IEA Shadow Monetary Policy Committee

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IEA's Shadow Monetary Policy Committee votes by six vote majority to raise Bank Rate to 1% in March

Following its latest gathering, the Shadow Monetary Policy Committee (SMPC) voted by six votes to three to raise Bank Rate to 1% when the official rate setters next meet on 10th March. All three dissenting SMPC members wanted to hold Bank Rate at its present ½%. The SMPC members advocating a ½% increase in Bank Rate did so for three main reasons. A repeatedly mentioned one was the threat to the credibility of the UK's counter-inflation framework if the Bank went on ignoring persistent overshoots of the inflation target. The concern was that it would eventually require a more aggressive and disruptive monetary tightening if credibility was lost than if Bank Rate went up immediately. Three SMPC members also questioned the Bank's reliance on a closed economy 'output-gap' model of inflation rather than an open-economy model in which sterling had a major role to play in determining the price level and was a crucial transmission mechanism through which monetary policy affected the economy. The third concern amongst the SMPC hawks was that accelerating inflation was covertly and inappropriately reducing the real rate of interest, and that this could itself lead to a self-feeding upwards spiral in the rate of price increase.

One explanation of why other SMPC members thought that it was better to hold Bank Rate was the apparent weakness of UK activity in late 2010. Nobody doubted that the negative fourth-quarter growth figure was distorted by December's severe winter weather. However, the doves believed that there had been either a 'growth pause' or a small fall once the weather distortion was removed. The counter view was that reduced oil production, a worsening in the trade deficit on real non-oil exports, and a growth in the negative national accounts discrepancy had also distorted the figures and that real private-sector home demand was still recovering at a satisfactory pace. Other reasons for wanting to hold rates were the slow growth of broad money and concern about the possible consequences of the government's fiscal retrenchment.

The SMPC itself 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 body in Britain and meets physically to discuss the issues involved distinguishes the SMPC from the similar exercises carried out by several publications. The next SMPC minutes will be published on Sunday 3rd April.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold.
Bias: Strong bias to a ¼% rise.

Worsened economic outlook

Over the last two to three months, the economic outlook has worsened in two very obvious ways. The final quarter 2010 GDP data were very disappointing, even after discounting the impact of the well-publicised bad weather. There were expectations that the Office for National Statistics (ONS) might have revised the preliminary estimate in a favourable direction in its second estimate. However, the opposite happened and the Government statisticians now estimate that GDP fell by 0.6% in the quarter. Within the components, household consumption and fixed capital formation both slipped back – both affected by the weather. However, it is noteworthy that the growth of household consumption was less than 1% in 2010 as a whole, because consumers' real incomes were squeezed by prices outstripping earnings and higher taxes. Government consumption was the most buoyant component in the final quarter, but this is set to reverse as fiscal retrenchment begins to squeeze the public sector this year. Net exports continued to disappoint in the quarter (and indeed for 2010 as a whole). Exports growth was commendable, but was outstripped by the increase in imports. On present form, it is hard to see quite how this component of demand will deliver the contribution to GDP growth over the next few years that the Office for Budget Responsibility (OBR) expects.

Signs of recovery this year may just be 'noise'

Indicators so far available do suggest that there was some bounce-back in activity in January. But how much of this was 'noise', and how much an improvement in underlying activity, is impossible to say at present. In the meantime, unemployment is rising. It was some 44,000 higher in 2010 Q4 than in Q3. Unfortunately, inflation has also taken a turn for the worse, mainly reflecting rising global commodity prices. The turmoil in North Africa adds to the uncertainty over oil prices. Consumer Price Index (CPI) inflation was 4% in January and the Bank's forecasts suggest that it could rise towards 5% in forthcoming months. Higher indirect taxes have also added to CPI inflation. The ONS's estimate of year-on-year CPI inflation excluding indirect taxes (CPIY) was just 2.4% in January, though this does look on the low side. Nevertheless it is clear that the increase in prices inflation is being driven by factors outside the Bank of England's direct control.

Delphic Mr King

The worry is, of course, whether higher price inflation lifts medium-term inflation expectations and/or wage settlements. On the former the Governor of the Bank was tantalisingly Delphic at his February Inflation Report conference. *"The experience of above-target inflation may materially push up longer-term inflation expectations. Or it may not. Only time will tell"* he said. On the latter, earnings growth has remained subdued but recent surveys suggest that pay settlements might pick up modestly in 2011. I do not expect a significant 'wage-price spiral' to materialise in the foreseeable future, however, given the current economic uncertainties.

The Bank's dilemma

The Bank of England is in a dilemma, torn between a weak real economy and above-target inflation. My central view is that the Bank should start ticking-up interest rates fairly soon, not least of all to 'normalise' them from the emergency ½% level originally agreed in March 2009. If the first quarter GDP figure (due out at the end of April) suggests that growth has resumed, then May looks an appropriate time to increase Bank Rate to ¾%. However, and before then, I vote to keep the official discount rate at its current ½%.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate to 1%.
Bias: To raise and to hold QE.

US Federal Reserve's lax monetary policies have induced food price rises that have de-stabilised the Middle East

Monetary policymakers face an unenviable task, and lack adequate guidance. Broad money growth picked up a little towards the end of 2010, but was still low at 2.3%. The economy contracted by 0.6% in the end quarter of last year and yet we have inflationary pressures that are partly, though by no means wholly, accounted for by an increase in the velocity of circulation of money. The US Federal Reserve's second phase of quantitative easing has set off a commodity scramble amongst developing countries, with oil and food prices rising. These rising food prices have then been a contributory factor to the civil unrest in the various Arab states, feeding back into further oil price increases. The UK could, of course, have insulated itself against import price inflation by tightening so much that the pound appreciated. However, this might have come at the expense of net trade and thus even less growth through the course of 2010 than we actually saw. Furthermore, Britain has just commenced upon a very significant fiscal contraction, with spending scheduled to fall by close to one fifth, relative to GDP, over the current Parliament. This fiscal tightening should have been accompanied by additional quantitative easing, from June 2010 onwards, but the natural window was missed. It is easy to understand why the Monetary Policy Committee (MPC) has felt paralysed from acting in either direction - neither raising interest rates nor doing additional QE, when in fact it probably should have done both. Doing additional QE would have been difficult from a presentational perspective with inflation above target and some growth being observed through mid-2010, whilst raising interest rates would have been difficult to justify when the economy fell back into contraction.

Quadruple failure of UK inflation targeting regime

The MPC cannot be expected to manage everything about the economy alone. Under the operational independence framework for the Bank of England, it is supposed to be set an inflation target by the government that it then attempts to meet. But the inflation target in the UK has failed, in four key ways. First, it has produced a huge asset price cycle to which the framework had no response. Second, the top-end of the target was effectively redefined in 2007, and then all-but continuously exceeded thereafter. Third, a monetary policy framework only has meaning if it constrains policymakers to actions that they would not pursue absent the framework. However, the UK's inflation target has not constrained the MPC at any meeting since the summer of 2006. Finally, the only putative advantage of an inflation target over a price-level target is that an inflation target can be changed each year. However, it has become politically almost impossible to vary the target - missing the target has become preferable to resetting the target to a level at which it constrains action. The consequence is that the target has become degenerate.

MPC has made no attempt to prevent inflation going above 3% in recent years

For some years now - but especially in 2008, 2010, and 2011 - the government of the day has been setting the Bank targets of 2%, with an error band of 1% either side, that almost nobody considered it a good idea for the MPC to try to adhere to. The MPC has duly made no attempt to prevent inflation being above 3%. Then, and in letter after letter, Mervyn King has written to Chancellor after Chancellor stating that inflation is above 3% because it would have been a bad idea to try to keep it below 3%. And Chancellor after Chancellor has accepted that that was fine - not a single admonishment for consistent missing of the inflation target has come from any occupant of No. 11 Downing Street. The UK's inflation target has become nothing more than an explanatory device. When has it constrained policy since 2006? What monetary policy decision has the Bank taken since 2006 that it would not have taken if it had not had an inflation target to meet? In what sense is the UK's inflation target a framework of constrained discretion, as an inflation target is supposed to be? The essence of the credibility of a target is not that economic agents have a vague generalised sense that the Bank cares, a bit, about inflation. The credibility of a promise is that one will try to keep the promise whether one wants to or not. The inflation target has no credibility in precisely this sense: that nobody believes that the MPC will attempt to try to stick to the target if it does not want to. This is because repeated and sustained experience tells us that the MPC does not try to stick to the target when it is inconvenient to do so and that there are no consequences for the MPC from missing it.

Something must give if credibility is to be restored

Something must give if credibility is to be restored. And it is crucial that credibility is restored, for there will need to be a concerted effort to get inflation down in 2012, with serious rises in interest rates – these will need to be much, much faster than is currently priced in or even discussed - and the cost of getting inflation down, in terms of unemployment rising and GDP lost, will be less if credibility is greater. The least attractive, indeed, disastrous, course would be to attempt to enforce the target already in place. It would probably be best – and, indeed, most feasible and straightforward - for the government to replace the inflation target with a price-level target, declare that the new price-level target would be enforced, and then enforce it properly. Alternatively the government could, for 2011, adjust the inflation target to something that it does believe it would be appropriate for the MPC to try to deliver upon, and then enforce the target.

Nominal interest rates should rise to offset the cuts in real rates implied by accelerating inflation

These are matters for Mr Osborne. For now, the MPC must decide how to proceed with the unconstrained discretion it possesses. Much press discussion is very confused. There is no-one that wants actually to tighten policy - which would entail raising real interest rates. Even were there to be a 1% rise in rates by mid-year, inflation-adjusted interest rates by then would still be lower than in mid-2010. The only issue before us is how much lower we permit real interest rates to go as inflation surges up. In my view, we should take the opportunity of falling real interest rates to try to get nominal rates back towards their natural floor at about 1.5%. This is not about tightening, for two reasons, at least. First, raising rates to 1.5% would only return them to a natural zero level, reconnecting Bank Rate to the monetary transmission mechanism and reducing the margin subsidy creates by below-floor Bank Rate. Second, even raising interest rates by 1% will not keep pace with the rise in inflation. Let us begin with a half-point rise, and take matters from there.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate to 1%.
Bias: To raise Bank Rate again. QE to remain on standby in case the economy turns down further.

There are good reasons for delaying a rate hike

There are plenty of good reasons for why a rise in the rate of interest should be delayed. The economy is far from recovered from the depths of the recession. The pace of recovery in 2010 was much less than was originally thought with the fall in output in the last quarter being worse than the flash estimate. Consumer spending was flat in the fourth quarter but importantly business investment fell back reversing the gains in the third quarter and hope that QE was beginning to filter through to domestic demand and the real sector. Earnings growth, at around 2%, remains muted in all sectors so underlying inflation shows no immediate prospect of taking off, and the news from the job market is not an encouraging one.

But need to preserve monetary credibility has to take precedence

So why would an interest rate rise at this juncture be at all appropriate? The argument for a rise is one of credibility. If the Bank of England believes that the factors driving up headline inflation are temporary, they have failed to get this message over to the markets, which have signalled a systematic rise in inflation expectations. The mounting expectations of an immediate interest rate rise may have halted temporarily with the news of the worsening economy. However, anticipations of a rate rise will gather pace at the next sign of cost pressure. The problem for the Bank is that the costs of a rate rise are already building up through the expectations effect. Sterling is strengthening and investment possibly delayed. The Bank of England is in the unenviable position of overseeing an economy that is adjusting to a rate rise that is yet to happen and will take the flak for a policy that is still waiting in the wings. It might just as well try and salvage what little credibility it has left and raise rates now instead of waiting any longer.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate to 1% and hold QE.
Bias: To raise Bank Rate further and reverse QE.

Achieving inflation targets should be Bank's only objective

Various commentators have been focusing on the potential weakness of the economy as a reason for holding interest rates down, and therefore have been thinking of monetary policy purely in terms of the short-term trade-off between inflation and growth. However, this trade-off is dominated in the Bank's remit by the requirement to keep inflation on target over the medium term. This responsibility comes ahead of any short-term objectives for growth or unemployment. The inflation target is the Bank's only objective technically. It has to satisfy it and only then, if it does so, may it look at issues of growth and unemployment. The problem for the Bank is that it has now failed to satisfy it for three out of the last four years. Hence it has failed to keep inflation on target 'over the medium term'. In the current year and probably next year it will again fail almost certainly, and by a wide margin; hence its failure is now systematic.

Nasty outbreak of 'time-inconsistency'

What we are witnessing is a nasty outbreak of 'time-inconsistency' in which the Bank argues that it should allow this failure to continue because if it were to bring inflation down it would damage growth. It uses weasel words like 'inflation is caused by factors beyond its control'; these words are nonsense since it can perfectly well bring inflation down with the factors that are under its control. Inflation in total is under the Bank's control - full stop. However, what the Bank has decided is that inflation above target does not matter compared with growth.

Time for sobriety

This is a bit like an alcoholic saying that one more drink does not matter because in the medium term he will be sober. But of course an alcoholic ought to obey rule-based behaviour, if he wants to be cured - i.e. in his case not to drink at all. The Bank needs to remember it is subject to a rule, i.e. that it has to control inflation to a target systematically, 'over the medium term'. Now, of course, it says it is doing this by promising to do it in two years' time. However, sincerity about the future is not enough. For it to be behaving according to this rule, it must be seen on average to achieve its target. This it is not doing. Hence, inflation expectations are rising and commentators such as Jeremy Paxman on the TV programme *Newsnight* publicly question whether the target is meaningful and is told by reputable economists that it is 'not binding'.

Dangerous stuff

This is dangerous stuff; far more dangerous than whether growth will be somewhat reduced by money tightening now. Look at it this way. The UK has spent thirty-odd years of sweat, lost output and general political capital getting inflation under control and getting agreement from society as a whole that inflation should be kept down at 2% as a primary target of government policy. Ordinary people who do not understand economics have come as a result to accept this as an axiom of economic policy, not to be questioned. We call this state of affairs 'credibility' of a fundamental economic policy, much as we treat the credibility of the 'rule of law', another basic institution of UK society. We obey and implement laws with a literalness and seriousness that leaves continental observers incredulous; for them EU law for example is partially disregarded, but here it is treated on a par with all our law - because the rule of law is a strong institutional pillar of our society.

Bank's credibility at risk

The Bank is putting this institutional capital at risk with its casual talk of current trade-offs and its endless violation of its target. It may be – since we do not really have a good model of how credibility is created and destroyed - that it will get away with it. Or it may be that it will, in a matter of a year or two, completely destroy the framework that has been erected with such pain over three decades. The point is that this risk is just not worth taking. This is why in this particular comment I will not talk about the short-term outlook. I will simply argue on the credibility issue that it is time for the Bank to take no further risks with it and do something. As it happens its first moves to raise rates will not be very painful; but they will be far from a 'futile gesture'. Rather they will be a cheap down payment on a new direction in which they give notice that inflation will be brought down and in a matter of months not years. We need a return to rule-based behaviour by the Bank. The next move in rates should be a rise of ½%, with a bias to raise further. There should be no further QE, with a bias to reversal.

Comment by Gordon Pepper

(Lombard Street Research and Cass Business School)
Vote: Hold Bank Rate.
Bias: Hold QE in reserve.

Mr King's wider responsibilities

The Governor of the Bank of England has wider responsibilities than those as Chairman of the Monetary Policy Committee, for example, to prevent the UK from following the path to financial crisis trodden by Greece and Ireland. Whilst it is legitimate for members of the Monetary Policy Committee (MPC) to differ from their Chairman, they run the risk of being impertinent if they criticise the Governor. Are they also going to criticise the International Monetary Fund (IMF) and the US Secretary of the Treasury for indulging in UK party politics?

Invalid criticisms and legitimate concerns

Commentators in general may also be criticised. The quarterly GDP figures are an erratic series; the first published estimates are frequently revised; and the revisions may be substantial. Commentators who blow from hot to cold about the economic outlook because of a fluctuation in the latest data are ridiculous. A legitimate worry, however, is that inflationary expectations will rise because people fail to distinguish between a jump in the price level and inflation. It is certainly the job of the MPC to stop the former from turning into the latter but monetary policy cannot prevent an increase in UK prices that is caused by commodity prices rising in US$ terms - this is distinct from that part of the rise in sterling terms that is due to a fall in the external value of the pound, which is affected by monetary policy.

Economic slack should prevent current jump in price level becoming inflation

The current amount of slack in the economy, fiscal tightening and little money available for expenditure on goods and services should be sufficient to stop the jump in the price level from becoming inflation. In the past action to manage expectations that conflicts with reality has usually been proved wrong in other than the short run. In my judgement there is not yet sufficient evidence to justify an increase in interest rates. The data for wage settlements have, for example, not yet responded to the increase in the price level. I side with the Governor.

Oil price chaos

For those who disagree, an extreme case clarifies the issues. Suppose that chaos in the Middle East extends to major oil wells, which close down, leading to an acute shortage of oil, the price of which doubles. Should the MPC really increase interest rates because of the resulting rise in the UK consumer price index at a time when the shortage of energy is threatening a very serious worldwide recession?

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Raise Bank Rate to 1%; hold QE at present level.
Bias: To raise Bank Rate again.

Losing the war against inflation

Nothing puts a military alliance under more pressure than the prospect of defeat. It is not surprising that some dissonance has arisen within the MPC given how badly the war against inflation seems to be going. Fortunately when they invented the jury system – which is the essential model for the MPC - the Anglo Saxons produced an institution that could accommodate a wide range of views while delivering a clear verdict at the end of the process. A 'not in front of the children' attitude to free and open debate may be more comfortable for the officials involved. However, it does not make for better policy making. Consensual 'group think' is always dangerous. The British economy would be in a better position if an earlier generation of MPC members had questioned the restricted inflation targeting mandate and the unduly limited range of monetary policy tools allocated to them under the 1998 Bank of England Act. The nation would also be better off if dissident MPC members had requested prudential increases in capital and liquidity requirements in the mid 2000s, when there were clear signs that the credit excesses of the Heath-Barber and Lawson booms were being repeated. However, the most likely result of increasing capital and/or liquidity requirements - now that it is far too late to avert 'boom and bust'- will be a damaging increase in credit rationing, which will make the recovery from the recession even more problematic.

Is Britain a small open economy or a large closed one?

At the heart of the debates on the MPC seems to be a divergence of view as to whether Britain should be predominantly regarded as a small, open, trade-dependent economy or as a large closed economy, similar to the US or the Euro-zone. In practice, all economies are a hybrid of both, so the debate may be about the relevant weightings to attach to each approach. In a small, open economy, the logarithm of the domestic price level should eventually settle to equal the logarithm of the overseas price level minus the logarithm of the exchange rate. This seems to be the analytical approach underpinning the views of the MPC's most hawkish member, Andrew Sentance. In a pure closed economy, there is no exchange rate to worry about, and the output gap arguably becomes the dominant influence, if one is prepared to ignore the stock of money. Even so, the different time-series properties of inflation and the output gap mean that the output gap can only affect the rate of change in inflation, not inflation itself. This need not be an insurmountable problem because inflation can then be related to the cumulated past history of the output gap. However, the output gap approach can still be rendered irrelevant if there are frequent large shocks to aggregate supply. People have also questioned whether the output gap model of inflation can be applied to a primarily service orientated economy, where the concept of full capacity is more nebulous than in old-fashioned metal bashing.

Output gap operates at the global level and exchange rate is a key influence on UK inflation

In practice, the world economy appears to be so integrated that the output gap works at the level of the aggregated world economy, to the extent that it operates at all, while the UK itself lies closer to the small, open economy paradigm than it is to the large closed economy model. The two implications are that: 1) the purely domestic output gap is unlikely to have a strong effect on British inflation; and 2) the external value of sterling has a powerful influence on UK prices in the long run. This does not mean that both the output gap and the open-economy determinants of the price level – overseas prices and the exchange rate – cannot be included in one 'error-correction' model (ECM) of the UK price level. Simply relying on the output gap alone, however, leads to a castrated and incomplete ECM in which neither the price level nor the inflation rate are properly determined. Such a model will almost certainly understate inflation when the pound is trading well below its equilibrium level.

Bank Rate should have been raised in 2010 and recent inflation figures are genuinely poor

From a tactical perspective, it is a pity that the Bank of England did not move towards a 'half-normal' Bank Rate of, say, 2% to 2½% in 2010 before the VAT hike took effect and recent turmoil in the Middle East had pushed up the price of oil. Such a hike would probably not have trickled too far down the money-market yield curve given how far Bank Rate appears to be a slack variable in the system. However, it would have demonstrated that the MPC was committed to its inflation target and might have helped to tether inflation expectations. However, that is water under the bridge. The question now is where we go from here. The first point is that recent inflation figures are pretty poor, even if one does not accept that CPI and RPI inflation have been understated because of the failure to properly allow for clothing price increases (see: page 39 of the February 2011 Bank of England *Inflation Report* for details). As they stand, the official ONS figures show that: annual CPI inflation was 4% in January; both the all-items RPI and RPIX were 5.1% up the year, and the yearly inflation in the 'double-core' RPI, which excludes mortgage rates and house prices, was 5.2%. Much of this inflation can be arguably attributed to higher indirect taxes. The CPIY measure, which excludes indirect taxes, was only 2.4% up on the year in January, while its retail-price equivalent, RPIY, was 3.8% higher. However, the 'Y' measures are virtually unknown to the general public and are irrelevant where wage bargainers, domestic savers and overseas investors are concerned.

Fourth quarter GDP figures not as weak as they look

One reason for not wanting to raise Bank Rate is the apparently weak fourth quarter national accounts data published on 25th February, which revised the weather-distorted contraction in real GDP in 2010 Q4 from 0.5% to 0.6%. However, on closer inspection the figures are not as poor as they look. Furthermore, the large negative contribution from net exports at a time when world trade is bouncing back and sterling is highly competitive suggests that the UK economy is badly supply constrained. This poor supply elasticity has almost certainly resulted from the damage done to the productive base by a decade's feckless tax-and-spend policies. In particular, while headline GDP rose by only 1.3% on average last year, and by 1.4% 'through the year' (i.e. fourth quarter to fourth quarter), the non-oil component of GDP showed equivalent increases of 1.6% and 1.7%, respectively, and the volume of private domestic expenditure – which had contracted by 10.9% in 2009 – showed an annual average increase of 3.6% in 2010 and an increase of 4.6% through the year. The main reason growth was not faster was the deterioration in the deficit on real net exports. This knocked 1 percentage point off the aver-

age growth of real GDP in 2010 and 0.9 percentage points off the growth rate through the year. One odd thing about the ONS figures is the growth in the negative statistical discrepancy between 2009 and 2010, which reduced growth by 0.4 percentage points on both an annual-average and through-the-year basis. It may be unduly harsh to claim that anyone who trusts the initial ONS estimates probably also believes that fairies live at the bottom of the garden. However, there are grave problems with the national accounts, which are illustrated more fully in the Power Point presentation *Uncle David's Chamber of Data Horrors*
(available from www.xxxbeaconxxx@btinternet.com).

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate to 1%; no extension of QE at present.
Bias: To raise Bank Rate further.

MPC's intransigent members

The intensification of global inflationary pressures has added to the UK's embarrassing departure from the official inflation objective. Over the next three months, the headline CPI inflation rate might reach 5%. The rationalisations provided by the Governor of the Bank of England in a recent speech have fuelled the debate over the seriousness of the inflationary outbreak and accentuated the divisions within the MPC. The latest *Inflation Report* conceded little to the contrary view that higher inflation was liable to persist without corrective action. To assume that Bank Rate will be raised in line with the profile implied by the money market curve is to believe that MPC members are unified in a course of action. The intransigence of some members suggests that there should be no presumption that the MPC will secure a majority in favour of a Bank Rate rise at all soon.

Bank's forecasting model is woefully inadequate

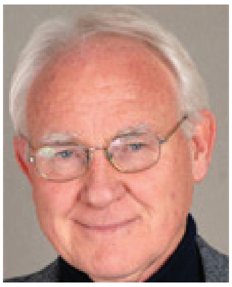
For my part, much of this intransigence is the result of overconfidence in the model used by the Bank of England to simulate the behaviour of the UK economy. I believe that this model is woefully inadequate in several respects and provides an unreliable guide to likely inflation outcomes in the UK. The re-ordering of the global economy and the advent of supply chain management in the 1980s calls for a radically different characterisation of the production process, the management of inventory, the role of modern logistics and powerful new technologies of supply management and control. It is little short of insulting to persist with the archaic characterisation of the economy as a giant factory, as implied by the output gap paradigm.

The new supply-side paradigm

The modern reality for Britain, as it will become for other developed economies, is that large global corporations or domestic conglomerates dominate the distribution of goods and services and manage their supply chains so as to retain pricing power and preserve profitability. The forces of effective competition have been in secular decline for more than a decade, but it has taken the global credit crisis to reveal their inflationary overtones. Currency depreciation has highlighted the transformation in supply elasticities that have accompanied the new supply-side paradigm.

MPC has missed its opportunity to address inflation concerns

The MPC is heavily compromised in its policy actions by its adherence to the failed paradigm of the negative output gap. Having refrained from the commencement of the normalisation of Bank Rate during 2010, the decision has become complicated by the erratic data points in the fourth quarter of last year. The very weak reading for UK GDP in 2010 Q4, of a ***minus*** 0.6% quarterly change is distorted to an unknown degree by severe December weather. A better sense of the underlying growth rate of the economy will not be known until the latter part of April. While economically justified, interest rate increases have become politically unpalatable. The Bank of England has missed its moment to address inflationary concerns and the consequences of this neglect may well become a cause of great regret in future. Sterling is a vulnerable currency and its fortunes should be carefully observed. My vote remains for a ½% increase, with an end-year target of a 2% Bank Rate.



Comment by Mike Wickens

(Cardiff Business School)
Vote: Raise Bank Rate to 1%.
Bias: Hold at 1% in short term. Rates will need to rise further in longer term.

Key issue is how seriously MPC regards its inflation remit

The key issue for the MPC continues to be how seriously it regards its remit to achieve a target inflation rate of 2%. For five consecutive quarters, the Governor has had to write to the Chancellor to explain why inflation is above 3%. Each time he has argued that inflation is only temporarily above target and is expected to fall back soon. The current *Inflation Report* admits that this might take over a year. It is significant that, in its response to the Governor, the new government has not objected to inflation being above target. With the recent increase in VAT, perhaps the Chancellor feels he is not in a strong position to do so. Nonetheless, there is increasing concern that inflation expectations are rising, something that would undo much of the past achievements of the MPC.

MPC is sitting on its hands, waiting for something to turn up

There are two main reasons why inflation has risen over the last year or so. One is the VAT rise. The other is the increase in commodity prices. In other words, demand, which has been weak, is not the cause, although the *Inflation Report* shows that it is strengthening and expected to continue to do so. The intellectual basis for inflation targeting is the use of interest rates to control demand. As demand is not currently a problem, the MPC appears to be sitting on its hands and waiting for something to happen. There is, however, an alternative strategy. As inflation is largely due to the price of imported commodities and these are priced in foreign currency, mainly the US$, the obvious policy is to appreciate sterling by raising interest rates. In the process this would reverse the fall in sterling over the last two or more years that has made UK inflation so vulnerable to commodity price increases. An appreciation of sterling might reduce the demand for exports and hence output. Nevertheless, with UK export markets recovering strongly, especially in the Far East, income growth abroad will almost certainly dominate the higher cost of UK exports.

The US model of central banking does not apply to the UK because of Britain's openness and the Fed's more flexible mandate

To judge by the amount of discussion of the role of sterling in the current *Inflation Report*, the MPC does not appear to have taken into account that the UK is an open economy with a floating exchange rate. Nor does it seem to realise that its own model shows that the exchange rate channel is the most important in the transmission of monetary policy in the short run. Those with a long experience of the UK economy know this only too well. The US is a flexible inflation targeter and has a relatively closed economy in whose currency most commodities are priced. This means that it does not provide a good exemplar where the UK is concerned. In the longer term, the correct response to a worsening terms-of-trade is to adjust to relative prices. These may entail currency depreciation. However, and in the short term, a country like the UK that is in principle a strong inflation targeter should appreciate the exchange rate by raising interest rates. Doing nothing either suggests a lack of understanding of how an open economy with a floating exchange rate should behave, or that the MPC does not take its remit seriously.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold Bank Rate.
Bias: To ease via QE.

Highly unlikely that UK is on the verge of a major 1970s style inflation episode

Despite the legitimate worries about price inflation - after all, the headline rate was 4% in January, twice the target rate of 2% - the steady drift towards increasing interest rates will make a bad situation worse. The economy is not growing and the fear about inflation could lead to a rise in rates that could lead to renewed recession. In particular, it seems highly unlikely that the economy is on the verge of an inflationary episode to rival that of the 1970s or 1980s, even if this is being obscured by the shift in relative prices that is globally underway. That having been said, a number of events in the last few days and weeks ought to give pause to the growing cacophony of noise to raise rates. Start with the latest GDP figures for 2010 Q4, which showed after the recent revisions a larger fall of 0.6% rather than the initial 0.5%. This meant that, real GDP contracted by 0.1% in the fourth quarter without the 'snow effect' and not the flat outcome reported earlier.

Output is essentially stagnant

The indications for the first quarter of this year are that there is some growth bounce back underway, following the weather-related shock of 2010 Q4, but that its extent is highly uncertain and less than the assumption of 0.8% growth made in the Bank of England's February *Inflation Report.* Instead, the economy may essentially still be stagnant in 2011 Q1 when adjusted for the 'snow effect' of 0.5%. Of course, those that worry about inflation will not be swayed by arguments about growth. The point for those that want to see higher Bank Rate is that price inflation is above target and has been so consistently for some time. This is felt to be undermining the authority of the MPC because it is not being seen to react to its remit to keep inflation at 2% in the medium term. And this will lead to its job being harder in future, meaning that it will have to keep interest rates higher for longer than otherwise to keep inflation on track. However, this analysis is the wrong way round, in my view. Reacting to relative-price shifts by pushing the economy into renewed recession would: 1) lead to a fall in domestic prices as internal deflation is used to offset imported price inflation; 2) undermine the MPC's position and make its job harder as its apparent lack of proportionality leads to calls for it to be reformed, and 3) perhaps, cause the Bank to be deprived of its operational independence to set rates if it loses public trust.

Latest oil price shock will be more deflationary than inflationary

Unfortunately, another shock is coming from the soaring oil prices as a result of the democratic movements sweeping away dictators in the Middle East and North Africa. With economies in the advanced nations weak, the effects of the higher oil prices should be more deflationary than inflationary. The risk, though, is that it is the fear of inflation that might win out, because oil prices are likely to keep consumer prices in the UK higher for longer at a time of heightened concern.

Monetary policy is only tool available to offset recessionary forces

With consumer confidence declining, business confidence is at risk of a fall and with it industrial output. Unemployment is set to be under upward pressure as the fiscal squeeze starts in earnest from April and May, meaning that the private sector may not be able to take up the slack. With wage inflation weak, and under pressure from rising unemployment, there is little risk of a wage-price spiral. What is more, with no possibility of a looser fiscal policy in the form of tax cuts or spending increases to offset the cut in income from the rise in oil prices, only monetary policy is in a position to take the strain. In practice, this means keeping official rates where they are in the face of the rise in oil prices. Money supply growth and the pace of UK export growth do not seem sufficient to offset the deflationary headwinds the economy currently faces. For these reasons, Bank Rate should remain on hold.

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.

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 (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.

Forthcoming membership changes

Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School) and Akos Valentinyi (Cardiff Business School) will be joining the SMPC in April 2011 and Peter Spencer (University of York) will be retiring after fourteen years as a member. Peter Spencer's valedictory submission will appear in the April SMPC poll.

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