



Shadow Monetary Policy Committee

May 2013

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IEA's Shadow Monetary Policy Committee votes by six to three to raise Bank Rate by ½% in May

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 16th April, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 9th May. Five SMPC members wanting an increase of ½%, another voted for a ¼% increase, and three voted to hold Bank Rate. This vote distribution implies a ½% increase on normal Bank of England voting procedures. The recommendation of a rate rise in May represented the fourth consecutive month that a majority of the SMPC had voted in favour of higher interest rates. However, it was the first time for several years that a majority of the shadow committee had recommended an increase of ½% rather than ¼%.

While the SMPC has recommended a more hawkish stance than the official rate setters recently, there has always been a SMPC minority who wished to freeze rates until there were clear signs of recovery. The SMPC was also more hawkish than the official rate setters during the credit bubble that preceded the 2007 and 2008 financial crash. It is hard to argue, with hindsight, that the Bank of England was justified in ignoring the signs that the Heath-Barber and Lawson credit booms were being repeated in the earlier 2000s. There appear to be three main intellectual differences between the majority view on the SMPC and the official one. These are: 1) the extent to which weak growth is a supply-side phenomenon, rather than a demand-side one; 2) how far misguided financial regulation has led to a damaging restriction in the supplies of money and credit, and 3) whether Quantitative Easing (QE) has been exhausted as a stimulus or, alternatively, should be re-directed towards private sector debt.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded correspondingly as more significant than the exact vote. The next two SMPC e-mail polls will be released on the Sundays of 2nd and 30th June, respectively. The next quarterly SMPC gathering will be held on Tuesday 9th July and its minutes will be published on Sunday 28th July.

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Minutes of the meeting of 16th April 2013

Attendance: Phillip Booth (IEA Observer), Roger Bootle, Kent Matthews (Secretary), Patrick Minford, David B Smith (Chairman), David H Smith (*Sunday Times* Observer), Peter Warburton, Trevor Williams.

Apologies: Tim Congdon, Jamie Dannhauser, Anthony J Evans, John Greenwood, Graeme Leach, Andrew Lilico, Akos Valentinyi, Mike Wickens.

Chairman's introductory comments

March Budget disappointment was what one would expect from the fiscal consolidation literature

The Chairman began the meeting by stating that he had been overseas at the time of the March Budget. However, he was not surprised that the official borrowing projections had been revised up yet again or that the official growth projections had had to be revised down. This is exactly what one would expect from the extensive international literature on fiscal consolidation. The Chancellor had consistently pursued what were known as 'timid' Type 2 fiscal consolidation policies – in which taxes were raised and the volume of government consumption increased, albeit through poor control rather than overt intent – and the result had been exactly what one would expect from the fiscal stabilisation literature; i.e., persistent deficit overshoots and growth way below official expectations. The interesting questions were: who on earth the Chancellor was looking to for advice, and why the Conservatives had spent their thirteen years in opposition without ever getting to grips with the intellectual issues involved? The Chairman then invited Trevor Williams to give his assessment of the global and domestic monetary situation.

Economic situation

Flat monetary growth in developed economies

Trevor Williams began his presentation by stating that he would start with an examination of the global monetary statistics and then work down to the Euro area and finally to the UK. He started with money supply growth in the leading three (G3) international economies and the emerging economies, which showed continued stagnation in the former and a slowing in the latter. Within the developed economies, the USA had seen some acceleration but was still below recent highs, whereas monetary growth in the UK had picked up but was still running at a very low rate. Monetary growth in Japan and the Eurozone remained flat. In Asia, monetary growth was dominated by China but here there was a slowing. Monetary growth was robust in Latin America but this looked to be an excessive growth rate if continued for too long. Brazil was, perhaps, an example of where there has been too much focus on excessive credit creation rather than supply-side reforms.

Credit growth flat... credit conditions tightening

Credit growth in the developed economies was also slow and flat, with the UK still in negative territory. Surveys of bank lending conditions in the emerging markets revealed a tightening of credit standards. Furthermore, the price of credit had been rising in the USA, UK and Eurozone with adverse consequences for economic recovery. Policy rates remained low in the advanced economies and had remained stable in the emerging economies.

Global inflation contained and level of world GDP still heading higher

Global inflation had remained under control and it was also contained and falling in the developed economies. Global GDP was still heading up. However, the gap between the growth of the emerging economies and the sluggishness of the mature economies remained as large as ever. Elsewhere in the real sector, manufacturing output in Asia

had risen sharply but had fallen back in the mature economies. The bottom line was that there was insufficient strength in the world economy for an inflationary danger to emerge. Inflation was not a major problem. A plot of output gap and core inflation for the major economies revealed no discernible pattern and little in the way of inflation risk. This meant that policy rates could remain low.

Euro risks reduced but problems remain and divergence continues.

Trevor Williams went on to examine the statistics for the Euro area starting with ten year government bond yields. Euro area risks had reduced on the surface, owing to policy action, but underlying problems remained. While the European Central Bank (ECB) balance sheet was set to stabilise along with that of the US Federal Reserve, the Bank of Japan balance sheet was set to take-off. Despite the increase in ECB liquidity to the markets, corporate lending rates in Italy and Spain had widened against Germany and France. Euro area divergence continued with differences in manufacturing growth between Germany and the rest. In Germany, house prices had been rising gently, while those in Spain and Ireland had been declining.

Output prospects have worsened but inflation is low

In the UK, inflation was likely to remain above target but wage inflation would be weak and the economy was likely to slow in March after a good start to the year. The indicators were signalling a worsening of output, following some signs of growth at the end of 2012. The British economy had seen some improvement in money and credit conditions. However, these were insufficient to spark a strong revival in growth. Nevertheless, the latest figures for 2013 Q1 (*Editorial Note*: this refers to the figures released on 25th April) showed that the economy expanded by 0.3%, based on the 44% of output data available in that quarter. This offsets the fall of 0.3% in 2012 Q4, if left unrevised. The good news was that world inflation trends remained benign. With commodity prices off lower in recent months, as the world economy slowed, inflation was set to stay low, recently in line with the weakening of global growth. The Bank of Japan had joined the QE party, and seemed prepared to go for higher inflation to revive their economy, with attendant risk for government debt.

Discussion

Concern over recent changes to official inflation measures

The Chairman then thanked Trevor Williams for his excellent presentation. He said that, in keeping with tradition, he would ask the IEA Observer, Philip Booth, to make a vote as the meeting had been inquorate. He then kicked off the discussion by expressing some unease about the manner in which the Retail Price Index (RPI) had recently become an 'un-statistic' as far as the Office for National Statistics (ONS) was concerned. The figures were still being published under the banner "NOT NATIONAL STATISTICS". However, the ONS could not have it both ways. If the RPI was not a useful variable, why had the ONS persisted with its publication every month since the late 1940s? If it was worthwhile then, why had it now ceased to be useful, given that it was widely employed in private-sector contracts as well as for Index-Linked Gilts?

Unleashing the inflation tax

David B Smith's fundamental concern was that, having failed to achieve a meaningful fiscal consolidation, the Chancellor was now planning to go even further in unleashing the inflation tax – perhaps, with the hoped-for acquiescence of Mr Carney and the Bank's proposed more flexible inflation mandate – and was trying to disguise that decision by downgrading the RPI and its constituents. David B Smith added that some of the new measures of the price level (such as CPIH, which added housing costs to the established Consumer Price Index or CPI) were potentially useful. Unfortunately, only a relatively short back run from February 1998 onwards was available for the new

measures. This was too limited a period to permit of any serious econometric modelling, something that represented a serious impediment to a forward-looking inflation targeting framework. David B Smith then added that it was not clear that the new RPI 'Jevons' (RPIJ) – which was named after a Victorian economist – was superior to the old RPI from a conceptual viewpoint. That depended on the assumption that there was no loss of consumer utility when one switched from, say, apples to pears because the price of apples had gone up, even if one disliked pears. All that one could say was that retail-price inflation fell somewhere between the 2.7% shown by RPIJ and the 3.3% shown by the RPI, and not that any one measure was superior. There followed a short discussion about the proposed statistics.

Call for votes

The Chairman then asked Patrick Minford and Roger Bootle to make their respective comments immediately, as he knew that they both had to leave before the adjournment of the meeting. In addition, he said that he would need to call for two further votes *in absentia* in order to complete the magic nine. These votes were subsequently supplied by Jamie Dannhauser and Andrew Lilico. Having taken the votes of Roger Bootle and Patrick Minford, the Chairman stated that it was time to go round the table and record everybody else's views. He said that, on this occasion, he would allow the discussion to continue into the voting round and that other people's comments on the votes would be recorded for once. This reflected the relatively small size of the group remaining and the fact that there was still a reasonable amount of time left. The votes concerned are listed in alphabetical order below, including the two votes cast *in absentia*.

Comment by Phillip Booth

(Institute of Economic Affairs and Cass Business School)

Vote: Raise Bank Rate by ½%.

Bias: Hold QE.

Reservations about the mortgage guarantee scheme

Phillip Booth said that he was nervous about the mortgage guarantee scheme. He said that there was an inconsistency between the government encouraging the banks to build up capital, so that they would not fail and be a burden on the taxpayer, and at the same time for the government to guarantee loans directly. The logical policy was for the government to create a legal framework to allow banks to fail and to deal with the 'too big to fail' problem. In response, Kent Matthews said that he did not see an inconsistency in the government having a too-big-to-fail policy and the government absorbing the risk of bad assets of the banks through an asset guarantee scheme. It was a logical extension of a too-big-to-fail policy.

Supply side problems cannot be solved by monetary policy

Phillip Booth said that the underlying problems were on the supply-side. He said that the productivity problem could not be solved by monetary policy and that Bank Rate should be raised by ½%, given the forecast for inflation, and that there should be no further QE.

Comment by Roger Bootle

(Deloitte and Capital Economics)

Vote: Hold Bank Rate.

Bias: To cut to 0.1%.

Monetary policy may have reached its limit

Roger Bootle said that for once he agreed with Patrick Minford (see below) in his assessment but not in his conclusion. He said that the banking system was broken. In

the 1930s, the banking system had supported the recovery, as it had also done by-and-large in former recessions. He agreed that there had been regulatory overkill. Roger Bootle added that it was not clear why there was a need to tighten regulation now rather than later. He said that the popular culture of putting bankers in the stocks did not help the recovery process. This was because active bankers were needed to get the economy out of its current mess.

Fall in commodity prices...inflation will be lower than expected.

Roger Bootle added that the Treasury attitude of fattening up the publicly owned banks for sale was not the right structure for recovery and that the government was not addressing the problem of the banks. The economy was flat but there remained potential for improvement. The fall in commodity prices had been significant. Oil at around \$100 a barrel (Brent crude) was an important milestone. He said that inflation would probably come in better than expected. If inflation fell by the end of the year, the portents for recovery were good. He said that he was only a lukewarm supporter of QE. Sterling had depreciated sufficiently already, so there was no need for further QE. He added that there should be no change to interest rates immediately. However, it may be necessary to cut rates further to 0.1%, and have negative rates imposed on bank reserves held at the Bank of England, if the economy remained moribund.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate and QE.

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

Underlying inflation is running below the 'headline' figures

In his vote *in absentia*, Jamie Dannhauser stated that CPI inflation remained stubbornly above the 2% target. It could go to 3% in the months ahead, in his view. However, around 1 percentage point of this could be explained by higher administered prices, suggesting a more subdued rate of underlying inflation. Absent the effect of higher university tuition fees, 'core' UK inflation had been below 2% since November. Indicators of price pressures in the more recent past, for instance the three-month annualised change in 'core' inflation, painted a picture of benign inflation. Other series, such as average wage growth or the annual change in the gross value added deflator, support the contention that the current inflation overshoot was not generalised.

Output growth remains disappointing

Output growth continued to disappoint. The first quarter data might well show a small expansion in real GDP, but there was little momentum in the economy. External risks to growth remained sizeable given the fragility of the underlying economic position of the Euro area, even if complacent financial markets suggested otherwise. Monetary growth had picked up somewhat. There were signs that the *Funding for Lending Scheme* (FLS) had led to an easing of credit conditions, especially in the mortgage market. The increased availability of higher-risk loans to first-time buyers in particular could have a marked impact on house prices in the short-term and UK households' propensity to save. Prospects for consumption had improved since the autumn.

Monetary policy should be biased towards ease for the time being

Following news that the FLS was to be extended, there was no need to alter policy this month; it seemed advisable to wait-and-see what additional support to credit supply and broad money growth might be forthcoming. Nevertheless, with slack in the economy, particularly in the labour market, and good reasons to fear that persistently sluggish demand growth would feed through into damage to Britain's supply capacity, monetary policy should be biased towards additional ease until such a time that there

was a clear, self-sustaining momentum in broad money growth. The demands from regulators for UK banks to increase their capital buffers – by between £25bn and £50bn – by year end would be an important headwind to monetary creation in the short-run that monetary policy could attempt to offset.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate; no more QE.

No 'magic bullets' to save the economy

In his vote *in absentia* submitted following the SMPC gathering, Andrew Lilico expressed the view that, with GDP growth somewhere between slightly negative and slightly positive for two years, it was understandable that policymakers were scrabbling around for some new magic bullet to boost the economy once more. Such initiatives included the FLS, the 'help to buy' scheme and flexible inflation targeting. What policy makers did not want to accept was that there are no painless fixes here. This was not a crossword puzzle to solve with a moment's inspiration.

Growth defeatism must be resisted

On the other side, were a few defeatists who said that we must learn to live in a growth-free world. Andrew Lilico claimed that we should not accept that either. The government could do some positive things to boost medium-term growth. For example, it could: cut the size of the state; raise public sector productivity; raise the workforce size through higher retirement ages, and privatise or liquidate the nationalised banks.

A habit is not the same thing as an economic policy

Macroeconomic policy, *per se*, could not boost medium-term growth – as Mark Carney had acknowledged recently. Done to excess, though, macroeconomic looseness could damage growth, and had arguably been doing so for some time. Those that argued for yet more stimuli should ask themselves this question: "What would persuade me the path of stimulus was not working, if not the past three years' experience?" If the answer is: "Nothing", what you have in place is a habit, not an economic policy.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate; additional QE to be used only if the Euro crisis re-emerged.

Monetary policy has run its course

Kent Matthews said that nothing had changed in the economy since the last physical meeting of the SMPC, held on 15th January, to make him change his mind on policy. Monetary policy had run its course and there was no sign that the economy was going to respond to the low interest rates or the past policy of QE. He agreed with Phillip Booth that the problem of the economy was a supply-side one. QE and low interest rate policy had distorted the capital markets making inefficient the natural process of financial intermediation. Low interest rates were keeping enterprises that should have died in a state of 'un-death'. This was starving new enterprises of much needed funds. Bank policy was hampering the efficient working of the capital market. While there was a need to regulate banks, he agreed that this was something for the future. Even announcing tighter regulation in the near future would influence commercial banks' expectations and create perverse effects. Tighter regulation should be suspended until

it was clear that the economy was on the road to recovery. He voted to raise Bank Rate by ½% and to hold QE which could be deployed if the Euro crisis were to flare up as it would inevitably.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate.

Excess conservatism of Bank of England has blocked the UK credit channel

Patrick Minford said that the credit channel was blocked. America had managed to unblock its own credit supply through the US Federal Reserve buying sub-standard assets. However, the Bank of England had refused to buy anything other than gilts. The conservative attitude of the British Central Bank towards policy and towards the regulation of the commercial banks had blocked the credit channel. QE had distorted the capital market, which had made it cheap for the government to borrow but not companies. Distortionary monetary policy had resulted in firms being kept artificially alive while starving credit elsewhere. Funding for lending was an attempt to unblock the credit channel but with little success. He said that the capital regulations for the banks should be suspended in order to unblock the credit channel. QE should be stopped and interest rates should be pushed up. The problem was that the Treasury was focussed on fattening up the Royal Bank of Scotland group and Lloyds for sale so that the taxpayer did not incur a loss. It meant that the banks were more engaged in building up capital than in lending and reviving the economy. He said that interest rates should be raised to 1%.

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 privatise state-dependent banking groups; raise Bank Rate further, and hold QE.

Tax-and-spend policies and regulatory shocks have clobbered the UK's supply side

David B Smith said that the economy had experienced a major – and predictable – supply withdrawal. There was a mass of empirical evidence that a rising government share in national income reduced capacity in the long term, even though there might be a short run boost from fiscal policy. His own statistical research suggested that roughly one-third of the output shortfall in the OECD area as a whole since 2008 had occurred because of the increased socialisation of the international economy since 2000, although the rest does seem to have been associated with the financial crash. In the UK, there were three things going on simultaneously. First, the increased socialisation of the economy had contributed to slightly over one half of the output shortfall since 2008, although the rest was statistically associated with the crash, if these were assumed to be independent events. Second, monetary policy had provided some transitory stimulus. However, monetary ease could not stimulate output in the long run – when the supply side was the crucial influence – and it had probably exhausted its effectiveness by now. Third, incentives and regulation had had perverse effects, especially in the case of the commercial banks.

The need now is for bold micro reforms

With macro-policy exhausted, there was an overwhelming need to implement bold micro reform of the economy generally and financial institutions, specifically. For competitive reasons, as well as the too-big-to-fail issue, we needed to go back to

smaller banks with regional head offices in some cases. This could be quickly brought about by breaking up the big state-owned banking groups into their historic constituents and flogging off the bits at the best price that could be achieved. He accepted that this might leave the government with a rump 'bad bank'. However, competition and manageability should be the goals, not trying to get the taxpayers' money back. Policy needed to address three issues. These were: first, deregulation; second, government spending, and third, the structure of the banking market. He voted to raise Bank Rate by ½% to restore monetary discipline to refocus on inflation. There was nothing further to be gained from additional QE.

Should there be a state imposed breakup of the banks?

Philip Booth cautioned the committee not to advocate a top-down bank restructuring because markets were not being allowed to come to a natural solution. In response, David B Smith said that he accepted Philip Booth's argument as a general rule, when the starting point was a competitive system. However, that was not the case with the British banks, which were heavily cartelised, often as a result of officially encouraged mergers, such as those of the early 1920s and the late 1960s, which had reduced the number of clearing banks from eleven to five.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by ¼%; no extension of QE.

Bias: To raise Bank Rate further.

Existing stock of QE should be re-directed towards privately-issued assets

Peter Warburton agreed with the diagnosis that blockages in private sector credit transmission were the greatest impediment to UK economic recovery. Policy innovations, such as the extended FLS and the help-to-buy initiatives were designed to "fly under the radar" of an overbearing financial regulatory regime. FLS has demonstrated beyond all reasonable doubt that it is market interest rates that matter to economic behaviour rather than the largely irrelevant Bank Rate. Paradoxically, to regain relevance, Bank Rate needs to increase in order to reconnect with the market structure of rates. With the Budget announcement of a new Bank of England remit and the invitation to further policy experimentation, it is imperative that Bank Rate is not committed to remain at ½% for an extended period. Were this to be done, its irrelevance would be ever more apparent.

Japanese QE is large enough to reflate the wider global economy

However, with the addition of the massive dose of Japanese quantitative and qualitative easing, the force of global reflationary policy has increased materially. Japan has an urgent agenda for economic expansion and for policies to affirm the credibility of the 2% inflation target. It would be a surprise if the global economy did not strengthen, and also display more of an inflationary bias, in the remainder of 2013. UK's distinctive susceptibility to imported inflation, aggravated by early-year Sterling weakness, reinforces the argument for beginning the process of Bank Rate normalisation.

QE should be diversified to bring in private sector debt, including that issued by SME's

There are compelling reasons to diversify some of the £375bn of existing QE into a portfolio of other assets, including securitised property, infrastructure and possibly even SME (small and medium-sized enterprises) assets as a means of lowering the regulatory burden of the banks that relates to these loans. The fact that the 'Bad Bank' debate has revived in recent weeks is a reminder of how little structural progress has been made to restore health to the UK banking system.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking)

Vote: Hold; no further QE.

Bias: Neutral.

Higher Bank Rate will increase defaults

Trevor Williams said that Bank Rate should be held and that QE should also be on hold. In the UK, household savings had risen and government savings were not as negative as they once were. However, significant further adjustment was required before they were stable. Corporate balance sheets were robust but adjusting lower as household savings rose. In other words, corporate profit growth seemed to have slowed sharply. The wider current account balance of payments deficit last year, at 3.7% of GDP, was a sign that the savings/investment balance in the UK was still misaligned. A troubling economic environment in Europe was making it very difficult for the UK to grow through exports, although the situation was not helped by the domestic fall in productivity and the subsequent rise in unit labour costs. Nevertheless, raising interest rates was not the answer, despite the legitimate worries about the negative effects of keeping them too low for too long. Keeping rates on hold did not preclude the need for supply-side reforms to help kick start confidence and recovery. Indeed, it bought time for this to happen. An immediate increase in rates would most likely lead to higher default rates and hit already fragile consumer and business confidence, further delaying recovery rather than speeding it up. He voted to hold Bank Rates and hold QE. However, the Bank should buy non-gilts if further QE was to be exercised.

Policy response

1. On a vote of six to three, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in May. The other three members wished to hold.
2. There was only modest disagreement amongst the rate hikers as to the precise extent to which rates should rise. Six voted for an immediate rise of $\frac{1}{2}\%$ but one member wanted a more modest rate rise of $\frac{1}{4}\%$.
3. All those who voted to raise rates expressed a bias to raise rates further. There was also a common view that QE would be more effective if it was directed towards the purchase of private-sector liabilities, rather than government bonds.

Date of next meeting

Tuesday 9th July 2013.

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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