



Shadow Monetary Policy Committee

November 2012

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

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 16th October, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Britain's Bank Rate should be held at ½% on Thursday 8th November. Among the dissenters, one wanted to raise Bank Rate by ¼% and another wished to see a ½% increase while – at the opposite extreme – one shadow committee member thought that Bank Rate should be reduced to a nominal 0.1%. Looking further ahead, six SMPC members believed that Bank Rate should be raised in the near future, provided there were no further major shocks arising from overseas, and seven said that there should be no additional tranche of quantitative easing (QE). However, two members voted to increase the stock of QE by £50bn and £200bn, respectively. In addition, several SMPC members argued that QE would be more effective if it included the purchase of more private sector assets.

There was a widespread view on the IEA's shadow committee that a substantial part of the UK's poor growth performance since 2008 reflected supply-side weaknesses, including those caused by the hugely increased share of government and government-financed expenditures in national output since 2000, and that these weaknesses could not be overcome by injecting more nominal demand into the system. Unfortunately, the contrast between the weak output figures and the stronger trend showed by the labour market data up to 2012 Q2, made it hard to know how much spare capacity was available. However, the strong third quarter GDP figures, released after the SMPC gathering on 25th October, suggest that the underlying growth trend currently may be the equivalent of some 1¼% per annum.

The SMPC is a group of economists who have met 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 similar exercises elsewhere. Because the committee casts exactly nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a consequence, the discussion and nine independent analyses should be regarded as more significant than the precise vote. The next two e-mail polls will be released on the Sundays of 2nd December and 6th January, respectively. The next SMPC gathering will be held on Tuesday 15th January 2013 and its minutes will be published on Sunday 3rd February.

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Minutes of the meeting of 16th October 2012

Attendance: Roger Bootle, Jamie Dannhauser, Anthony Evans, Andrew Lilico, Kent Matthews (Secretary), David B Smith (Chairman), Akos Valentinyi, Peter Warburton, Trevor Williams.

Apologies: Philip Booth (IEA Observer), Tim Congdon, John Greenwood, Ruth Lea, Patrick Minford, David H Smith (*Sunday Times* observer), Mike Wickens.

Chairman's Comment

Continuity and change

The Chairman said that he was pleased that one of the newer and younger members of the SMPC would be doing the background presentation that evening, for the second successive quarter. Any committee that had maintained as much of its original membership as the SMPC had done since its establishment in July 1997 – he noted that no less than four founder members were physically present that evening – needed an infusion of new blood from time to time. He added that the SMPC was not a closed shop and that applications to join the committee from qualified younger monetary economists would be welcomed. The Chairman then invited Jamie Dannhauser to give his assessment of the global and domestic monetary situation.

The Global Economy

Weak world trade and global overinvestment

Jamie Dannhauser referred to his presentation which showed that the recovery in world trade had been slower than that which had followed any other world trade downturn since 1974. Global industrial investment had slowed. The savings and investment figures for the advanced and emerging economies indicated a history of excessive saving and overinvestment in the global economy. Fiscal consolidation had continued in the developed economies that had seen recent deficits in excess of wartime experience. World monetary and credit conditions remained weak and the lending survey of banks in emerging markets showed gradually tightening credit conditions. The Chinese economy had experienced a sharp growth slowdown. A hard landing had already occurred and there would be little policy stimulus until after the leadership changeover in China. There were some signs of improvement in the current quarter but underlying growth in China could remain weak for some time.

Easier US credit conditions but M3 broad money growth is demand driven

Recent work by the International Monetary Fund (IMF) on fiscal multipliers indicated the potential impacts of the expected US fiscal squeeze in 2013. The consolidation programme was taking place against the backdrop of easing credit conditions. The commercial banks in the USA had increased credit availability. However, the growth of US broad money on the M3 definition, which was currently around 4% year-on-year, had been boosted by portfolio outflows from bank debt into monetary assets, which suggested an increase in money demand rather than in money supply. There remained other reasons for caution, one of which was the still low level of real business lending relative to other post-war recoveries. Another reason was that US banks were still heavily reliant on foreign funding from non-banks.

Spanish bailout is a potential disaster

In the Eurozone, lending to the public sector continued to grow but lending to the non-bank private sector had fallen. Broad money had grown moderately but the European

Central Bank (ECB) lending survey indicated a continued tightening in lending standards. To the extent that the Spanish bailout package imposed even deeper fiscal retrenchment, it could be a disaster for Spain if the country was to sign up. It had the validity of a treaty and Spain would be stuck in an agreement that would be undeliverable with the outcome of a potential walk-away by Germany.

Improved Eurozone money market conditions

Bank lending rate spreads to firms and households have continued to widen and coincident indicators of activity in the Eurozone continue to point downwards. Nevertheless, money market conditions were much improved as evidenced by the continued decline in the Libor-OIS and FX swap spreads.

UK Monetary Conditions

Widening spreads and weakening credit availability

In the UK, the underlying monetary picture remained weak. Spreads on syndicated loans had been rising. Nevertheless, companies were sitting on cash. The corporate liquidity ratio had been rising and there was no issue of a lack of access to credit by the company sector as a whole. Spreads on mortgage products had increased in the past year and were now in the range of 300 to 500 basis points (bps). Meanwhile, the marginal cost of sterling funding to UK banks had been falling. The Bank of England credit conditions survey indicated that, except for mortgage loans, credit availability was unlikely to change much in the coming quarter.

Funding for Lending Scheme (FLS)

The Funding for Lending Scheme (FLS) represented a sizeable funding subsidy, which should encourage a greater supply of credit. How big a monetary stimulus it would provide remained unclear, however a Financial Services Authority (FSA) rule change had allowed banks to use their existing capital base to support new loans under the FLS which effectively imposed a zero risk-weight on new loans funded by the scheme.

UK Activity and Inflation Trends

Stagnant UK business spending

Activity indicators showed a stagnant profile for the British economy. The UK economy was bumping along the bottom and experiencing zero-growth but there was probably no double-dip recession. Firms were prioritising cash on the balance sheet. UK goods exporters were benefitting from the weakness of sterling. However, this was being offset by declining exports from the services sector.

Employment situation may deteriorate

Household net worth and the savings ratio had risen but the story was less of a balance sheet repair than a labour market one. Employment intentions suggested a slowing in employment growth. Unit labour costs were rising and this would lead to deterioration in the jobs market if it continued. Real government departmental spending was expected to decline in absolute terms over the coming years. Fiscal multipliers under normal circumstances would be low but this was questionable in the current circumstances.

UK output gap may be around 4%

Inflation at 2.2% was marginally above the official target and was expected to rise in the coming months under the pressure of rising energy costs. The above-target outcome for inflation was entirely because of the pass through effects of increased costs. Underlying inflation was about 1½%. Inflation expectations on indirect and

survey measures had fallen. While the recession had destroyed capacity, estimates of the output gap were probably in the region of 4%.

Discussion

The over-investment debate

Peter Warburton questioned Jamie Dannhauser's conclusion that there had been over investment in the pre-2008 period, saying that the figures were based on a dubious adjustment for purchasing power parity (PPP). Jamie Dannhauser responded that he believed the figures were appropriate but would go back and check the basis on which they had been compiled. Akos Valentinyi said that the backdrop to the fiscal consolidation in the developed economies was the emergence of the sort of budget deficits previously only encountered in wartime. Jamie Dannhauser said that what was important was what the monetary offset would be.

China the new Japan?

Andrew Lilico and David B Smith then discussed whether the Chinese economy would slow down to in a similar way to the Japanese one, which had also enjoyed 10% plus real growth rates in the 1960s and early 1970s. The general view was that it would be another twenty years before China's economy began to resemble the Japanese situation, although the longer-term demographic outlook for China was clearly not favourable.

Question marks over fiscal consolidation pledges

Peter Warburton said that fiscal consolidation may not result in actual fiscal change. Jamie Dannhauser said that considerable political uncertainty existed about the fiscal consolidation programme in the USA. Akos Valentinyi said that the uncertainty of the fiscal consolidation extended to Europe with the problem of the democratic deficit in Greece, no structural adjustment was likely to occur.

Chairman's call for votes

As Roger Bootle had indicated that he had to leave by 6.30pm and time was pressing, the Chairman next asked him to make his comments before asking everybody else to cast their votes. These are listed in alphabetical order below. Because a full set of nine SMPC members had attended the meeting, there was no need for any votes in absentia this quarter.

Comment by Roger Bootle

(Deloitte and Capital Economics)

Vote: Cut Bank Rate. Increase QE.

Bias: Carry on increasing QE as necessary.

Discrepancy between employment and output figures

Roger Bootle said that he was puzzled about the underlying truth of the economic statistics. In his experience, London did not feel like a city in recession. However, the outlook was not very good. There was no hope of an expansion in bank lending. Real disposable income would rise if inflation eased but the signs were that inflation would rise in the short term. The discrepancy between the stronger employment data and the weak GDP figures remained a puzzle and QE could be used more effectively to stimulate activity, in his view. He therefore voted to cut the rate of interest further to 0.1% and to increase QE by a further £200bn, to take the total QE stock to £575bn.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate. Do not extend QE.

Bias: To increase QE and expand asset purchases to include private-sector assets, specifically bank debt.

Extend QE to include more private assets

Jamie Dannhauser said that he was not as bearish as Roger Bootle, although he generally held a similar view. He said that he wanted to wait and see what the effects of the FLS would be. The stresses related to the Eurozone had fallen back but he remained deeply concerned about the ultimate resolution of the crisis. He added that he was concerned about the hysteresis effects of a stagnating economy. Jamie Dannhauser's conclusion was that rates should stay on hold but QE needed to be extended to include non-bank private sector assets.

Comment by Anthony J Evans

(ESCP Europe Business School)

Vote: Raise Bank Rate by ¼%. No QE.

Bias: To raise Bank Rate.

QE now suffering diminishing returns

Anthony J Evans said that it looked as though a corner has been turned in the domestic economy but that the recovery would be like a barbeque – long and slow. Monetary policy had a role as a preventative but QE was now suffering from diminishing returns. Nominal GDP was increasing but this was largely through price increases. He said that this pointed to a supply-side problem. Inflation was set to rise. Monetary policy could still be useful if the situation changed and there was a genuine liquidity emergency. However, if interest rates were to return to normal at some point, they needed to be increased. It was unlikely there would be an ideal time to do this. Nevertheless, there was currently a window of opportunity and policymakers might also learn important lessons about the transmission mechanism from a moderate rate rise. Policy had to be rebalanced. He said that there should be no further QE and Bank Rate should be raised.

Comment by Andrew Lilico

(Europe Economics)

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

Bias: To raise Bank Rate.

Bank has lost its credibility with respect to anti-inflation policy

Andrew Lilico said that policy makers missed the chance to raise rates in 2010 and early 2011 and now should be looking for every new opportunity that presented itself. The correct policy concern was to raise the medium-term rate of growth, not the short-term rate. There existed a real danger of unemployment rising: firstly, as firms shed low productivity employees, and, secondly when, inflation having risen, policymakers do finally act against it. Credibility was not just about what rate of inflation is expected but about the belief that, if inflation were to rise, the Bank would conduct appropriate policy to bring it down — such credibility had gone, and it would be expensive to get it back. He said that the economy could experience both rising inflation and rising unemployment. Monetary policy had long-since done all that it could, and there was a

need to normalise as quickly as could be achieved without tipping the economy over into slump. He voted to raise Bank rate by ½% with no further QE.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Hold Bank Rate. No further QE.

Bias: To raise Bank Rate.

Permanent loss of output following the financial crisis

Kent Matthews said that there was growing evidence that this particular financial crisis had been followed by significant capacity destruction. Research published in the *American Economic Review* showed that financial crises could lead to permanent and unrecoverable output contractions. The problem for monetary policy was that, if the output gap was small as a result of a permanent contraction in output, then QE was not just ineffective but was also storing up an inflationary balloon that would eventually burst with negative consequences for future monetary policy.

Need to normalise Bank Rate so that real rates become positive

Kent Matthews added that there was a need to return to a 'normality' in which real interest rates were non-negative. The question of when Bank Rate needed to rise was a matter of fine judgement. With each passing month, economic uncertainty provided further reasons for keeping interest rates where they were. Right now, the weakness of Europe dominated the short term position of the UK. However, interest rates would have to rise in the near future to bring the economy and economic policy back into the realms of normality. He said that he was less optimistic about a resolution to the Eurozone crisis, which would continue for the foreseeable future and economic uncertainty along with it. If the crisis were to worsen, it would be better for the Bank to have room to manoeuvre by lowering rates from a position of normality. Supply-side policy should be the medium-term objective of the government.

Potential abuse of FLS

He said that he too wanted to give the FLS a chance to work. However, and if it looked as if the commercial banks were using the scheme to widen spreads and increase liquidity rather than to increase lending, the case for raising rates was strengthened. For now, Kent Matthews voted to maintain Bank Rate at its present position with no further QE.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Hold Bank Rate. No additional QE.

Bias: To avoid regulatory shocks, raise Bank Rate and hold QE.

QE gives rise to political moral hazard and encourages fiscal irresponsibility

David B Smith said that he had attended the Office for National Statistics (ONS) conference on the discrepancy between the output and employment data immediately before coming to that evening's SMPC meeting. Furthermore, a paper dealing with the issue by Peter Paterson *The Productivity Conundrum, Explanations and Preliminary Analysis* had been placed on the ONS website that day (i.e., 16th October). Nevertheless, it still remained difficult to reconcile the weak GDP figures with the strong employment data. He added that his main concern about Roger Bootle's call for a further substantial bout of QE was the political 'moral hazard' it gave rise to in encouraging fiscal fecklessness. He accepted that the immediate economic impact of further QE need not be inflationary provided that the broad money supply was constrained by other – but probably, inherently undesirable – means such as

regulatory-induced credit rationing, which was where we were at present. He was also concerned that, if Roger Bootle's proposal was implemented, the gilt-edged market would be so socialised that it would cease to function properly or be available as a normal implement of monetary policy thereafter.

Increased government consumption since 2000 had halved sustainable UK growth rate

David B Smith added that his recommendation was to hold Bank Rate, but with a bias to raise it in the near future, and that it was time to prepare the financial markets for a putative rate rise. He also said that there should be no further use of QE, except in a lender of last resort situation. The increase in government's share of the economy, which had been accompanied by increased and damaging regulation of the financial and energy sectors, had slowed the growth of potential GDP. International growth studies suggested that the rise in the share of the economy devoted to public sector consumption since 2000 had knocked the growth of potential GDP down from 2¾% to 1¼% at best.

Large balance of payments deficits indicate a supply shortfall, not deficient demand

Current policy was dominated by the short term. If the Coalition was not prepared to tackle the fiscal crisis through a package of genuine public spending cuts and lower taxes, then it was essential that it did everything in its power to improve the supply side through other measures, such as deregulation of the labour and goods markets and tax simplification. He added that an open economy, such as the UK, which had experienced a current account balance of payments deficit of 4% of market-price GDP in the first quarter and 5.4% in the second quarter was not obviously suffering from a deficiency of aggregate demand relative to total supply, to put it mildly. For much of the post-War period, officials would have argued that the balance of payments equalled the Keynesian demand gap with sign reversed.

Choice of new Bank governor crucial for institutional rebuilding

His final comment was that institutions did matter. Like a defeated army, the Bank of England now needed a thorough institutional overhaul and the choice of the new Governor of the Bank of England would be crucial in that respect. Monetary policy was discredited and a new Governor had to restore credibility to the Bank through rebuilding its existing institution as well as taking on its new regulatory responsibilities. However, he welcomed the story on the front page of the 10th October *Financial Times* that the Financial Services Authority (FSA) had been quietly relaxing its crucial capital and liquidity rules in order to stimulate lending. This suggested that regulatory policy would be less perversely pro-cyclical than it had been hitherto, with consequent benefits to the real economy.

Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Hold Bank Rate. No additional QE.

Bias: To raise Bank Rate.

Political uncertainties constrain rate setters

Akos Valentinyi said that the coordination of fiscal and monetary policy was important but that growth before the crisis was above potential. Part of the downturn was the correction in output from this overshoot position. However, there remained uncertainty about the size of the gap although his view was that there will be inflation pressure in the future. Political uncertainty also impinged upon policy and there was a case for keeping rates on hold in consequence. He voted to end QE and to raise rates in the near future.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Hold Bank Rate. No additional QE.

Bias: To raise Bank Rate and diversify QE into private sector assets.

Underlying UK growth rate now only some 1%

Peter Warburton said that UK macroeconomic policy was at a dangerous juncture and risked coming apart at the seams. The whole presumption that it was possible for the Bank of England to operate an independent monetary policy was at stake if the Government were to steer away from fiscal normalisation. Subject to a re-affirmation of the fiscal policy course on 5th December, it was appropriate to leave monetary policy on a loose setting. Indeed, the case for an easing of banks' capital constraints was mounting, given that these appeared to be binding on economic outcomes, particularly the achievable rate of real economic growth. Abstracting from a number of temporary distortions, it seemed reasonable to suppose that the underlying growth rate for the UK was in the region of 1%, much less than before the global financial crisis. The financial crash was part of the crowding out transmission mechanism.

Attempts to stimulate growth likely to deliver high and unpredictable inflation

Over the longer term, this constraint could be lifted by improved supply-side policies, but the concern in the short term was that attempts to stimulate economic growth would merely deliver high and unpredictable rates of inflation. Given the likely positive impact of the FLS, Peter Warburton believed that there should be no further asset purchases of gilts. These had created an undesirable boom in the gilts market, which had been exacerbated by foreign demand for bonds that were not contaminated by the situation in the Eurozone. Bank Rate should stay on hold while the FLS was being evaluated but there should then be a bias to tighten. The existing QE pool should be diversified into private sector assets.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)

Vote: Hold Bank Rate. Increase QE by £50bn in November.

Bias: Neutral.

Weakening global economy has added to pressures on UK policy makers

Trevor Williams said that the global economy was weakening and the challenges facing the UK remained as intense as at any time in the last year, with some risks predominating to the downside. Key amongst these was the weakness in our key export markets and the deleveraging by households and companies. Hence policy should remain loose for now. With the backdrop just described, the announcement of a further £50bn tranche of QE in November seemed appropriate. However, the increased QE needed to be concentrated on private sector assets rather than gilt-edged securities, as hitherto. Thereafter, policy should be kept neutral, with a bias to tighten should recovery become sustainable. The outlook for fiscal policy should become clearer after Mr Osborne's 5th December *Autumn Statement*. However, an expansionary monetary policy looked as if it had to be one of the offsets to economic weakness until such time as recovery appeared more certain.

Policy response

1. On a vote of six to three the committee agreed that Bank Rate should stay on hold.
2. Six members said that Bank Rate should be raised in the near future and seven said that there should be no further QE activity.
3. Two members voted for an immediate rise in rates and one voted for a further cut.
4. Two members voted to increase QE and two voted to extend QE to include private sector assets.

Date of next meeting

Tuesday 15th January, 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 (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 Business School), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Wholesale Markets). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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