IEA Shadow Monetary Policy Committee

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IEA's Shadow Monetary Policy Committee votes by five/four margin to raise Bank Rate to 1% in February

Following its latest gathering, the Shadow Monetary Policy Committee (SMPC) voted by five votes to four to raise Bank Rate to 1% on 10th February. The four minority SMPC members all voted to hold Bank Rate at ½%. The five SMPC members who wished to increase Bank Rate did so for three main reasons. One was the threat to the credibility of the UK's counter-inflation framework if the Bank continued to ignore persistent overshoots of the 2% Consumer Price (CPI) inflation target, especially when the inflation rate perceived by many people was the 4¾% or so recorded by the various retail price measures. Another was the view that the aggregate global economy was closer to overheating than depression. The third reason for a rate rise was the belief that the depreciation of sterling had not been an exogenous 'Act of God' but that it, instead, reflected the relative laxity of Britain's monetary stance compared with other countries.

Several factors explained why four SMPC members thought that this was not a time to raise Bank Rate. One fear was that the economic recovery was so anaemic that it would be de-railed by the additional business uncertainty generated by even a small hike in Bank Rate. Another concern was that the UK banking system was so fragile that it would be incapable of generating sufficient money and credit to support recovery if the official rate went up. Both doves and hawks agreed, however, that the Basle III proposals on bank regulation were perversely pro-cyclical and risked reduced global supplies of money and credit leading to a renewed global recession. Finally, there was a fear that the hike in Value Added Tax to 20% would squeeze living standards even further, depressing household consumption.

The SMPC is a group of independent economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it is the longest established such group in Britain and meets regularly to debate the deeper intellectual issues involved distinguishes the SMPC from the similar exercises carried out by a number of publications. The February SMPC poll was largely finalized before the publication of the weak preliminary UK GDP figures for the fourth quarter on 25th January. However, the experience of other countries that had 'real' winters more frequently than Britain suggested that much of this lost activity will be recouped by the middle of this year. The next two SMPC minutes will appear on the Sundays of 6th March and 3rd April, respectively.

Chairman's comments

Forthcoming SMPC membership changes

David B Smith began the meeting by stating that it was time to recruit some new, younger members to the SMPC, which had now been in existence for almost fourteen years with most of the founder members still actively involved. He had no particular bias as to whether the new members should be primarily academic or business economists, provided that they had youth on their side. Some of the more senior members had already indicated that they were willing to step down, if suitable replacements could be found. He thought that it was now time to start the recruitment process before the present membership ended up on the great Monetary Policy Committee (MPC) up in the skies. It was agreed to invite two new members, one from the academic side and another from the professional side. Two names were put forward and the relevant Curriculum Vitae circulated. He then called on Trevor Williams to provide his analysis of the global and domestic monetary situation.

The Monetary Situation

The International Situation – Global activity positive surprises

Global activity has bounced back together with global money growth but poor loan availability remains a problem

Trevor Williams referred to his prepared slides on the *SMPC Quarterly Meeting – Recovery Slows as Inflation Rises*. He referred to the first slide which showed forecasts for world GDP, Trade and UK GDP and outcomes to date, which all showed better than expected results. Global GDP had bounced back along with a turnaround in global money supply growth. Both the US and Euro area showed a strong pick up in nominal GDP growth but the money supply, while reviving, remains weak. Emerging markets showed strong monetary growth and inflationary pressure. However, figures from the Organisation for Economic Co-Operation and Development (OECD) showed that the current recession was on a lower recovery path both from 'normal' ones and even previous recessions associated with financial shocks. The worst of the credit conditions problems may be over, however. Both American and Euro-zone credit conditions had improved since late 2008. Nevertheless, spreads continue to widen, albeit at a decreasing rate. Bank lending in the USA remained tight. Poor loan availability also continued to be an issue for the UK.

The UK Economy – output growth will weaken sharply in first quarter

How the present recession compares with earlier ones

Referring back to the charts, Trevor Williams said that broad money growth was declining but Consumer Price Index (CPI) inflation was accelerating. A comparison with historic UK recessions showed that the recovery path of the current recession was above that of the 1930s and now matched the same phase of the 1979-83 business cycle. The Lloyds-TSB Business Barometer survey pointed to a slowdown in the final quarter of 2010 and sluggish growth this year. One reason was that household real income was falling although

consumer spending had shown some revival. Exports have helped the recovery and order book surveys suggest that good export performance will continue. However, inflation is rising and inflation expectations based on the Lloyds Consumer Barometer survey had risen to a two-year high. The Purchasing Managers Index (PMI) survey of input prices suggested that inflation was unlikely to abate in the coming months. Firms were raising prices to rebuild profit margins and there was ample evidence of spare capacity in the economy. Fiscal tightening will see the loss of 450,000 public sector jobs by the end of 2014. While bond-market yield curves were signalling a rise in short rates, consumer confidence remained weak and house prices had started to fall again. Importantly, the inflation figures were not all what they seemed. The CPIY inflation measure, which stripped out the effects of indirect tax changes on the CPI, was bang on target at 2% and RPIY was at 3.5%. There was plenty of spare capacity in the economy. Now was not the time for the MPC to raise rates.

Size of state sector makes GDP an unreliable indicator for historic comparisons

David B Smith then thanked Trevor Williams for his presentation. The Chairman added that recession comparisons using GDP as the main measure may not be all that helpful now that government has such a large share of it. The OECD's figures showed that general government expenditure was 51% of UK GDP last year, with the equivalent figures for the US, Euro-zone, and OECD in total being 42.2%, 50.7% and 44.6% respectively. These were at least twice the ratios observed in the US and Britain in the late 1930s, for example. David B Smith then invited Patrick Minford to record his comments as he knew that Patrick had to leave early. Peter Warburton added that, with a return to fiscal balance a remote prospect, he anticipated that indirect taxes would rise even further.

Discussion

Fiscal tightening and QE to increase broad money growth

Money supply figures are poor indicators

Patrick Minford said that he was unmoved by Trevor's excellent presentation and that he remained consistent with his previous vote set out in the January SMPC report that Bank Rate should be raised by ½% to 1%. He did not think that the money supply figures were a good guide currently to the availability of liquidity; new external finance was now being raised largely from equities, and small firms appeared to be participating in this. He remained hawkish and posed the question, what rate of inflation would persuade the MPC to raise rates? He remained concerned about the Bank's loss of credibility and rising inflation expectations.

Other indicators suggest that there is no underlying inflation problem

Roger Bootle said that there were three arguments regarding the direction of Bank Rate. First, except for the actual inflation numbers, all the other indicators suggested that there was no underlying inflation problem and other numbers were foreshadowing weaker inflation figures. Unit labour costs had gone up with the productivity collapse at the low point of the recession. However, cost pressures were now easing as productivity recovered. Second, the money supply figures indicated a very weak economy and Quantitative Easing (QE) had not changed that. The third - and the only meritorious argument - was the one about credibility. However, he said that the Bank acting now would not do anything for its credibility but could damage the wider economic recovery.

For too long the Bank has relied on an unobservable variable – 'capacity'

Peter Warburton said that he took a different view. For too long, the Bank of England had relied on an unobservable variable – 'excess capacity' – as an argument for inflation to come down. Its own inflation forecasts had been serious under-estimates for two years. The latest story from the Bank, that hidden spare capacity would re-emerge in the economic upturn, was no more credible. It was time to switch from the old paradigm of capacity utilisation to the modern paradigm of supply-chain management. Global supply chains were pregnant with global inflation, he asserted. Private-sector inflation was coming back and people were getting used to it. An inflationary psychology was taking hold again in the UK. From the monetary side, the question was one of monetary disequilibrium, which related to the levels of money. On the evidence of the past year, there had been sufficient liquidity in the economy to allow the GDP deflator to hit a 5% annual pace. Inflation was observable and rising and demanded a policy response.

Economic agents face 'signal-extraction' problem

Kent Matthews said that he gave much greater credence to the credibility argument than Roger Bootle. He accepted the monetary argument of Tim Congdon and others that the costs of raising Bank Rate might be severe, given the weakness of broad money growth and that recovery was not fully established. The only good news was the recovery of manufacturing exports;

a sharp appreciation of sterling could damage this improvement. It was a finely balanced position but allowing inflation psychology to take hold could pose even greater long term costs. The problem was that economic agents faced a signal-extraction problem about the source of world energy and commodity price inflation and were unable to distinguish between absolute and relative prices. It was indeed the case that real factors in the emerging markets would raise energy and commodity prices and these would be relative price effects with no long-term inflation consequences. However, the global monetary argument also had force and this could explain the rise in energy and commodity prices. The signal extraction problem could lead to imperfect responses by markets. This explained the upward creep in inflation expectations to some extent. The Bank could not afford to allow inflation expectations to rise, even if the rise was based on imperfect information in its view. It was better for the Bank to be seen to be leading the market rather than reacting to it. Even though the financial markets were discounting a rate rise, in the near future, by acting sooner rather than later, the Bank could go some way towards restoring its credibility.

Bank Rate should be held, unless wage settlements start to rise

Ruth Lea said that inflation was driven by high commodity and rising input prices caused by the depreciation of sterling as well as the impact of increased indirect taxes. The Bank could not be expected to do anything about these factors. Unemployment would begin to rise. Indeed, it was already edging higher, and would stay high. She said that she would be surprised if pay settlements would respond. She said that Bank Rate should not be raised unless wage settlements start to rise.

Basle III rules will lead to shrinkage of bank's assets

Tim Congdon said that the enforcement of the Basle III rules would lead to the shrinkage of commercial banks' assets, and weaker monetary growth than would have been the case otherwise. The Euro-zone had its problems with the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain). However, he did not think that there would be a double-dip recession in the UK. There was no serious medium-term problem of inflation at current rates of broad money growth.

Votes

Votes are listed alphabetically and...

The Chairman then intervened to suggest that the voting and discussion had become unduly conjoined, with people making their rate recommendations along with the discussion. In order to restore discipline, he asked each SMPC member present to make a vote on the appropriate monetary policy response. The votes are listed alphabetically rather than in the order they were cast, since the latter simply reflected the arbitrary seating arrangements at the meeting.

...there were no votes in absentia

Since only eight members of the shadow committee were present at the meeting, Philip Booth was co-opted to vote as a ninth SMPC member, in order to eliminate the need to call for an additional vote *in absentia*. The Chairman traditionally votes last, so as not to influence the votes cast by the other members of the shadow committee.

Comment by Philip Booth

(Institute of Economic Affairs and CASS Business School)
Vote: Raise Bank Rate to 1%. Increase QE when appropriate.
Bias: Neutral.

Parallels with the 1970s

Philip Booth said that he was reminded of the 1970s when the argument was continually made that inflation was caused by special 'cost-push' factors. The Bank of England is supposed to target the CPI and CPI has been above target for some time - it is wrong to blame specific 'one-off' increases in prices for this. Philip Booth added that we should also be wary of dealing with problems such as slow economic growth - which may have other causes - by loosening monetary policy; this was another mistake of the 1970s.The rise in commodity prices cannot be completely divorced from monetary looseness, either in the UK or elsewhere. There was also a valid concern about the credibility of the UK monetary framework. He voted to raise Bank Rate by ½%.

Comment by Roger Bootle

(Deloitte and Capital Economics)
Vote: Hold.
Bias: Neutral on Bank Rate; do more QE.

Sterling depreciated before QE occurred

Roger Bootle said that the problem with Philip's argument was that the timing was all wrong. The depreciation of sterling occurred alongside the banking crisis and QE came later. He voted to keep Bank Rate on hold.

Comment by Tim Congdon

(International Monetary Research)
Vote: Hold. Continue with QE.
Bias: Neutral.

Basle III danger

Tim Congdon re-iterated his previous warning concerning the dangers of Basle III for bank lending. He voted to hold Bank Rate.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold.
Bias: Neutral.

Inflation not the Bank's fault

Ruth Lea said that inflation was caused by factors that were beyond the control of the Bank of England. She voted to hold UK borrowing costs.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate to 1%. Conduct QE if economy weakens.
Bias: Neutral.

Policy response was finely balanced

Kent Matthews said that the decision to raise interest rates was a finely balanced one. He voted to raise Bank Rate to 1% but then to hold and monitor its effect.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate to 1%.
Bias: Tighten.

Bank Rate now of little relevance to market rates

Patrick Minford had made his recommendation in the early part of the SMPC gathering as he then had to attend another meeting. He argued that the Bank needed to react to the large inflation overrun to ensure its long-run credibility. Giving such a signal would have little contractionary effect on activity as Bank Rate was now of little relevance to market conditions. He voted to raise Bank Rate to 1% with a bias to tighten further.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Raise Bank Rate to 1%. Hold QE stock at present level.
Bias: To tighten at a measured pace until Bank Rate is 2% or 2½%, then to pause.

GDP not sensible policy objective

David B Smith said that the way inflation was generated in a small open economy was through: 1) the world money supply and interest rates affecting global inflation; and 2) the relative stringency of domestic monetary policy - as opposed to the monetary stance overseas - determining the exchange rate. The weaker pound of recent years was not an exogenous 'Act of God', but a direct result of the policies adopted by the MPC. He said that the Bank's model of inflation would be improved if it had the real exchange rate as well as the output gap among its determinants and that a slightly stronger exchange rate would aid the disinflationary process. Credibility was also an important consideration when setting Bank Rate. The private sector had come through a very serious recession. Setting policy on the basis of GDP figures that reflected such a highly socialised economy was pointless. A more sustainable fiscal balance can only be restored if the private-sector tax base expanded relative to the spending of the government sector. Fortunately, private sector activity now appeared to be bouncing back quite strongly in both the OECD area and Britain in particular, and supply chains were cranking up again. From a purely tactical perspective, he regretted that Bank Rate had not been raised in 2010, some months before the 20% VAT rate was implemented, and said that February 2011 was not his preferred month for implementing a rate hike. However, the MPC was losing its credibility with large sections of the population whose perceived inflation rate was 4¾%. One reason for raising Bank Rate now, at the start of the 2011 wages round, was to demonstrate that the MPC would not remain supine in the face of further inflation overshoots. He said that there was no imperative to be over aggressive with policy but a ½% rise was overdue.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate to 1%.
Bias: Tighten.

The UK economy can cope with further rises in Bank Rate

Peter Warburton argued that there had been a strong economic case for raising Bank Rate from its emergency low rate for more than a year. An excellent opportunity to begin the interest rate normalisation process against a backcloth of vibrant output and employment growth had been wasted last summer. The Bank's inflation gambit had failed and its credibility was at issue. If for no other reason, Bank Rate should rise by ½% rise immediately to restore faith in the inflation mandate. The Bank should look through any weather-related economic weakness and seek to bring its discount rate back to 2% as soon as was prudently possible. Should the economy suffer a material setback during the course of this year, the more appropriate remedy would be another dose of QE.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold.
Bias: To loosen via QE if economy weakens sharply in first half 2011.

Bank should hold its nerve…

Trevor Williams said that he accepted the points made about the confusion between relative and absolute prices. This does have an impact on credibility. However, it is for the Bank to carefully explain the argument that inflation factors are temporary. The Bank should hold its nerve and put rates on hold. The UK is not benefitting from the upturn in world economic growth. The monetary situation is bleak. He voted to keep Bank Rate on hold and be prepared to re-engage in QE if the money supply continues to contract.

Further Comment by David H Smith (*Sunday Times*)

The chairman then asked the non-voting *Sunday Times* observer, David H Smith, if he had any comments to add based on his own extensive observation of the UK economy.

David H Smith said that it had been an excellent debate. He did not agree with his namesake that GDP was a meaningless concept or that the government sector was so large as to make the measure meaningless. The Bank of England faced an inflation problem and a forecasting problem. However, the main problem for the Bank was one of communication. The Bank needed to explain the turbulence in inflation and the reasoning behind its policy inaction.

Policy response

1. A five to four majority of the shadow committee felt that Bank Rate should be raised by ½% to 1% on Thursday 10th February.

2. Three of the rate raisers had a bias to tighten further.

3. Three out of the nine voted to hold QE as a policy contingency if the economy worsened further.

4. One member felt that QE had run its course and further action was required.

Notes 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.

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 current members of the Committee include: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), Andrew Lilico (Policy Exchange and Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Gordon Pepper (Lombard Street Research and Cass Business School), Peter Spencer (University of York), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds TSB Corporate 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 nine votes are cast.

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