Shadow Monetary Policy Committee

October 2012

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

In its most recent e-mail poll, completed on 25th September, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Britain's Bank Rate should be held at ½% on Thursday 4th October. Two of the dissenters wanted to raise Bank Rate by ½% immediately, while another desired an increase of ¼%. There was a further divergence with respect to quantitative easing (QE). Most SMPC members thought that QE should be held at its present level. However, there was one who wanted a phased withdrawal on counter-inflationary grounds, while another believed that additional monetary stimulus would be needed if the recent improvement in financial-market sentiment proved transitory. The Draghi proposals for the Eurozone, which had led to the improved market sentiment, were believed to have bought time but not, necessarily, to have produced a permanent solution.

In addition, there was a body of opinion on the SMPC that the longer-term risks associated with current monetary policies were increasing and could lead to a damaging upwards 'gear shift' in inflationary expectations. The US Federal Reserve's QEIII proposals were a particular concern because of their open-ended nature. There were also reservations as to whether the European Central Bank's theoretically unlimited commitment to purchase peripheral Eurozone debt could be anything more than a gigantic bluff. Most of the sixteen German Federal States were themselves net fiscal recipients. This meant that the Eurozone's public debt stock was effectively being underwritten by Bavaria and, to a lesser extent, Baden-Württemberg, not Germany.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts 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 correspondingly should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 16th October and its minutes will be published on Sunday 4th November. The next two SMPC e-mail polls will be released on the Sundays of 2nd December 2012 and 6th January 2013, respectively.

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Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate; continue with agreed asset purchase programme.
Bias: Additional monetary stimulus.

ECB Draghi plan and further US QE have stabilised financial markets

The release of the detailed ‘Draghi plan’, and the announcement of additional monetary stimulus in the US, has buoyed financial markets. Equities have rallied further. There have been even more dramatic moves in Eurozone periphery government bond markets. For instance, the yield on Spanish ten-year paper has fallen by nearly 100 basis points (1 percentage point) since the early September European Central Bank (ECB) meeting. There have been signs of further improvement in bank funding markets as well. An indicative measure of UK banks’ marginal funding costs for variable rate sterling loans has fallen further in recent weeks and is now around 150 basis points below its May peak. This could be due, in part, to actions by the Bank of England to ease funding pressures on UK banks. The Extended Collateral Term Repo (ECTR) facility has brought sterling London Inter-Bank Offered Rates (LIBOR) closer to the expected path of Bank Rate. The fall in sterling LIBOR-OIS spreads has been larger than that for other major currencies, consistent with a beneficial impact from recent Bank of England initiatives. The Funding for Lending Scheme (FLS) is unlikely to have had much effect on the market cost of funding. However, it will offer UK banks a major subsidy, the size of which will be linked directly to the quantity of lending to the real economy. Commercial banks with outstanding loans to UK households and non-financial businesses of some £1,200bn have applied for access to the scheme. Relative to what would have happened otherwise, it should reduce both the cost of credit and the degree of credit rationing, potentially to a substantial extent. This should boost demand and potential output, leaving the effect on inflationary pressures uncertain.

Energy and food prices

Upward pressure on global food and energy prices suggests the near-term path of UK inflation will be slightly higher than previously expected. The implications for medium-term inflation are, however, limited. Higher food and energy costs have occurred alongside softening emerging world growth and downward revisions to global growth further out. This suggests that they are driven predominantly by supply disruption. The net effect on UK domestic spending is likely to be negative to the extent that credit constraints are preventing the normal process of consumption smoothing. At a global level, demand may also be reduced – higher commodity prices generally transfer income to countries with lower spending propensities.

Resolving the Euro-zone mess would lift the black cloud off the global economy

However, the most difficult monetary policy judgement relates to the Eurozone crisis, and the lasting effects of the ‘Draghi plan’. These proposals could have a dramatic impact on asset prices and demand in the near-term, if they manage to reduce uncertainty about the Euro’s future and the disaster premium that is evident in parts of the financial markets. A clear path to resolving the mess in the Eurozone would go a long way to lifting the cloud of uncertainty that hangs over the global economy, notwithstanding the widespread concern surrounding the ‘fiscal cliff’ in the US. The Federal Reserve’s promise of open-ended monetary stimulus, until its employment objective is achieved, is an important move. It would seem to be the first of many steps towards the more formal targeting of nominal demand.

But downside risks remain significant

However, downside risks remain significant. Although Europe has cleared two important hurdles – the German constitutional court ruling and the Dutch elections – successfully, there remain several still to jump. Thus, the progression towards banking union in the Euro area is already stumbling. The farce in Athens continues. Spain is yet to apply for a bailout, and therefore ECB bond buying. While it looks like it will get there soon, there is the potential for a bust-up between Madrid and Berlin further down the line. Mr Rajoy is adamant that he will not take orders from the Troika on fiscal policy or supply-side reform. However, he may have to, given that Spain looks set to miss its budget targets by some margin this year – the general government deficit appears to have been 9% of GDP in the first half of 2012, compared with a full-year target of 6.9% of GDP. Then, we come to Italy, where application for a bailout remains a distant prospect.

So, improvement in market sentiment may prove transitory

In short, the improvement in market sentiment may not be long-lasting. Much can still go wrong. Now is not the time for a change in the monetary policy stance. In coming weeks, it will be important to assess the initial effects of the FLS on banks' willingness to lend and the durability of the post-Draghi recovery in sentiment and risk appetite. On balance, it is still likely that additional monetary support will be required in the months ahead. As noted in previous months, this is not simply because demand will be insufficient to close the output gap; but also because persistently weak demand will impose unnecessary long-term costs on the economy, by depressing Britain's long-run supply capacity. In the aftermath of a severe banking crisis, when demand, potential supply and the economy's sustainable level of output are closely intertwined, monetary policy should err on the side of doing too much.

Comment by Anthony J Evans

(ESCP Europe Business School)
Vote: Raise Bank Rate by ¼ %.
Bias: Hold QE.

Monetary policy makers are not being straightforward with the wider public

It continues to be troubling how the Bank of England has switched from an explicit inflation target to an implicit nominal GDP growth target. This goes against one of the key principles of the present monetary regime, which is transparency with the general public. While some savers can benefit from loose monetary policy – due to the subsequent increase in asset prices – those attempting to build their wealth are being hit hard. As the brilliant 19th Century French economist, Bastiat, would have pointed out, this is a classic case of policy makers favouring the visible – in this case, inflated asset prices – over the unseen (foregone returns). The counterfactual claim that, without monetary stimulus, all savers would be harmed on account of a financial meltdown cannot hang over the public indefinitely. We are now four full years from the height of the crisis, and need to take a step back. Recent Fed announcements come disturbingly close to an election cycle, and QE infinity is simply a free pass for profligate government spending.

There is a window of opportunity to raise Bank Rate that should be used

At some point an attempt must be made to restore interest rates to their natural rate, and it cannot wait until conditions are ideal. As things stand, the Consumer Price Index (CPI) is stubbornly above target, output is sluggish but stable, and the Eurozone crisis is having a lull. There is a risk that tightening monetary policy now could change this. Nevertheless, if you believe that interest rates are some distance from the natural rate, a minor rate rise would still constitute a loose monetary policy. Furthermore, it would be useful to see just what impact such a rise would actually have on market rates.

Bank policies are creating the very uncertainty that is dampening aggregate demand

The government continue to trial new policies attempting to improve the flow of credit to the real economy. The downside risk is that regime uncertainty is increasing. This can have the unintended consequence of dampening aggregate demand. It would be helpful if the Bank of England restated the full suite of monetary policy they have at their disposal, and clarify the conditions under which they would be used and, indeed, eventually retired. If the Eurozone implodes, or a stock market crash occurs this autumn, interest rate decisions now will not make a massive difference. It is important that the Bank of England is willing and able to prevent liquidity crises. Nevertheless, the pre-emption of tail risk should not be part of the monthly vote on Bank Rate. Rather, that should be guided by the level of interest rates consistent with an economy growing at or near potential, with low inflation, and a sustainable equilibrium in the market for loanable funds. This may appear to be a somewhat schizophrenic approach to monetary policy, but there is no such thing as a policy decision that's right for all scenarios.

Comment by John Greenwood

(Invesco Asset Management)
Vote: Hold at 0.5%.
Bias: Maintain asset purchases at £375bn; only increase the total to offset declines in M4.

The three headwinds slowing UK recovery

The British economy continues to make slow progress against at least three headwinds: firstly, the need to repair balance sheets in the household and financial sectors; second, the weakness of economic activity abroad, particularly in the Eurozone, our largest trading partner, and, third, the tendency for inflation to exceed personal income growth over the past year or two, thus eroding purchasing power in the crucial consumer sector. None of these headwinds will be overcome quickly, and none can be suddenly circumvented by any magical fiscal or monetary solution.

Britain's recovery likely to be slow and painful

Given the high levels of outstanding debt among householders and the overriding need to restore stability to the banking sector, policy-makers can take only limited measures to accelerate balance sheet repair. A review of the historical evidence on the recoveries from past financial crises suggests that the time taken to achieve a full recovery depends on factors such as: the extent of leverage at the onset of the crisis; where, or in which sectors, the leverage was concentrated; the national savings rate, and the underlying growth rate. Unfortunately, Britain scores very poorly on all these measures, implying a prolonged and painful climb back to full economic health.

Balance sheet repair is progressing slowly

The repair of household and financial sector balance sheets is proceeding slowly. The debt-to-disposable income ratio of households has declined from a peak of 175% in 2008 Q3 to 152% in 2012 Q1, equivalent to the leverage ratio reached in 2005. Some economists have pointed out that financial assets of households have increased by an amount comparable to the growth of debt, implying zero increase in net debt, but this is simply the consequence of the buyers or borrowers paying the sellers for their assets. What matters is that, since house prices have declined and credit conditions have tightened, a substantial fraction of households have a debt level higher than desired and wish to reduce it. It is impossible to know how far households will wish to reduce their debt-to-income ratio. However, and based on the experience of the 1990s this is likely to take the best part of a decade, as it did then.

Bank de-leveraging has a lot further to go

With respect to the banks, they entered the crisis with leverage ratios in excess of 50 times (measured as un-weighted assets to common equity) and that ratio has declined to about 33 times. For better or worse, Basel III is proposing a leverage ratio of 22 times (4.5% capital to risk assets, supplemented by an additional 2.5% capital buffer) and the Vickers Commission has proposed a leverage ratio of 10 times for large retail banks, so there is still a considerable way to go.

Problems overseas are slowing demand for UK exports

On the external side, the crisis in the Eurozone (and the consequent recessions in the periphery and slowing growth in the core), the sub-par growth of the US economy, and the slowdown in China and the rest of east Asia are all contributing to weak demand for British exports. Slower growth of Britain's exports than might otherwise be the case implies a longer period will be needed to rebalance the economy away from consumption and housing towards exports and business investment. Needless to say, the UK government can have almost no meaningful influence in accelerating the recoveries of foreign economies.

Lowering inflation to boost personal income growth should be main monetary goal

Probably the area where the authorities can make the most contribution is in overcoming the tendency over the past year or two for inflation to exceed personal income growth, which has had the effect of eroding purchasing power in the crucial consumer sector. However, the solution is not straightforward even here. Promoting additional domestic spending by monetary or fiscal means may weaken sterling and encourage inflation; restraining domestic spending too much could weaken the recovery and delay private sector rebalancing.

Nominal incomes should be running ahead of inflation during 2013

CPI inflation slowed to 2.5% year-on-year in August, and should decline further. The fact that Britain has suffered higher CPI inflation than either the US or the Eurozone over the past two years reflects three factors: the surge in monetary growth in 2009 and 2010; the fiscal choice to raise indirect taxes such as VAT, fuel duties, and air passenger duties, and the weakness of sterling. However, now that monetary growth has slowed as the demand for loans has plummeted and the fiscal accounts are gradually improving (albeit too slowly to meet the Coalition's target of stabilising the debt-to-GDP ratio by 2015/16), there are better prospects of nominal incomes exceeding inflation in 2013. This in turn should promote real GDP growth. In this environment, the Bank should hold rates stable at 0.5%, but be prepared to undertake additional asset purchases if monetary growth plunges again.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate; complete the latest £50bn QE stimulus.

Green shoots? What green shoots?

Sir John Major tempted fate recently with his talk of the 'green shoots' of economic recovery and the omens remain poor at present. Even though the 2012 Q2 GDP figure may be revised up again to show a fall of 0.4%, compared with the preliminary 0.7%, as a result of the latest revisions to the construction output data, the underlying picture looks depressed – even if there will almost certainly be a positive GDP 'bounce' in 2012 Q3. The employment figures remain, at face value, puzzlingly strong. However, once allowance has been made for: the rise in part-time work; higher self-employment;

an increase in the numbers on government training schemes, and a short-term 'Olympics factor', the increase in employment looks less impressive. It is admittedly true that there has been a pick-up in August's Markit Purchasing Managers Index (PMI) for the services sector but the balance (at 53.7) remained down on the figures recorded earlier in 2012. Meanwhile, the August PMI for manufacturing merely showed an *"easing in the downturn"* – i.e., no green shoots there – and the construction PMI recorded the *"fastest drop in new orders since April 2009"*.

Fiscal stabilisation strategy is way off course

The Chancellor recently announced the date of the Autumn Statement (5th December) when the revised forecasts from the Office for Budget Responsibility (OBR) will surely show a further deterioration in the projections for both GDP and the public finances compared with March. The latest official statistics indicate that the cumulative PSNB in the first four months of the 2012-13 fiscal year was around £10bn higher than in the equivalent period of 2011-12, once allowance has been made for the £28bn transfer of the Royal Mail pension fund. It seems almost certain that meeting the rolling fiscal mandate will slip another year – i.e., to 2017-18 – compared with the 2014-15 date originally forecast by the OBR in June 2010. In addition, the fixed 'supplementary target', which specifies a falling debt/GDP ratio in fiscal 2015-16, will probably be missed. It seems unlikely that the Government has the appetite for the spending cuts and/or tax hikes required to meet this target. Indeed, the markets are already being softened up for the target to be missed. Sir Mervyn King said recently that it was 'acceptable' to miss the target if the economy continued to grow slowly.

Bank of England in 'wait and see' mode

Under these circumstances, the Bank of England looks set to maintain its very accommodative monetary policy for months, if not years, to come. Nevertheless, the Bank is unlikely to make any further move before November as officials are in 'wait and see' mode. They will take stock of the impact of both the current £50bn of QE stimulus and the FLS scheme before making further moves. More QE is anticipated before the end of the year, but the Bank is not expected to cut interest rates further. It makes sense to continue to support a very accommodative monetary policy, but the time to consider a further tranche of QE is November at the earliest. Bank Rate should be left at 0.5%. There is little point in cutting it further.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no more QE.
Bias: To raise Bank Rate further and restore interest rates to 2% in fairly short order.

Labour's share of national output has been reduced and…

Relatively little has changed in the macroeconomic picture in recent months. Data-miners search for evidence of turning points in car sales or sentiment indices or try to cast doubt upon the GDP figures by comparing them with employment data. Suppose that both the GDP and output data are correct – output is falling slightly whilst employment is rising. What would that mean? If we think of a fairly standard production function, in which there is capital and labour and each has a share in output (for the technically-minded, I have in mind a Cobb-Douglas form), then if output is falling whilst labour rises, that must mean either that labour's share in output is falling or that the stock of capital is falling. Given that wages have been rising more slowly than prices for some time, it might be natural to imagine that the key factor is a fall in labour's share in output; prices are rising more quickly than salaries, so salaries comprise a reducing proportion of total expenditure. There may be something in this, but it is also true that a significant driver of price increases has been rises in the cost of other factors, including energy and raw materials.

…real value of capital stock is falling

An alternative, and not-incompatible, hypothesis is that the real output value of the capital stock is falling. There are many reasons this could be so. There is the straightforward one that with business investment so low there may be depreciation. However, and more significantly, there is a good chance that a significant portion of the current capital stock is obsolete. Partly, that could be the result of technological developments. Investments might have been made in the late 2000s on the basis that, with total demand growing rapidly, there would still be residual demand that would not be satisfied by internet-based or other new technology based services. However, the shrinkage in the economy has made it possible to serve a larger portion of the demand purely with new technologies, rendering the capital supporting older technologies obsolete. There could also be significant geographically-based obsolescence. Much human or other capital could have been based on servicing demand stemming from the Eurozone. However, the composition of UK trade is likely to switch decisively away from the Eurozone over the next few years. This could be driven by regulatory changes such as the UK's departure from the EU or by big shifts in international tastes (e.g., increasing future Chinese tastes for consumption).

Economic challenges facing UK cannot be addressed through monetary initiatives

Reflecting upon these points, we note first that the GDP and employment data may not be as incompatible as they first appear. Secondly, if the above factors are in play, then the challenges the economy faces are even less likely to be malleable through monetary policy. If labour's share in income is indeed falling, then even some output recovery may not see wage-based households finding it easier to service their debts (e.g. their mortgages), implying an even more challenging five-year outlook for the UK's banks. If capital is obsolete – and likely to become more so, potentially – then attempting to stimulate demand through low interest rates and QE is futile and counterproductive.

Time for monetary policy to retire

Monetary policy is an excellent and powerful short-term tool. Active demand management can have potentially extremely valuable impacts over a timescale of, say, nine months to three years. However, we are now five years in to the financial crisis and have seen interest rates at zero for three and a half years. Monetary policy cannot help the economy any more than it has already done. It is long past time for it to withdraw from the field. From here, desperate and futile attempts to engage in ever more monetary stimulus can only serve to increase the risk that, if and when the economy does finally start to recover, we have to deal with strong inflationary pressures – meaning a further recession early in the true recovery. As monetary policy-makers, we have done our best. It is time for active monetary management to retire gracefully from this battle and leave the task to other more suitable mechanisms.

Comment by Patrick Minford

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

Poor GDP figures have stimulated helpful policy changes

The steadily improving labour market data suggest that the British economy is now growing. It seems likely that the third quarter GDP figures will show a good rebound when we get it in a month or so and that the process of upward revision of the previous figures will continue. This is why, disregarding the arithmetic implied by the earlier Office for National Statistics (ONS) estimates, we will continue to show growth for the current year. There have been some side benefits of the poor GDP figures and all the popular talk of 'double dip recession'. These have come in the form of several policy changes, as the coalition have had to focus on ways of delivering growth, at the expense of their previous priorities of the green agenda, anti-banker populism with manic reregulation, and infrastructure decisions designed to make non-economic points (such as the HS2 rail link and the denial of the third Heathrow runway). Mr Osborne has taken charge of the new direction and we now have: 1) the new FLS programme under which the marginal costs to the banks of making extra lending will be cut; 2) urgent consideration of how business lending can be boosted – perhaps by creating a new business bank, perhaps by spinning off parts of the two behemoth banks under government control as new banks, designed to boost competition and lending on the high street; 3) a review of airport provision, opening up the issue of runways from 2015; 4) a new labour regulation reduction for Small and Medium Enterprises (SMEs) based on much of the Beecroft Report, and 5) a new Cabinet in which the balance has tilted towards ministers who want to deregulate more actively, and a programme to liberalise planning decisions.

New ECB measures have led to a calming of the Eurozone crisis

How far these measures will make a difference remains to be seen. However, with the help as well of a calming of the Eurozone crisis by the ECB's announcement of direct purchases of weak governments' bonds when their yields are threatened by crisis, we may now see an easing of the great credit freeze-up, which may well be the key factor holding back the recovery.

Reasons for an improvement in public finances

We still have poor news on the progress of public borrowing. However, there has undoubtedly been a large cutback in public sector employment. After allowing for reclassification, this reduction has been around 600,000 since 2010, or about 10% of the total. Benefit payments have been boosted by indexation to the soaring RPI. However, it should become easier politically to cut benefit packages as growth strengthens and, with employment improving, payments should gradually fall back automatically. Furthermore, and with profits having grown substantially, the big corporate tax-gathering season in the final quarter of the present fiscal year should be a lot stronger. With retail sales finally rising in volume terms at around 3% we should also see better VAT receipts.

Problem of middle class welfare

Now that the government has finally come around to a pro-business agenda, the achievements in other areas are starting to come into focus. The first is the austerity programme. Second, is the reform of the National Health Service: it is to be hoped finally embedding the 'internal market' started by Lady Thatcher. Third, is the strengthening of the new independent schools programme started by Tony Blair; and the associated attempts to raise the standards of teaching and those set in examinations. Last, but not least, there is the withdrawal of benefits from middle-income households under the various attempts to reform the benefits system. The previous tax credit system had begun to pervert the incentives of the better off. Unfortunately, there is not much that can be done in practice about the effect of the benefit system on the least well off. The best that can be achieved is that the pressures to get into the labour market can be increased, people can be pushed into cheaper housing and huge payments to dysfunctional families can be curbed. Nevertheless, the political commitment to help the poor ensures that incentives at the bottom are weak. The key is to stop the system before it reaches up to pollute incentives for the middle classes. This is politically possible, and economically desirable, even if it produces points just below middle income where marginal withdrawal rates get very high; generally these have little effect on middle class people.

Time to normalise monetary policy

Against this background, monetary policy may be able to get back to some normality in the UK. It is clear that growth is gradually returning in line with improving market fundamentals. If the latest initiatives mean that lending improves, this will help the process along. As recovery proceeds, it will become increasingly dangerous to leave the vast reservoir of bank liquidity created by QE, let alone to add to it. QE, which has mainly had the effect until now of making government borrowing extremely cheap and depressing returns to savers, could start to pose a serious inflationary threat. We could move from credit famine to credit binge rapidly. So the Bank needs to move in good time to withdraw this threat; these things cannot be left until the moment the binge is underway.

Astonishing decision by US Federal Reserve

The decision by the US Federal Reserve to go for a third round of QE by printing US$40bn a month to buy mortgage-backed securities, until such time as unemployment comes down, is an astonishing decision which seems to forget the basic tenet of macroeconomics: that monetary ease cannot create employment except when applied temporarily as an attempt to counteract a negative shock. The Fed risks an even worse inflationary threat than here in the UK since its commitment is so bare-faced and open-ended.

Monetary summary and rate recommendation

Summing up the situation in the US and the UK, we have a slow recovery and weak growth; bank credit seems to be frozen. We have a huge regulatory reaction to the past crisis that, with the Eurozone crisis, may well account for this freeze-up. QE seems to have lowered the cost of government funding but not apparently the terms of credit to smaller firms, while it has added massively to bank reserves. It would have been better to tackle the credit problem at its root in excess regulation; and keep some control on the reserves injection. As it is, both governments are beginning to understand the regulative issues and trying to ease up on them. The US is directing QE directly into the credit market, while the UK is subsidising banks' marginal lending costs. There is a desperation now engulfing monetary policy which looks dangerous – much like the desperation that engulfed the Heath government's policies in 1971, with every lever being pulled to target unemployment. This desperation needs to be curbed. Interest rates should start to rise and QE should be stopped and then reversed. Bank Rate should go up to 1% at once, with further increases to follow, and QE should be steadily reversed. The unfreezing of credit should be done by easing of capital and liquidity regulations, on top of the new FLS.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate; no immediate increase in QE.
Bias: To avoid regulatory shocks; break up large state-dependent banking groups; raise Bank Rate, and maintain QE on standby.

Money supply acceleration suggests foundations of recovery are being laid

Both international monetarists and the domestic closed-economy variety might take some comfort from the fact that the annual increase in both the aggregate Organisation for Economic Co-operation and Development (OECD) stock of broad money and its British equivalent appear to have accelerated during recent quarters, albeit continuing to run at historically low rates. In the case of the OECD area as a whole, broad money growth fell precipitously from a rate of 9% in late 2008 and early 2009 to not quite 2½% in the first quarter of 2010 but then started accelerating into the 6¼% to 6¾% range where it has broadly fluctuated since the second half of 2011. Likewise the growth of Britain's $M4^{ex}$ broad money supply definition had averaged only some 1½% to 1¾% in 2010 and 2011 but had picked up to 3.9% by July 2012. Since these rises are running somewhat ahead of inflation, which was 1.9% in the OECD area in the year to July, real money balances are now growing. At the same time, the demand for the interest-bearing bank deposits included in broad money remains weak because of the low or negative real returns being paid on such assets. The relative strength of oil and non-oil commodity prices, the modest recovery in equity markets since May, and the emergence of positive annual house price inflation in the UK (the ONS index increased by 2% in the year to July), also suggest that there is now a broadly adequate supply of money relative to the demand for it, both overseas and domestically. The fact that there has been only a limited output response so far is consistent with the view that we are still only in the earliest stages of the monetary transmission process towards recovery.

But monetary data may be distorted and credit to the private sector is being crowded out

There are three caveats, however. The first is that broad money is notoriously difficult to define and measure. The OECD figures may be distorted because they now include relatively high inflation economies such as Turkey. The OECD used to publish a useful series for broad money excluding the high inflation economies, and its consumer price index equivalent, but ceased to do so a few years ago. The second concerns the distinction between money and credit, in a situation where banks are holding an increasing share of their balance sheets in government debt – partly, because they are obliged to do so on alleged regulatory grounds. The accepted view is that it is the money stock that matters in the long run, irrespective of whether money is being driven by credit extended to the private sector, loans to government, regulatory changes or transactions with the overseas sector. However, the availability as well as the price of credit can be a powerful influence on activity in the short run, even if firms can economise on its use in the long run, just as they can do with other inputs into the production process such as energy or raw materials. The extent to which businesses chose to reduce their reliance on a particular input, such as credit, depends on the costs and benefits involved. However, some two-thirds of small businesses seem to have more bank deposits than debt and would benefit from higher rates of interest. It is important not to be unduly swayed by a vocal minority of credit-hungry businesses, particularly as the credit is often used to support speculative activities rather than the creation of real wealth.

However, recovery can be aborted by really stupid policy initiatives, of which we have had many in recent years

The third caveat is that there is no recovery so robust that it cannot be de-railed by really dumb actions on the part of politicians, the central bank or financial regulators. There have been far too many such blunders in the 21st Century. There are several reasons why the recent recovery has been disappointing. Nearly all of them can be blamed on the political and bureaucratic classes rather than the citizenry. First, the supply side of many leading Western economies has been garrotted by the large increases in government spending since 2000 or so. Almost all the leading economies appear to have moved onto a permanently lower growth path as a consequence. Second, the globally-synchronised move towards increased financial regulation has been introduced at precisely the wrong point in the business cycle. Over-regulation may be in the best interests of the bureaucrats concerned, for 'public-choice' reasons. However, it is stopping global banks from properly supporting a private-sector recovery. The third reason has been the tax uncertainty associated with current large budget deficits. The statistical evidence indicates that budget deficits crowd out private activity under most circumstances and do not stimulate it as Plan B advocates allege. Furthermore, there is strong evidence that such crowding out is especially powerful in open economies, with a floating exchange rate and a public debt to GDP ratio approaching 100% – all of which applies to Britain. Finally, politicians have created huge uncertainty for all private-sector economic agents by their misguided policies and grandiose projects. This is an important reason why business is not investing and consumers are reluctant to spend. Here, European Monetary Union (EMU) is the stand out example. However, EMU is almost certainly doomed; if for no other reason than it is impossible for the 12.5m population of Bavaria and, to a lesser extent, the 10.7m citizens of Baden-Württemberg to underwrite without limit the debts of the 317m inhabitants of the Eurozone. The other fourteen Federal German states absorb more fiscal resources than they generate in taxes. So, the Eurozone is effectively being backed by Bavaria, not Germany.

Recent inflation trends

The target CPI increased by 2.5% in the year to August, while both the all-items RPI and the old RPIX target measure increased by 2.9%. The 'double-core' retail price index – which excludes mortgage rates and housing depreciation and is the most historically consistent inflation measure – rose by 3% over the same period. These figures are not particularly low by international standards. Annual Eurozone inflation was 2.6% in the year to August and Chinese inflation was 2.0%. The equivalent US and Canadian figures were 1.7% and 1.3% (July), respectively, while the consumer price indices in Switzerland and Japan have fallen by a respective 0.5% and 0.4% over the past twelve months. The ONS series for producer output prices, which some people consider an early indicator of retail prices trends, accelerated from a year-on-year inflation rate of 1.8% to 2.2% between July and August but was still well down on the rates of 6% or just over recorded in the third quarter of 2011. Furthermore, the unchanged yearly rise of 1.2% in producer output prices excluding food, beverages, tobacco, and petroleum products recorded in August was also well down on the recent peak of 3.7% recorded in September 2011. With the annual increase in economy-wide earnings only 1.5% in the year ending in May/July, there seems to be little risk of UK inflation accelerating in the immediate future, whatever one fears about the longer term inflation risks associated with current fiscal and monetary policies. The recovery in the sterling index since the summer of 2011 has been a useful aid to constraining domestic inflationary pressure, even if it has not been a deliberate policy goal.

Summary of UK growth and inflation prospects

The latest Beacon Economic Forecasting (BEF) projections suggest that Britain's national output will contract by an average of 0.3% this year, given the published data available on 25th September – unfortunately, this report had to be finalised before the publication of the revised national accounts on 27th September. The UK economy is then expected to grow by 2.1% on average next year, before accelerating to 2.7% in 2014. However, this assumes that the current official data are reasonably accurate. This is something that many data users have reservations about. It would not be a surprise if the 2012 growth rate were to be revised up to a positive 1% to 1½% in the fullness of time, for example, given the strength of the labour market indices. If one maintains the supposition that the ONS data is reasonably valid, then CPI inflation is expected to ease to 1.9% in the final quarter of this year and 1.5% in 2013 Q4 but then accelerate to 2.4% in the closing quarter of 2014. The annual increase in the 'double-core' RPI is expected to be 2.3% in the final quarter of this year, 1.9% in late 2013 and 2.9% in 2014 Q4. However, a disturbing feature of the ten-year ahead BEF projections is that inflation continues to pick up thereafter, with both UK CPI and OECD inflation rates breaking through the 5% barrier in the latter years of the decade.

Current hyper-loose monetary policies could engender an inflation threat in the second half of this decade

This predicted shift onto a higher inflation plateau is essentially a delayed consequence of the hyper-loose monetary conditions that have prevailed in recent years, which may take more than half a decade to fully work through. This is an issue that badly needs to be debated, if central banks are to achieve their inflation goals and maintain the credibility needed to avert stagflation without having to aggressively slam on the brakes at some stage. As it is, Bank Rate is expected to be held at its present ½% until the third or fourth quarter of next year before rising to 2% or so by the end of 2014. There have recently been some noticeable downwards revisions to the earlier published figures for Public Sector Net Borrowing (PSNB) which seem to result from Local Authorities – who have also done much of the public sector job shedding – not fully spending their financial allocations. The ONS now claim that PSNB was £119.3bn in fiscal year 2011/12. The BEF projections show the PSNB falling to £86.7bn in 2012-13, rising to £129.7bn in 2013-14, and then easing to £117.1bn in 2014-15. However, these figures have been distorted by the £28bn transfer of assets from the Royal Mail Pension Fund after the start of the current financial year. Without this distortion, the PSNB would have been projected at just over £114.7bn in the current financial year.

The October Bank Rate decision

As far as the October Bank Rate decision is concerned, the temporarily reduced uncertainties in Continental Europe suggest that there is a window of opportunity to raise Bank Rate and that the Monetary Policy Committee (MPC) should be preparing the financial markets for such a move, perhaps before the year end. However, a rate hike is not being advocated for this month because the markets have not been psychologically prepared and the authorities are metaphorically walking on eggshells where confidence is concerned. The medium-term aim should be to get Bank Rate into the 2% to 3% range at which point it may re-engage with the money market rates that determine borrowing costs. The authorities also strongly need to resist ill-considered regulatory proposals, which unduly hamper the credit- and money-creation processes. Finally, QE should be reserved for lender of last resort purposes only and not employed as an instrument of day to day monetary policy.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Hold Bank Rate; diversify existing QE into non-gilt assets.
Bias: To raise Bank Rate.

Mr Osborne's 'extend and pretend' deficit reduction programme

Over the next few weeks the Chancellor of the Exchequer, George Osborne, and his Treasury colleagues have some very important decisions to make in regard to the *Pre-Budget Report* on 5th December. Since the original budget deficit reduction plans were laid in June 2010, the lacklustre performance of the UK economy has forced a postponement of the date by which the structural element of the deficit is eliminated. Merely to repeat this exercise of 'extend and pretend' will fool no-one, least of all the accursed rating agencies whose favour the Chancellor continues to curry.

Vital to hold line on fiscal normalisation

To fail at the hurdle of fiscal prudence now, despite the obvious disappointment over recent borrowing trends, would carry a deeper significance. If the coalition loses its nerve at this juncture and simulates the policy dilution that Ed Balls has long advocated, its legitimacy will be rightly called into question. Recent activity, trade and employment data suggest that there is no cause for panic on the fiscal front. With the

Bank plainly in unconditionally easy mode, it is vital that Osborne holds the line on fiscal normalisation.

Risk of fiscally-generated inflation

The alternative, which is close to becoming a reality in the US, is to open the door wide to a fiscally-generated inflation in which inflation expectations are cut adrift from central bank targets or objectives. The UK may regard itself as a cut above the Eurozone average, but its over-dependence on foreign gilt purchases is a potential source of vulnerability. As UK inflation outcomes explore the upside again, this is no time to abandon ship on the fiscal objectives. This discipline has to come from the Treasury, since the Bank has forfeited the means to offset the absence of fiscal restraint. The UK is at risk of conceding the inflationary argument if it fails to reiterate its commitment to budget deficit reduction. Bank Rate should remain on hold until the UK reasserts a positive GDP growth rate.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)
Vote: Hold Bank Rate.
Bias: Neutral.

Signs the downturn is coming to an end

The UK economy has moved on since QE was announced just a few months ago, with signs that the downturn in the first half of this year is coming to an end. Certainly, the data from early leading indicators, including Lloyds Bank proprietary data, would suggest that the economy will return to growth in the third quarter, perhaps anywhere between 0.5% and 1%. Broadly speaking, the economy appears to be flat. But data point both ways on this. The PMI surveys are suggesting that services and manufacturing activity are either close to or heading above the critical 50 expansion level, so heralding some month-on-month growth in output in these sectors in the quarter ahead.

Inflation has eased but higher food prices and energy costs limit scope for further falls

That having been said, the volume of retail sales fell back by a modest 0.2% in August – or by 0.3% if fuel is excluded. Following July's pick-up in inflation, the annual rates of increase in the CPI and RPI inched lower in August, driven by slower increases in clothing and footwear prices and the absence of utility price increases, compared with last year. To be more specific, CPI inflation eased from July's 2.6% to 2.5% in August. Looking ahead, a combination of supportive base effects and a high degree of spare capacity should continue to pull CPI inflation lower. Service sector prices inflation fell from 3.4% in July to 3.2% the following month. Excluding seasonal factors, CPI fell from 2.3% to 2.1% in August. However, the acceleration in global food and oil prices, together with the prospect of a renewed round of domestic utility tariff rises, threatens some upward pressure on inflation going into the end of year. This makes it harder to see a very sharp drop occurring.

Labour market statistics suggest stronger output than is officially recorded

Meanwhile, the public finances were a little better than market expectations and basically showed stabilisation on the year. However, 2012-13 has got off to a poor start with the cumulative deficit some £13bn worse than this time last year, excluding the effects of one-off capital transfers. Notwithstanding the other figures, the unemployment data remain most powerful. The labour market report showed further evidence that, notwithstanding the reported contraction in economic activity in the first two quarters of 2012, employment has risen sharply. In the three months to July, employment rose by 236,000 – representing a pace of job growth historically associated with robust economic activity. Despite the strong rise, unemployment only fell by 7,000 people as job growth was met by a sharp rise in the labour force over the same period. Meanwhile, the timelier claimant count measure of unemployment continued to post marked falls, suggesting labour market strength continued into the third quarter. The labour market poses a puzzle for the broader economic picture and continues to cast some doubt on the scale of output loss recorded over the current recession.

Bank Rate likely to be held in October and this will be the right decision

The MPC minutes for September's meeting showed that the official rate setting committee was unanimous in its decision to leave Bank Rate and the asset purchase target unchanged in September. However, some members thought further stimulus was more likely than not in due course, with one member stating there was *"a good case"* for additional easing this month. Yet uncertainties over the underlying pace of economic activity and the surprising strength of employment growth make October's decision relatively easy. Bank Rate is expected to remain on hold in October and this will be the right decision for the economy. At the moment, the best policy option is to leave rates on hold and keep the policy bias neutral.

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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