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Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee unconvinced by forward guidance and votes five/four to raise Bank Rate by ¼%

In its most recent e-mail poll, finalised on 27th August, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) decided by five votes to four that Bank Rate should be raised on Thursday 5th September. Three members wanted an increase of ½%, while two advocated a rise of ¼%. This split vote for a rate hike would imply a rise of ¼% on normal Bank of England voting procedures. However, a substantial minority of four SMPC members believed that Bank Rate should be held at its present ½%, although most members did not wish to see an immediate addition to the stock of Quantitative Easing (QE). The upwards revised second quarter UK growth figures, and the somewhat improved prospects for the Euro-zone, indicated that the pace of UK recovery was quickening. However, there was disagreement as to how long this could continue.

In contrast to the Monetary Policy Committee (MPC) minutes, the SMPC report contains individual and named contributions. It is significant, therefore, that several SMPC members independently expressed serious reservations about the Bank of England's 7th August paper on forward guidance. These ranged from fears that the Bank's theoretical model was gravely flawed, to issues of practical implementation, including whether a lagging labour market indicator of the business cycle represented an appropriate threshold for re-considering Bank Rate. One danger of using a lagging indicator was that policy might end up doing too little too late – or too much too late – and create accelerating inflation or worsening boom-bust cycles. The final three SMPC polls of 2013 will be released on the Sundays of 6th October, 3rd November and 1st December, respectively.

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This will be the last SMPC publication to appear as a printed document. The SMPC commentaries will continue to be compiled by Lombard Street Research, but will only be disseminated in electronic format from next month onwards. Anyone on the printed distribution list who wishes to receive future reports should provide their e-mail addresses to Tom Crew, whose details are given below. Alternatively, these reports can be downloaded from the websites www.iea.org.uk, www.economicsuk.com/blog, www.lombardstreetreseatch.com and www.lloydsbankcommercial.com.

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Comment by Tim Congdon

(International Monetary Research Ltd)
Vote: Hold Bank Rate; no change in asset purchases.
Bias: Hold Bank Rate for next three months and use rate setting and QE to achieve growth in broad money of 3% to 5%.

Recovery resumed in earnest

At long last, the UK economy's recovery from the traumatic shock of late 2008 and 2009 seems to have resumed in earnest. To remind, the recession began in the middle of 2008, and at its worst phase from 2008 Q4 to 2009 Q1 national output was falling by 2% to 2½% a quarter – i.e., at annualised rates of almost 10%. Output did recover in the year to mid-2010, but only by about a third of what had been lost in the previous year. Since then, output has on average moved forward, but the advance has been weak and intermittent compared with the steady progress of the Great Moderation, the period of roughly fifteen years from the start of 1993. According to official data, output remains well beneath its level at the previous peak in early 2008. However, the official data may be wrong and will undoubtedly be revised. Nevertheless, they have to be taken as 'the truth' for current purposes.

Hopes rest on stronger consumer spending

Hopes of a more sustained recovery in late 2013 and 2014 partly rest on stronger consumer spending. This may be related to stronger house prices and partly on the rehabilitation of the banking system. The world economy is also making progress. However, the Eurozone periphery remains crippled by the various dysfunctional features of the monetary union.

Monetary stimulus is working through

A critical influence in the UK background is that the growth of the quantity of money has picked up in recent quarters to the highest figures since the start of the financial crisis in late 2007. Corporate liquidity has been comfortable, enabling companies to expand by recruitment, by acquisition and by increases in capital spending. Share prices have also been buoyant. Personal sector wealth may not be back to previous peaks in 2007 and 2008, but the gains since the trough in early 2009 have been spectacular.

Trend growth has been low and there is not much excess capacity

Because official estimates show output to be lower than at the early 2008 peak, some observers have prescribed monetary activism to boost demand, output and employment. (See, for example, James Zuccollo's *Kick-starting Growth*, a report recently published by the Reform think-tank.) They are apparently confident that inflation would not ensue. A run-away inflation process does indeed seem distant. For the moment, consumer price inflation is still within the 1%-either-side-of-2% corridor which is acceptable under the inflation targeting regime, if only just. However, it is striking that survey evidence on labour shortages does not indicate an economy operating with a wide margin of spare capacity. The survey prepared by the Confederation of British Industry (CBI) shows that the number of companies where shortages of skilled labour constrain output was roughly in line with the long-run average. On this basis, an extended period of above-trend growth would reignite inflation worries. The implied conclusion – that the trend growth in the last few years has been very low, perhaps only a mere 1% a year – is depressing, but cannot be escaped.

Disappointing inflation

According to its advocates, stimulatory monetary activism is justified partly by the government's commendable determination to bring the budget deficit down and restore sustainability to the UK's public finances. If fiscal policy cannot be used to boost the economy, monetary policy appears to have much in its favour. However, the years since 2009 have mostly been of above-target inflation (i.e., inflation above 2%) and often of above-corridor inflation (i.e., with the annual increase in the consumer price index more than 1% above the 2% target figure). Poor inflation numbers have been recorded despite the sluggish growth of demand. That, together with the survey evidence on labour shortages, argues against any deliberate attempt 'to go for growth'.

Artificial and distorting official schemes

The government obliged the Bank of England to introduce a Funding for Lending Scheme (FLS) in July 2012 and George Osborne, the Chancellor of the Exchequer, announced a Help to Buy scheme to promote house purchase in the 2013 Budget. Both schemes can be criticised as artificial and distorting. They are to be regarded as official attempts to negate the adverse effects on the economy of tighter bank regulation. It would be better simply to cancel or reverse the move to tighter bank regulation.

Broad money growth has picked up but has depended on QE

As already noted, the economy's better tone owes much to a recovery in the growth rate of the quantity of money. In the year to June, the annual growth rate of $M4^{ex}$ was 5.0%, with the money balances of companies (i.e., 'private non-financial corporates') up by 8.0%. ($M4^{ex}$ is of course the UK's traditional measure of broad money in the last twenty years; i.e., M4 excluding money held by 'intermediate other financial corporations' or quasi-banks.) It is important to understand that the money numbers, which are buoyant by post-2008 standards, are *not* the result of a revival in bank lending to the private sector. On the contrary, bank lending to the genuinely non-bank UK private sector (so-called '$M4^{ex}L$' in Bank of England jargon) actually fell slightly (by 0.7%) in the year to June. The growth of the quantity of money occurred only because the Bank of England continued to conduct expansionary quantitative easing (QE) operations.

Excessively tight regulation has impeded money creation

Tighter official regulation has held back the growth of banks' risk assets since 2008. Banks have been under pressure to 'deleverage' (i.e., to reduce their asset totals relative to their capital) and to 'de-risk' their assets (i.e., to reduce the ratio of risk assets, nearly all bank lending to the private sector, to total assets). The pressure continues, with the Bank of England – like other central banks – introducing a simple leverage ratio as a constraint on banks' balance sheets. Both Barclays and Nationwide have expressed anger about the new regulation, not least because it penalises them for having made some new loans in the last few years in response to official jawboning. Nevertheless, they must comply and have said they will to some extent reduce their assets.

Rate debate most complex – and least clear-cut – since 2009

So, we have two important institutions still 'deleveraging', more than six years after the closure of the inter-bank market to new business in August 2007. My interpretation is that bank lending to the private sector will remain sluggish in the next few months. It will remain sluggish despite the 'forward guidance' from Mark Carney, the new Governor of the Bank of England, that interest rates are to be kept low until the unemployment rate has dropped to 7%. However, this could be proved wrong, and the banking system and the economy may see more demand strength than is now the prevailing wisdom. This makes the debate on interest rates more complex and less

clear-cut than it has been at any time since 2009, and developments in the next few months may justify the first 'tightening' (in terms of QE and Bank Rate) since the start of the crisis. New mortgage lending seems to be reviving, perhaps partly because of the Help to Buy scheme, although the *stock* of mortgage debt is not rising rapidly. For the time being, I remain in favour of continued asset purchases by the Bank of England, in order to deliver broad money growth of between, say, 3% and 5% a year, and want Bank Rate to remain at ½%. On the other hand, I am opposed to a programme of outright monetary stimulus, and believe – as always – that over the medium term the rate of growth of the quantity of money should be geared to low inflation or, better still, price-level stability.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: Additional QE and a rebalancing towards non-gilt assets.

Output growth has picked up

UK output growth has picked up notably since the turn of the year. Early estimates suggest real GDP expanded at an annualised rate of 2% in the first half. The expenditure breakdown suggests the acceleration is broad-based, with net trade in particular making a sizeable positive contribution. Stronger first-half growth occurred against the backdrop of marked destocking, suggesting a more robust expansion of final demand. Although real government expenditure (consumption plus investment) has surprised on the upside, the main strength has been in private sector final demand, including net exports.

And survey evidence remains strong

Survey evidence suggests output growth may have strengthened over the summer. The July Purchasing Managers Index (PMI), for instance, implies a rate of expansion that is some way above the economy's historical rate of growth. The latest CBI surveys also paint an optimistic growth picture in the near-future. Particularly encouraging are signs of strengthening demand for British exports. In the housing market, prices, transaction volumes and rates of house-building are all up. The latter are now at their highest level in three years. Housing investment could thus be a significant source of final demand in coming quarters.

But still premature to withdraw monetary stimulus

Any withdrawal of monetary stimulus is premature, however. There remains significant slack in the labour market. It is less clear how much spare capacity firms are operating with. However, overall the UK output gap is still sizeable. A sustained period of output growth above 2½% is needed to make a dent into this slack. Indicators of underlying inflation are subdued: basic pay only grew by 1.1% in the year to 2013 Q2, while core inflation, which adjusted for last autumn's tuition fee hike is currently 1.5%, has been below the 2% target since last December. Relevant also, is the continued weakness of nominal demand growth – private final demand in cash terms has only grown by 3.8% in the last twelve months, a rate well below historical norms.

Because escape velocity has not yet been achieved

The economy has not reached 'escape velocity'. When it eventually does, there will still be no immediate need for tighter monetary policy. There remains plenty of scope for a period of robust growth before capacity pressures start to emerge, even if one is pessimistic about Britain's supply potential. Broad money growth is currently consistent with a period of solid, albeit unspectacular, demand growth. It remains to be seen how far the de facto tightening of monetary policy, induced by financial markets, will impact money and credit growth in the near future. However, the substantial

upward shift in expected (risk-free) interest rates seen in recent months will surely feed through to private credit growth, hence the expansion of bank deposits.

Forward guidance has yet to convince financial markets

The MPC's new forward guidance was meant to guide market rates downwards. To date, it has failed. The improving growth outlook has trumped the MPC's (conditional) promise not to hike Bank Rate until unemployment has fallen to 7%. It is far from clear whether this upward lurch in rates is justified by the likely path of GDP growth and inflation. Although there is no need to alter the monetary stance at this meeting, the rise in market interest rates, if sustained, would be a concern. A bias towards additional asset purchases is at this stage maintained.

Comment by Anthony J Evans

(ESCAP Europe)
Vote: Raise Bank Rate by ½%.
Bias: Further rises in Bank Rate.

Dangerous to wait until inflation spikes before tightening monetary policy

Despite falling in recent months, CPI inflation has been above target for so long that it is hard to treat 2.8% as anything other than alarming. Other inflation measures continue to be above target. One of the lessons from the build-up to the 2008 financial crisis is that asset bubbles can occur without runaway inflation and it is dangerous to wait until inflation spikes before trying to tighten monetary policy. The fact that house prices are rising as fast as in 2006 may just be coincidence. However, policymakers should be alert to the dangers caused by low interest rates. There is little evidence that they are any better at spotting, and stopping bubbles than they were in 2006. There is no rational reason to be reassured by Mark Carney's claim that we can deal with such problems as and when they emerge. One would like to see how Canada's housing market develops before according him that degree of foresight.

Bank of England has no clear policy on where it is heading

Generally, the economy is on a stable growth path. Most of the factors inhibiting growth are not directly affected by monetary policy; so, it is difficult for monetary policy to be seen as a source of higher growth. Low rates of GDP growth reflect a lower level of aggregate demand than prior to the crisis, but this is not necessarily bad. The economy would grow more quickly if people were able to form expectations about the future path of nominal GDP (NGDP). Unfortunately, the Bank of England allowed NGDP to contract significantly, and have no clear policy on where they are going.

Forward guidance not a major change

The introduction of forward guidance is not a major change in monetary policy. After all, the supposed inflation target of 2% remains in place – or at least it's not been explicitly abandoned – and the main tools with which the MPC can hit it (i.e., interest rates and QE) remain the same. That having been said, there is something new to it. However, it is concerning that the Bank has introduced a measure as politicised as unemployment into use for monetary policy purposes. Although it is not being targeted per se, it raises questions about the validity of Phillips curve type trade-offs, since it implies that policymakers are willing to permit above target inflation if unemployment is deemed too high. The main problems with the current UK jobs market include long term unemployment, which has even less to do with aggregate demand than the headline rate, and the rise of part time work or zero hours contracts – which can mask the extent to which reduced economic activity shows up in unemployment figures. The MPC say that they chose a modest threshold of 7% on the grounds that they didn't want to be behind the curve, but then what is the point?

No credible commitment

It is also hard to see how committed the MPC will be to adhering to such a threshold. The whole point of a credible monetary policy is that it requires the hands of policymakers to be bound. However, there are so many conceivable scenarios about what will happen to expected inflation, unemployment, etc. that it is hard to imagine that the authorities have no room to manoeuvre. Indeed, one difficulty with forward guidance is that it overstates the unity of the MPC. Although the spotlight has fallen firmly on Mark Carney, the fact that one member voted against the conditions under which forward guidance would be ignored is important. It means that right from the beginning there is uncertainty in terms of the commitment of individual members. One of the conditions is that the 7% unemployment threshold will be ignored if there is more than a 50% chance of CPI inflation rising above 2.5% in eighteen to twenty-four months' time. Although the press implied that this was a non-arbitrary 'knockout', it still rests on the interpretation and judgment of individual MPC members. To some extent it, therefore, increases the amount of uncertainty that is due to the discretionary nature of monetary policy decisions.

Aim should be to normalise rates as soon as possible

Broad money continues to grow at around 5%, and narrow money supply measures are even faster. The economy is not booming but low interest rates are a reason why. Given that the aim should be to normalise monetary policy as soon as possible, there is not sufficient fragility to shy away from this. There is little doubt that an unexpected increase in interest rates would cause immense confusion and be destabilising to the economy. Nevertheless, in voting for an increase in rates, it also has to be assumed that this decision would be communicated effectively.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no more QE.
Bias: To raise Bank Rate further, and soon.

Current UK broad money growth is appropriate for an economy with only 1% to 1.5% growth potential

The past couple of years have seen a steady pickup in monetary growth. In the final three months of 2011, the Bank of England's standard measure of broad money growth (seasonally adjusted $M4^{ex}$) had an annual growth rate of well below 2%. In the latest numbers available at the time of writing (June 2013) that rate is around 5%, where it has been throughout 2013. That is still, perhaps, somewhat below the 6% to 8% one might estimate would be compatible with CPI inflation of 2% and 2.5% or so real GDP growth rate in the long run. Nevertheless, given that the sustainable growth rate for the UK economy is probably only in the 1% to1.5% region at present, 5% monetary growth is about appropriate. Recent months have also seen a distinct pick-up in the UK macroeconomic data. GDP is estimated to have grown at 0.7% in the second quarter of 2013. Since then, most survey data has suggested a further pickup. Quarterly growth numbers pushing 1% seem plausible for the second half of 2013 in a way that few commentators would have dreamed only six months ago.

Second quarter GDP figures

The detail of the GDP growth figures implies a broad-based pick-up, including accelerations in investment and net trade, rather than just household consumption. Absent downside risk scenarios materialising (discussed in more detail below), there should be further scope for an expansion of non-oil net trade, especially if the situation in the Eurozone stabilises. Business investment may finally be responding to a combination of intrinsic pressure from long-postponed projects and the desire to shift from financial into real assets to gain greater protection from erosion

by inflation – which has been endemic over recent years and likely to accelerate over the next couple.

Syrian threat to oil price and inflation risk from potential loss of domestic monetary control

International events in Syria, and the possibility of their spilling over into a wider conflict, constitute a threat both to international trading conditions and to oil prices. An oil price spike could have implications for inflation down the line. However, it is appropriate for monetary policymakers to await events for the time being. The more intrinsic threat of inflation for the UK comes from the likelihood of a large further acceleration in broad money growth. The danger, here, is that the large injection of monetary base via QE becomes leveraged into broad money as the economy recovers and the banks becomes less distressed. The extended nature of the 2011 and 2012 'double-blip' soft patch in growth has not changed fundamentally the dynamics of the inflationary impact of QE on exit from recession, merely delayed it.

Underlying inflationary pressures will be exposed as the banking sector recovers

Absent further international events derailing British recovery, the underlying pressures should be expected to assert themselves, as follows. The first stage is that a huge increase in monetary base should translate into rapid broad money growth – increased capital requirements notwithstanding – and thus inflation down the line. Anticipating that inflation, investors and companies will exit from cash and financial assets into real assets in a distinct spike in business investment. Next, that spike in business investment will be associated with a rapid pick-up in GDP growth over a few quarters. Faster growth, in turn, will make the balance sheets of banks appear much improved temporarily. These stronger bank balance sheets will then facilitate a rapid pick-up in lending. Once this scenario is in play, the Bank of England will have neither the will nor the tools to control it fully. It will lack the will because the measures required to cap such rapid monetary growth will entail driving the economy back into recession; the Bank will not be willing to do that until it feels we have comprehensively escaped the previous recession. The consequence will be even higher inflation than the UK experienced in 2008 or 2011 – perhaps much higher.

Bank's loss of credibility will cause higher unemployment

When that inflation comes, workers will seek to protect their real wages by seeking rapid pay rises. When the Bank of England is, at last, willing to cap inflation, workers will not believe its promises and the consequence will be many workers stranded on excessively high wages who then become unemployed. The key problem with losing credibility on inflation is not the inflation – the inflation comes from the money growth, not the expectations. The key problem with losing credibility on inflation is the unemployment that will be the consequence.

Emerging Eurozone transfer union will ultimately pose problems but immediate need is to normalise Bank Rate

The key near-term issue liable to derail the scenario above is, as it was in 2011, the Eurozone crisis. That is by no means resolved, though considerable political progress has been made. Eurozone policymakers are finally acknowledging that the Eurozone will only work as a transfer-union; without debt pooling but with annual payments made from richer to poorer regions of the Eurozone via a greatly expanded version of the EU's current structural funds arrangement. A transfer union of that sort can only be delivered in combination with political union – the establishment of the EU Federation. The Euro was always going to imply the creation of a Single European State. For Britain, that EU Federation will have political and economic consequences within just a few short years but, for now, managing the great volatility likely to be associated with exit from the current recession is the priority for monetary policymakers. The Bank has missed each opportunity since 2010 for raising interest rates. It should not be missing yet another now.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE by £25bn per month.

Underlying strength of services sector coming through, now it is no longer offset by weaknesses elsewhere

The revised estimate of GDP growth in 2013 Q2 comes as a relief to UK economy-watchers. A quarterly increase of 0.7% is at last appreciable, if still not strong, growth. Is this a sudden onset of recovery? Not entirely, as the service sector has had growth averaging 1.6% per annum for the past two years. However, services expansion was overlaid by the weakness in manufacturing, a collapse in construction, a banking implosion and a decline in North Sea oil. Gradually those negative elements have dissipated. With North Sea oil, the government has been in talks with the major companies to give proper assurances that there will be stability in the tax regime for oil; previously, the North Sea was treated like a cash cow, with tax being used to collect ad hoc levies. Naturally, this produced a decline in new projects. In banking, there have been the two FLS schemes and, since the Budget, the Mortgage support scheme for first-time buyers. The latter has encouraged lending, especially for housing. In addition, there seems to be more awareness among ministers that bank regulation can be excessive for the good of the economy. Commercial bank profitability has risen and the Lloyds share holdings by the government are being readied for partial sale. In short, banking may be turning around.

Improved outlook for construction and manufacturing

Then we turn to the housing improvement, which has been spurred by the recent rise in house prices, apparently reflecting the mortgage subsidy scheme. This has put new life into construction prospects; and construction has at least stopped declining for now. Finally, manufacturing is picking up as the Eurozone flattens off into a slower decline and exports are being diverted elsewhere where growth is much stronger.

Misguided regulation has caused banking chaos and blocked the credit channel

Looking back at the string of disappointing growth figures since the recovery began in late 2009, it seems clear that a key element has been the new regulative approach to banking. This has caused chaos in the banking sector and blocked the credit channel. It has been justified by the need to prevent future crises. However, the evidence supports the view that the crisis was brought about by much wider factors than banking, even if banking problems made it worse. After twenty-five years of breakneck world growth, there was bound to be a downturn as the world ran out of commodities. So, the new bank regulation will not prevent future such crises of capitalism. However, as we have seen, it can be lethal to growth both by attacking the UK's key growth industry and by killing credit growth. Fortunately, now that the coalition politicians appear belatedly to have woken up to this – witness the outburst of Vince Cable about the 'capital Taliban' at the Bank of England – there may be more backpedalling on the new regulative miasma that has swept the British establishment in the wake of the crisis. This has over-compensated for the monetary and regulatory authorities previous failure to control the economy and banking boom of the earlier 2000s.

Government's approach entirely ad hoc

The trouble about the government's approach to this backpedalling is that it is entirely ad hoc. The Mortgage support scheme has unlocked lending to housing, and mortgages are up, as are house prices. This unlocking will mean that recovery will include the housing sector, as it would have absent the credit blockage; construction of housing will pick up, as it should. Nevertheless, lending to Small and Medium Enterprises (SMEs) continues to crash, as banks are heavily penalised for lending to

them because of the expensive extra capital they need to raise to back this up. Hence the two FLS schemes seem to have bombed out in respect of SME lending. How easy, after all, to 'increase lending' by lending you would have made anyway, so claiming the FLS subsidy, while continuing to cut back in aggregate lending to SMEs. The latest introduction by the Bank of England of the extra 'leverage' capital requirement is particularly clumsy and crass, coming as it does on top of the already cumbersome and damaging capital requirements related to risk-weighted loans.

Go back to a self-regulating regime with Bank as monitor

What needs to be done is a severe cutting back of these new regulative capital requirements in favour of a return to a self-regulating regime. The Bank should then act as chief monitoring agent, in the same way as existed prior to the 'Tripartite regime' introduced mistakenly by Gordon Brown in 1997. Formulaic approaches to capital needs are crude and essentially arbitrary. Also, when risk-weighted, as in the Basel III agreement, such capital requirements penalise lending to SMEs even through collectively these are no more risky socially than lending to blue chips.

And remove the 'punch bowl'!

A second need is to focus monetary policy back on its old task of 'taking away the punch bowl when the party gets merry' (the classic, if now clichéed, description due to McChesney Martin at the US Federal Reserve). This could be achieved by reintroducing money supply or credit growth targets into the conduct of monetary policy, in addition to the long-term inflation target. The problem with inflation targeting on its own has been that inflation does not respond much in the short run to excess credit growth, because of the power of belief that it will be subject to the target. Yet as we have seen, when a credit boom takes hold, it can cause a banking problem to be super-imposed on a recession brought about by the normal forces of capitalism.

Raise Bank Rate and reverse QE by £25bn a month

With a new Bank governor having just arrived, who has the confidence of the Chancellor, it may be that gradually policy will move in this direction and hence growth will be less restricted by the failure of the credit process. My forecasts assume that something of this sort will happen and hence I have growth staying in the 2% to 3% range from now on. So, coming finally to the monetary judgement, it is suggested that we need a gradual normalisation of monetary conditions. Contrary to the misguided forward guidance given, I would like interest rates to start being raised now, with a ¼% rise this month, with QE gradually being reversed, by £25 billion each month. At the same time, the FLS schemes need to be reformed to deal exclusively with SME lending (and for now mortgage lending; but Help to Buy will probably be enough to keep house lending unfrozen after the end of this year). Regulative targets for risk-weighted capital and leverage should be delayed for at least five years. Longer term, the regulative system needs to be rethought along the lines above.

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 state-dependent banking groups before privatisation; raise Bank Rate to 2½%, and maintain QE on standby.

Forward guidance and the 1950s Phillips curve

The emphasis placed on the Labour Force Survey (LFS) measure of unemployment as the trigger for re-considering whether a Bank Rate increase was justified in the Bank of England's 7th August *Monetary Policy Trade-offs and Forward Guidance* paper appeared at first glance to represent a reversion to a static 1950s Phillips curve model of inflation in which the long-run Phillips curve did not shift vertically upwards

with rising inflation expectations and there were no horizontal shifts in the 'natural' rate caused by institutional factors such as the replacement ratio of benefits to post-tax earnings. As such, it seemed to 'un-learn' all the knowledge that policymakers and economists had acquired over the past half century.

The Bank appears to be trying to salvage the Conventional Theoretical Macroeconomic model

However, a more considered view is that the Bank's economists were trying – perhaps, subconsciously – to rescue the Contemporary Theoretical Macroeconomic Model (CTMM) which originated in the US and became the accepted policy framework for the US Federal Reserve in the Greenspan era. The CTMM was pushed by American economists who wrongly wanted to take the money supply out of theoretical models. Its intellectual dominance explains why international policymakers were indifferent to the behaviour of the banking sector before the global financial crash; put crudely, if money did not matter, then neither did the behaviour of banks. A major weakness of the CTMM is that it requires a reliable measure of the Keynesian concept of the pressure of demand – i.e., the 'output gap' – if it is not to fall to bits. This is because the CTMM can be reduced to three equations in its simplest text book form: one for the output gap; another for the rate of inflation, and a third for the nominal rate of interest, with both the latter pair including the output gap as an important explanatory variable.

However, the CTMM is profoundly flawed and barely applicable to the UK

Ahead of the global financial crash, the author attacked the CTMM and its dangerous policy implications in his May 2007 Economic Research Council paper *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England After Ten years of Operational Independence* (www.ercouncil.org). The full criticisms of the CTMM made therein will not be repeated here. However, it is possible to regard the Bank's paper as an attempt to rescue the CTMM by substituting a labour-market measure of the output gap for the previous GDP-based one, which is now admitted to be un-quantifiable. One reason is uncertainty as to how far the shortfall of activity below its pre-2008 trend reflects a supply withdrawal as opposed to a demand shock. (A personal view is that it is indeed largely a supply withdrawal caused by the big government policies of the 'Brown terror' but that is too weighty a subject to be covered here.) Another is that the Bank's economists now regard the GDP figures produced by the Office for National Statistics (ONS) as too unstable to be of any practical utility – a sentiment with which one totally concurs.

Fatal weaknesses of CTMM are not cured by using LFS unemployment

However, the fatal weaknesses of the CTMM are not eliminated by the Bank's use of an unemployment threshold. First, a stationary variable such as the output gap or unemployment can only explain the rate of change of inflation not the rate of inflation for time series reasons. Second, the CTMM is a closed economy model without a government sector. However, both overseas developments and government spending and the tax burden are massively important in an open and highly socialised economy, such as Britain's. Third, the exchange rate is only considered as a short-term source of temporary shocks. In a small open economy, such as the UK, one would expect the domestic price level to eventually equal the overseas price level less the exchange rate when expressed in logarithmic terms. This issue should have been confronted in the Bank's paper. Finally, there does not seem to be a single mention of the money supply in the forward guidance report. This is an amazing lacuna in a central bank publication, even if one accepts that the velocity of circulation can vary significantly with the opportunity cost of holding broad money balances.

Get out clauses galore and need for a 'second pillar' approach

Perhaps fortunately, central bank officials can outdo Hollywood lawyers when it comes to get out clauses. The various 'knockouts' and other qualifications mean that the Bank of England can largely do what it likes in practice – complete discretion being the covert goal of most central bankers, almost regardless of whether they have the practical intelligence, operational competence and forecasting ability to use it wisely. Indeed, this represents a weakness of the whole forward guidance approach. It may be credible but otiose because the official forecasts are consistent with the consensus and proved broadly right after the event. Alternatively, officials may be overtaken by events so that the Bank has to give back word and further damage a credibility that has already been shredded by its consistent failure to achieve its inflation targets. There is also the problem that using a lagging indicator of the business cycle, such as unemployment, as a trigger means that rate setting is either dependent on accurate forecasting over a long-time horizon or is likely to end up 'behind the curve' and be de-stabilising in control-theory terms.

Forward guidance may shift uncertainty from Bank Rate to more important macroeconomic variables

Furthermore, reducing the uncertainty about the future short-term rate of interest may exacerbate uncertainty about other important variables such as prices and output. This is likely to occur if the populace believes that policy is likely to end up doing too little too late – or too much too late – and risks creating accelerating inflation or worsening boom-bust cycles. The latter appears to have happened in the first decade of the twenty-first century in the US and Britain. A personal view is that it would have been better to have adopted the carefully-considered methods originally proposed for the European Central Bank by Otmar Issing and his Bundesbank colleagues ahead of European Monetary union (EMU) instead of forward guidance. In particular, the adoption of a formal monetary 'second pillar' would have led to more stabilising policies in both the boom and the bust of the 2000s.

UK broad money growth satisfactory but vulnerable to regulatory shocks

As it is, the latest figures for the $M4^{ex}$ definition of the UK broad money stock showed a rise of 5% in the year to June, compared with 5.2% in May. The current monetary growth rate seems appropriate on a medium-term perspective given the rather subdued outlook for the growth of potential supply. One concern is that the government is crowding out the productive private sector from access to credit through the financial repression caused by excessively onerous regulations. The lending counterpart to $M4^{ex}$ declined by 0.7% in the year to June, for example. There is a serious risk that misguided additional regulatory shocks lead to a renewed downturn in money and credit, pulling the rug from under the nascent recovery.

Recent economic indicators

Annual CPI inflation rate eased to 2.8% in July, although the old RPIX target measure was still 3.2% up on the year and the 'headline' RPI and the new RPIJ showed annual rises of 3.1% and 2.6%, respectively. Core producer price inflation accelerated from 0.9% to 1.1% between June and July, and annual house price inflation on the ONS measure accelerated slightly from 2.9% to 3.1% between May and June. The adoption of LFS unemployment as the trigger for re-considering Bank Rate means that the labour market statistics have acquired a new importance. There is an interesting discussion on the merits of the various labour market indicators in the Bank's paper. The LFS measure of joblessness has been largely constant at 7.8% during the five quarters ending in April-June although the claimant-count unemployment measure eased by 2,900 in July to 145,400 down on a year earlier. Nevertheless, overall wage pressures remain weak and economy-wide earnings in April/June were only 2.1% up on the corresponding three months of 2012.

Three main reasons for an immediate rate hike

There are three main reasons for wanting a Bank Rate increase of ½% in September, accompanied by no further increase in QE. First, British interest rates will have to be normalised at some point and it is less disruptive to start the process early, and in small steps, rather than leave it too late and then have to slam on the brakes. This is the late Lord George's famous 'stitch in time saves nine' (i.e., a Bank Rate of 9%) criterion which contrasts markedly with Mr Carney's approach of holding Bank Rate until well after the recovery is firmly established. Second, the upwards revision to UK GDP in the second quarter announced on 23rd August, which meant that non-oil GDP rose by 1.7% on the year and 0.7% on the quarter – which represents an annual equivalent rate of 3% – suggests that the recovery is gathering momentum. Third, the continued large deficit on the current account balance of payments, which amounted to 3.8% of market-price GDP last year and 3.6% in 2013 Q1, is a prime face indicator that domestic demand is running ahead of aggregate supply, at least in a relative sense compared to our main trading partners.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%; no extension of QE.
Bias: To raise Bank Rate.

Bank's emphasis on demand-side shortfall is incorrect and unduly ignores the supply withdrawal

On Wednesday 7th August, the Bank of England's MPC responded to the Chancellor's Budget-time request to assess the merits of forward guidance. In so doing, it has made the most significant adjustment to its monetary policy framework since 2009 – pledging to keep Bank Rate and the size of the asset purchase programme at least at current levels until the UK's unemployment rate falls to below 7%. Currently, the rate stands at 7.8%. It is evident from the Bank's communiqué that it remains wedded to the notion that there is a high degree of slack in the economy. The assertion of unused economic capacity has been a consistent theme in Bank of *England Inflation Reports* over the past five years. During this time, inflation has been as high as 5% and persistently higher than the inflation target of 2%. Lacking a satisfactory measure of economic slack, it is impossible to test the assertion. Many survey measures of industrial capacity utilisation are close to regaining, or have already regained, the levels that pertained before the credit crisis of 2007 and 2008. The assertion of spare capacity presumes that the crisis damaged demand capability significantly more than supply capability. On the contrary, the evidence suggests that the potential growth rate of the economy has been reduced and the justification for further demand-side stimulus is invalid.

LFS unemployment a poor guide to economic slack

The LFS measure of the unemployment rate that forms the basis of the new policy framework gives only an approximate measure of the tightness of the labour market and notably fails to capture the extent of under-employment. The achievement of a 7% unemployment rate could be attained in a wide variety of economic circumstances, corresponding to different combinations of: labour participation (the proportion of the population of working age that is economically active); labour productivity (the output achieved by a unit of labour input), and labour intensity (the average length of the working week). The unemployment rate has a very loose connection to the MPC's concept of economic slack.

Nonsensical concept of economic slack

Within its own paradigm – the post-Keynesian sticky price model – the new policy framework is flawed and over-complicated. For those of us that reject the paradigm, the criticisms go deeper still. It is remarkable, twenty years after the global supply

chain revolution, that macroeconomists still have ‘slack’ as their central concept and domestic slack at that. Better to junk the whole concept of slack and work from the premise that domestic supply adjusts rapidly to global demand conditions. What business can afford to hoard productive capacity or excess inventory when the real cost of capital confronting it is positive? Unused capacity is under intense pressure to be scrapped or sold. The notion that businesses have mothballed commercially relevant spare capacity for four or more years is ridiculous. Supply chains and networks are managed such that supply conditions at the top of the chain are permanently tight. When demand disappoints, the pace of supply adjusts extremely quickly, since the storage capacity for inventory has also been managed lower over the years.

Forthcoming census-based revisions likely to cut unemployment rate

The Bank of England’s new framework makes a strong assumption about the supply response of the UK economy which conflicts with recent experience. Rather than a cyclical improvement in productivity, the outlook is for on-going stagnation or decline as overstated productivity gains in the pre-2007 period continue to normalise and as employment growth is concentrated in low-productivity jobs. In other words, the economy is rebalancing towards structurally lower average productivity. By implication, it may be possible to reach an unemployment rate of 7% quite quickly. As an aside, when the 2011 Census estimates of the UK population (roughly 1 million higher) are incorporated into the LFS, there could be an abrupt fall in the unemployment rate.

Confusion and chaos in the Bank’s paper

What starts out, within its own paradigm, as a clearly-defined framework of path-dependent interest rate and asset purchase guidance descends into confusion and chaos by the end of the statement. Three ‘knockout’ clauses are added, relating to inflation, inflation expectations and financial stability. In the case of the latter two clauses, no means of calibration are offered and hence no parameters on which market expectations can be based. Arguably, the remaining clause, which stipulates that the unemployment threshold will be scrapped if CPI inflation eighteen to twenty-four months ahead is more likely than not to be above 2.5%, is also notional. For years now, the MPC’s inflation expectations have been overly optimistic, resulting in consistent inflation overshoots. In the ten years, the MPC has not included a central expectation of inflation on a two-year horizon that breached 2.5%. This projection has been used, essentially, as a signalling device.

Pulled punches, not knockout clauses

The coup de grâce is the admission that neither the 7% unemployment threshold nor any of the knockout clauses represent trigger points for MPC action. Far from knockout clauses they are pulled punches. The MPC retains discretion over the appropriate course of action. The whole rationale for forward guidance is that pre-commitment exerts traction over the rate curve. To the extent that pre-commitment is retractable, no traction will be exerted.

Where is the Bank’s exit strategy?

Also worthy of note, is the absence of any mention of an exit strategy. In the question and answer session that followed the statement, it was stated that a rise in Bank Rate would be the first manifestation of policy tightening rather than asset purchase tapering or asset sales. In fact, the MPC goes to great lengths to emphasise that, in contrast to the Federal Reserve, tapering of asset purchases is not on the policy agenda. Indeed, the MPCs selected economic threshold of 7% unemployment rate is not expected to be reached until after 2016 according to its central projection. This is beyond its forecast horizon. This rather pessimistic projection, especially as the UK

economy gathers momentum, looks to be an overt attempt by the Committee to steer the financial markets to the timing of the first rate increase.

Prospect of higher US rates leaves MPC facing a dilemma

The announcement of the UK's forward guidance framework has coincided with the approaching timetable of tapering of asset purchases by the US Federal Reserve. So far, it is the unwinding of leverage in the US bond market, with a concomitant rise in bond yields, which is the dominant influence on the UK yield curve also. The MPC faces a terrible dilemma. Does it scream at financial markets that their interest rate forecasts are all wrong and hope to change the outcome? Or does it follow up the statement on forward guidance with an asset purchase programme designed to prise apart the short end of the UK and US curves? It is unlikely that the MPC will wait long before tinkering further.

Rate normalisation needed in 2010

Against a background of sluggish potential GDP growth and stagnant productivity, even a modest improvement in the growth outlook must be regarded as an invitation to begin the painful task of normalising the short-term interest rate. The era of ½% Bank Rate should have ended in 2010; instead it lingers on. The first steps towards rate normalisation – which might only be as far as 2% – should not be delayed. My vote is to raise Bank Rate by ¼% and to keep on going.

Comment by Mike Wickens

(University of York and Cardiff Business School)
Vote: Hold Bank Rate; no increase in QE.
Bias: To raise Bank Rate sooner rather than later (i.e., a rising forward curve) and winding down QE.

Questions arising from Bank's forward guidance paper

Mr Carney has quickly made his mark on the MPC by ushering in a change in the Bank of England's conduct of monetary policy: the introduction of forward guidance. This raises a number of questions some, but not all, of which are addressed in the Bank's accompanying paper *Monetary Policy Trade-offs and Forward Guidance* of August 2013. The main issues here are as follows. First, is this a good idea in theory? Second, how does the Bank's proposed implementation compare with what theory suggests should be done? Third, has its implementation elsewhere improved the impact of monetary policy? Finally, is it likely to improve UK monetary policy, worsen it or make no practical difference?

Forward guidance tries to operate via market expectations of future interest rates

In theory, forward guidance aims to influence the market's expectations about future short rates. In other words, it aims to affect the forward yield curve and long rates and, through these, economic activity, including inflation, output and unemployment. Instead of trying to infer current and future monetary policy from past behaviour, and so making mistakes, forward guidance, by signalling future policy intentions, attempts to align the market's views more closely to those of the Bank and so better implement monetary policy and enhance macroeconomic performance. It follows that a simple test of forward guidance is whether the forward yield curve accords with interest rate announcements.

However, such information is only beneficial if correct

Such additional information is, however, only beneficial if it is correct. The danger is that policy in the future differs from the forward guidance. This could be because economic conditions have changed unexpectedly, or because the policy objective has changed, for example, by switching from strict inflation targeting to flexible inflation

targeting in which output or unemployment or financial stability become additional targets.

Bank's 'knockout' conditions need spelling out further

In an attempt to minimise these problems, in the accompanying notes the Bank of England has tried to spell out the conditions under which it would change interest rates in the near future; it calls them 'knockouts'. The two main knockouts are a fall in unemployment below 7% and an unexpected exogenous positive shock to inflation, such as imported inflation. In the future, the Bank would need to develop a new communications strategy in which it spelled out how these conditions were being changed over time, and how it was altering its policy targets.

Forward guidance in other countries

Forward guidance was first introduced in New Zealand and Norway. Subsequently, it has been used by the US Federal Reserve. No harmful consequences have been found for New Zealand and Norway. Nevertheless, the counterfactual of whether outcomes would have been different had they not used forward guidance is difficult to assess. The initial experience of the US was that market forward rates seemed to have been little influenced by the Fed's forward guidance, and so the experiment was dropped. More recently, it has been reintroduced, but now accompanied by QE, which makes assessing the influence of pure forward guidance more difficult. This evidence suggests that forward guidance has done little or no harm, but neither has it produced any discernible benefits.

Nothing new in the UK context

In the UK, the forward guidance seems to be little more than a restatement of the policy being followed by the Bank, though not made explicit. Perhaps this is why MPC members known to favour the previous system have not opposed its introduction and were happy to let Mr Carney show publically his influence on monetary policy.

Bank's switch from 'strict' to 'flexible' inflation targeting

Nonetheless, the announcement muddies the waters of what monetary policy is trying to achieve. The Bank of England Act of 1997 and the accompanying memoranda states that the aim of monetary policy should be to keep inflation within 1 percentage point of a target value – 2% for CPI inflation – and only subject to achieving this should it aim to support the government's other objectives in output and employment. The wiggle room for the Bank was in how quickly it aimed to bring inflation back on target once it had breached the bands. The recent recession has shown that the Bank has interpreted this as indefinitely – or as long as inflation expectations are not being affected. The announcement of forward guidance has made explicit the new ingredient it has added to its policy objectives, namely, that the rate of unemployment is also a target. In other words, the Bank has formally shifted from being a strict to a flexible inflation targeter. This is despite the clear message from economic theory, which was widely accepted – including by most senior members of the MPC – that macroeconomic welfare is higher under strict rather than flexible inflation targeting. The difference is most pronounced when higher inflation is due to supply rather than demand shocks.

Disastrous history of the Phillips curve

Coupling inflation and the rate of unemployment has a disastrous history as witnessed by the demise of the Phillips curve which it turned out only held if monetary policy is accommodating. Even if the Bank does not take the view that targeting unemployment is in order to achieve its inflation objectives – which was how the Phillips curve was used – it is not clear whether the Bank thinks that by holding interest rates down it can reduce unemployment, or whether it intends to hold interest rates down until unemployment falls as a result of factors not under its control. The knockouts only add

to the confusion as they are determined by the Bank. In effect, they give the Bank complete discretion in setting monetary policy, as in the past.

Bank's approach puzzling and contrary to accepted theory

For some time, given its remit, the Bank's conduct of monetary policy has been a puzzle and contrary to accepted theory. Commentators have had to infer from its actions what the Bank's objectives are. The announcement of forward guidance has the merit of making these objectives more explicit. In effect, it has also given the Bank an additional policy instrument to accompany the short rate, namely, the long rate. For forward guidance to be effective it will be necessary to communicate its strategy for setting the long rate in a transparent way. To sum up, the best that can be said for forward guidance is that it makes the Bank's departures from its remit more explicit but it does not affect the Bank's room for discretion. As the raison d'être of forward guidance is to improve market expectations, it will be necessary either to forego the use of discretion or to communicate any change of strategy very clearly.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking)
Vote: Hold Bank Rate and keep QE at £375bn.
Bias: Neutral.

UK growth on the up

UK growth is on the up, with the revised figures showing that real GDP advanced by 0.7% in the second quarter. So far, the leading data for the third quarter – such as the PMIs for manufacturing, services and construction – suggests that growth in July/September will be similar to that recorded in the second quarter. The detail for the second quarter GDP data showed that services activity was robust, at *plus* 0.6% on the quarter (compared with *plus* 0.5% in 2013 Q1). Perhaps surprisingly, however, this was matched by strength in industrial output (*plus* 0.6% in 2013 Q2 compared with *plus* 0.3% in Q1) and outdone by construction (*plus* 1.4% versus *minus* 1.8% in Q1). The latest PMI's suggest that, with construction at 57.0, services at a ten year high of 60.2 and manufacturing at 54.6; growth is starting the second half on a strong and sustained note. Services are benefiting from a pick-up in household activity, manufacturing from better prospects in Europe (or at least a bottoming out of the downturn) and the US recovery, and construction from the revival in demand taking place in the residential housing sector helped by FLS and the prospect of Help to Buy.

But output still well below 2008 peak

Of course, the ONS pointed out that GDP was still 3.3% below its Q1 2008 peak. And private sector investment is 34% down from its pre-crisis high. Therefore, economic growth has a long way to go before it can be called robust. On top of that, it appears that it is consumer and government spending that are leading the recovery, which is hardly consistent with net debt to income ratios for households of over 140%. If business investment does not step up soon to lead the recovery, it will surely peter out or at least face significant enough headwinds to stall. We do not know what might lead to a serious shock in consumer or business confidence, it could be a crisis in Europe or some other event that by its nature we cannot forecast. However, recovery based on renewed household debt has to be seen as potentially resting on shaky foundations.

Monetary statistics indicate continued recovery

Still, the monetary statistics are supportive of a continued recovery and price inflation is slipping back. Core CPI inflation edged down to 2.0% for June, from 2.3% in May. On average, it has been around these levels for the past year, roughly in line with the trend seen in 2009. On a three-month annualised basis, the growth in $M4^{ex}$ broad

money was 4.7% in June, up from an upwardly revised 4.4% in May and ending a fall to a low of 2.8% in 2013. This means that the economic recovery is likely to persist. However, this will probably be at a pace that means that inflation is not a threat and that continued spare capacity in output and the labour market will last for some time. Despite financial market perceptions to the contrary, it is not clear that LFS unemployment will fall to 7% even in two years' time. Not least is the fact that very weak productivity, which if it picks up, say based on increased company investment and higher participation rates, means that unemployment might not fall much if at all.

Higher bond yields may persist

Higher long term interest rate might also persist – despite forward guidance – unless action is taken by the Bank of England. The improved UK economic figures; the evident recovery in the US, and hence the prospects of tapering by the US Federal Reserve, are serving to drive up longer term rates. In my view, validating the financial markets' expectations now with a rate rise is simply inappropriate. Bank Rate should stay on hold at ½%. Indeed, if the MPC is serious about forward guidance, given the challenge from financial market moves in the opposite direction to that intended by the official rate setters since its announcement, further QE cannot be ruled out.

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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