year anymore; in fact, consumer spending has been falling. Fifth, the UK supply side has been damaged by high levels of government spending as a share of GDP and its corollary, a higher tax burden. Finally, an arguably overvalued exchange rate during the fifteen years of unbroken growth up to 2007 meant that UK firms lost market share and increasingly became uncompetitive. That will take time to repair.

Key drivers of growth are still being repaired

The conclusion is that the key drivers of growth are still being repaired. This means that the UK economy would have exhibited a weak recovery even without the financial crisis – with it, the struggle is even harder. In the last month, oil prices have fallen, indicating a faltering world economy; the problems in Europe have loomed larger; money supply growth has struggled; both business and consumer confidence have fallen, and bond yields dropped to record lows. All this suggests that growth will struggle to break through right to the end of the present year. The good news is that inflation is finally falling back, helped by sharply lower oil prices in the past month. In short, the economy needs a stimulus. It could be tax cuts, direct or indirect or lower private borrowing costs.

**Bank of England
should purchase a
wider set of assets than
gilts when engaging in
QE**

The Bank of England may not be able to cut Bank Rate but it should use QE to lower the borrowing costs of SMEs and households. Of course, it needs to think creatively how exactly to do so. However, that does not appear to have been a problem for the US Federal Reserve and it should not be a problem for Britain's Monetary Policy Committee (MPC) either. Therefore, my vote is to keep Bank Rate where it is and to restart QE, but to purchase aggressively a wider set of instruments than simply gilt-edged securities.

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.

.....

For more than twenty years Lombard Street Research has provided many of the world's most influential investment institutions with creative, thoughtful and pertinent macroeconomic analysis and investment advice.

Genuine global-macro thinking drives all of our investment themes. This provides our clients with a fully integrated research input that is essential in the modern investment environment to either maximise returns or minimise risk.

Critical conclusions are expressed in actionable ideas for investors.

.....

Services include:

- Strategic Asset Allocation (12 month portfolio calls)
- Tactical Asset Allocation (3-9 month trading ideas)
- Investment Advisory (consultation on portfolio construction, use of derivatives/hedging)

.....

A worldwide network of offices in London, New York and Hong Kong allows us to provide a global service to a global audience.

London Tel: +44 (0) 20 7246 7850 london@lombardstreetresearch.com

New York Tel: +1 212 367 7644 newyork@lombardstreetresearch.com

Hong Kong Tel: +852 2521 0746 hongkong@lombardstreetresearch.com



Lombard Street Research

Independent • Objective • Creative

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