# IEA Shadow Monetary Policy Committee

## March 2015

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# Shadow Monetary Policy Committee votes six/three to hold Bank Rate in March

The Shadow MPC has voted to keep rates on hold, entrenching its reversal, at the last meeting, of its long-standing call for rate rises.

Those favouring a hold included members arguing that there is no inflationary pressure and/or that the recovery is not sufficiently rapid that the economy needs or could tolerate rate rises. Others contended that with inflation so far below target, with the notional inflation target (misguidedly) expressed as it is, rate rises could not be considered compatible with that target. One member urged, vigorously, that there should be a band of short-term discretion set around the inflation target that constrains how far it is permitted to deviate from target in the short-term, set at a level that the Chancellor wants met and is prepared to enforce.

Those advocating raising rates have emphasized that the strategy of maintaining near-zero rates has been damaging to real economic growth, to productivity growth, to the pressure to achieve a sustainable fiscal position and to longer-term financial stability. Low monetary growth has been the result of excessively strict prudential and liquidity regulations imposed upon banks. Monetary policy-makers should not collaborate in such financial repression.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. To ensure that nine votes are cast each month, it carries a pool of 'spare' members. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a result, the nine independent and named analyses should be regarded as more significant than the exact overall vote. The next two SMPC e-mail polls will be released on the Sundays of 5th April 2015 and 3rd May, respectively.

## Votes

## Vote in by Roger Bootle

**(Capital Economics)**
**Vote: Hold base rate. Hold QE.**
**Bias: Neutral**

## Vote by Philip Booth

**(Institute of Economic Affairs and Cass Business School)**
**Vote: Raise Bank Rate ½%. No further QE.**
**Bias: To raise, and as broad money rises to withdraw QE.**

## Vote and Comment by Anthony J Evans

**(ESCP Europe)**
**Vote: HOLD**
**Bias: Raise once inflation returns to the 1%-3% range**

**With an inflation target of 2% it is hard to justify a rate rise with inflation of 0.3%**

Continuing low rates of inflation make interest rate decisions in an inflation-targeting regime difficult. On the surface, there should be a clamour for expansionary monetary policy. In the year to January 2015 the CPI grew by just 0.3%, which was even lower than for December 2014. Policy makers must attempt to disentangle whether this is a supply side or demand side phenomenon. If they get it wrong, the results would be catastrophic. However it seems highly likely that this is driven by a falling oil price, which presents good news for consumers since it constitutes a positive supply shock. Policymakers are therefore wise to "see through" this (assumed) temporary reduction in the rate of inflation.

**Aggregate demand growth may be exceeding capacity growth**

The problem is that the balance of risks is probably in the other direction. Nominal GDP growth figures suggest that aggregate demand is in line with, if not exceeding, the capacity of the UK economy. It will be interesting to see how falling oil prices affect the GDP deflator but we will have to be patient. An advantage of inflation targets is that CPI data is issued monthly and so oil shocks can be quick to show up. But it will be important to ensure that the GDP deflator is not dragging down nominal income.

**Monetary growth may be picking up slightly**

Narrow measures of the money supply have been in decline over the last few months but this slide seemed to subside by the end of 2014. In December 2014 the growth rate of broad money (M4ex) jumped back up to 4.2% (from 2.9% in November 2014), which was the highest rate since February 2014. The deflation demonstrated by M3 has fallen (from -2.3% in November 2014 to -1.3% in December). And Divisia measures remain strong.

**Sensible to wait and see given the difficulties and risks of acting**

It is hard to know what policymakers should do right now. With such a dramatic fall in inflation a close eye should be focused on inflation expectations, but there is no sign that these are falling dramatically. The second release of the national accounts, due at the end of February, will help tell us more. And early March will see the publication of the Bank of England/NOP Inflation Attitudes Survey. For now, the sensible option seems to be to wait and see.

**Must now wait until inflation returns to normal to normalise rates**

When inflation returns to normal this could present another opportunity to normalise interest rates but the timing could be difficult. Thus far policymakers appear to want to wait until the evidence that the economy is recovering is irrefutable. This risks leaving things too late. If inflation rises at a quicker than expected pace whatever credibility that the Bank of England have for delivering 2.0% inflation will be in tatters. After so long of saying "though" inflation targets, perhaps we can start to see beyond them.

## Vote by John Greenwood

**(Capital Economics)**
**Vote: Hold base rate. Hold QE.**
**Bias: Neutral**

## Vote and Comment by Andrew Lilico

**(Europe Economics and IEA)**
**Vote: HOLD**
**Bias: To wait to raise rates until inflation rises.**

**The inflation target as currently set tells us we should not raise rates**

With inflation so far below target and no clear guidance from the inflation targeting regime that a departure of more than 1% is permitted, rate rises now cannot be considered compatible with the notion that the inflation target constrains policy-making (as it should do). This is just as wrong and dangerous now as it was in 2011 when inflation was permitted to go far above target but without any change to the target or guidance regarding how far above target was or was not permitted by the regime.

**An inflation target should consist of a medium-term point estimate and a short-term band of discretion**

An inflation target is not simply a vague long-term aspiration or a forecast by the central bank. It is (when well-constructed) a regime of constrained discretion. It should consist of a point target, to which policy must attempt to drive inflation over the policy impact horizon (some two to three years) plus a range of discretion within which inflation is permitted to deviate from the medium-target in the short-term. That range of discretion should be an inflation band — something like +/-1% or +/-3% or whatever range of discretion the goal-setter (in the UK, the Chancellor of the Exchequer) wants to grant the monetary policy-setter.

**Inflation targeting worked well from 1992 to 2007, so why was it abandoned?**

This was precisely the form of inflation target the UK had from the introduction of inflation targeting in 1992 until the band of discretion was breached and then, as a consequence, abandoned (rather than enforced or changed) in 2007. It is absolutely remarkable that, when inflation targeting using the combination of point estimate and band of discretion, had worked so well from 1992 to 2007, that it was so casually and pointlessly tossed aside — merely to avoid the political embarrassment of admitting that the target had been breached.

**Since no-one believes inflation should be 2% or 1% at present, the inflation target should be changed**

When the inflation target was systematically and significantly breached in 2008 and then again in 2011, without any attempt to change or enforce it, there seems to have been great confusion regarding some of us that complained that credibility had been lost. For me, at least, the point in 2008 and 2011 was not, in the first instance, that the Bank of England should be attempting to keep inflation to 2%. I urged on both occasions that since it was clear to everyone that it was undesirable to keep inflation below 3% in 2008 or 2011, the inflation target should be changed — either by raising it or by increasing the band of short-term discretion. The process of setting a target one does not want to meet seems to me to be literally a basis of ridicule. There seems to be some paranoia about changing the inflation target. Why that is, I am unclear. The inflation target was changed in 1997 and again in 2003 without that destroying the credibility of the regime. Why should it have been so bad to set a different target in 2008 or 2011 or 2015? No-one, as far as I am aware, believes that inflation should be being kept to between 1% and 3% or exactly at 2% in the early part of this year. So why have a rule that says that is what should happen?

**The current "inflation target" provides no constraint**

Obviously, the consequence of setting such a "rule" that one never tries to meet is that that ceases to be how to the "rule" is understood. We now see that there is no constraint whatever upon the extent to which inflation is permitted to deviate from target in the short term. Inflation of 0.3% is not a breach of the target. Inflation of -0.3% would not be a breach. Presumably inflation of -1.3% would not be a breach. Does anyone know what would constitute a breach? Minus 5%? Minus 20%? Nothing tell us. If nothing counts as missing the target, then the target does not constrain policy and ceases to be any kind of rule at all. It is nothing more than a vague long-term aspiration or a forecast. I repeat: an inflation target is supposed to be more than that and when we deployed inflation targeting in its true form it worked very well.

**Unanchored discretion does not have a history of ending well**

UK monetary policy-making is now far out at sea with no compass to guide it. This is not a failing of the Bank of England as such. It is a failing of the Chancellor. He should set a medium-term target he wants monetary policy to meet — a target for inflation or for monetary growth or for the price level or for nominal GDP. He should grant the monetary policy-setters a short-term range of discretion, allowing them to deviate from the target for a period to take account of macroeconomic conditions. The target and the range should be ones he actually wants them to stick to and he should

enforce the target. Something should count as missing; if there is a miss he should begin by expressing disapprobation regarding the miss and demand remedial action; and then if the miss persists someone should get fired. He should be willing to change the target if his view as to what is best changes, especially if the target itself is for some annual variable (e.g. annual inflation) as opposed to something longer-term (e.g. the long-term average inflation rate). I find the lack of concern about this issue very disturbing. We are back to the sort of anchorless discretion regime that was tried in the 1970s. That did not end well. I submit that there may be a lesson there.

## Vote and Comment by Kent Matthews

**(Cardiff Business School, Cardiff University)**

**Vote: Hold bank rate**

**Bias: To raise QE if the Eurozone crisis returns.**

**Hold rates but do QE if Eurozone crisis returns**

While low inflation is here to stay for the immediate future, with interest rates already effectively zero they cannot usefully be cut if the Eurozone crisis flares up again. In the event of a euro crisis we should instead be prepared to man the liquidity pumps with additional QE.

## Vote and Comment by Patrick Minford

**(Cardiff Business School, Cardiff University)**

**Vote: Raise Bank Rate; ½%;**

**Bias: To raise and QE to be reversed.**

**Growth is strong and unemployment is low, yet the appetite for rate rises is non-existent**

We are faced with a conundrum. The economy is recovering strongly, employment is growing strongly too and unemployment plunging, almost reaching the 'full employment' rate (of around 5%, I would estimate, against an actual of 5.8%). There are now also signs that wages are rising faster, and with inflation temporarily low, probably substantially faster than prices. And yet the two 'hawks' on the Bank's MPC have withdrawn to the dovish end of the spectrum and the MPC is unanimous once more in not raising rates, while leaving on hold Quantitative Easing (the purchases by the Bank of UK government bonds, which now stand at £375 billion, about a third of the total government debt outstanding).

**Deflation appears to have deterred rate rise pressure**

It seems that the joker in the pack is inflation which is temporarily low — the latest figure, for the January 2015 CPI, is 0.3%. This is fuelling fears of 'deflation' which has become a fear word, on the grounds that deflation in the 1930s created rising real debt and held back the recovery, according to some accounts. Yet this threat is to be honest quite empty; the situation is not at all like that of the 1930s.

**Monetary growth is low because of regulation**

Another element causing the unwillingness to tighten is the still slow growth of money and credit. Indeed the banking system is still under huge pressure from regulators, and still trying to shrink its balance sheet, it would seem.

**Keeping monetary policy loose is dangerous**

I would argue that there are great dangers to leaving money so loose in these circumstances, especially with an election looming the results of which are quite unpredictable and a public deficit still at 5% of GDP. Furthermore the current inflation figures are dominated by the collapse in oil and other material prices — a one-off phenomenon. Money and credit growth is reflecting the excesses of past-crash bank regulation; this in turn is leading to explosive growth in the new 'shadow banking' of peer-to-peer lending. Even though statistics on this are patchy, its rapid growth is undeniable. Without moving too sharply, the backdrop indicates a need to move monetary policy towards normality.

**Regulation over-reacted to a mis-diagnosis of the financial crisis**

However, one also needs to probe why we have reached this state where monetary policy is endlessly easy while the supply of credit and money has been so restrained. Of course the answer lies in the great reaction of regulative enthusiasm to the banking crisis. The irony of all this is that the crisis itself was caused by central bank failure to coordinate the supply of liquidity to the international banking system. It is true that we had a strong credit boom in the run up to the crisis, itself also permitted by excessively easy monetary policy. Yet a credit boom should not lead to a banking crisis. So we are constantly led back to the villains of the piece: the central banks themselves. First, a failure of excessive monetary ease; followed by a failure to ensure the liquidity of the world banking system. The political classes closed ranks around the central banks whom they effectively directed in their tasks; then they turned on the world's commercial banks, alleging that all was due to their cupidity and stupidity in taking outsize risks. It is true that some banks made bad decisions- certainly so in the light of later events. When things go wrong in the world economy, it is often the case that decisions made by individual actors turn out poorly. Like ants rolled over by a large tractor, they lie there, squashed and victims of tragic error. But could they have foreseen the tractor would suddenly roll down the road?

**Excessive prudential and other regulatory requirements upon banks have worsened the state of the economy**

At any rate, we now have the regulative reaction to these events; and as many of us warned they have worsened the state of the economy. We in Cardiff Business School have argued in recent work that they will not stop another crisis because crises stem from large-scale world shocks (usually to commodity prices) and the best hope of controlling crises is through active monetary policy, both in boom and slump. In the UK and the US there has been some attempt to dilute the new regulative excess. Here there have been the Funding for Lending Schemes (that subsidised lending to banks that expanded their balance sheets) and the Help to buy scheme (that subsidised first-time home owner mortgages). In the US the regional banks have been less intruded upon than the big money-centre banks; and competition and new lending has come from them. In the eurozone unfortunately the banks have been quite unable to recover from a series of hammer blows: first the collapse of the

economy, then the impulse from the ECB for them to buy southern countries' government debt to help resolve the run on euro debt, and finally the ECB's misguided vilifying of their balance sheet weakness (much of which resulted from this very impulse). So eurozone credit and money show no signs of life.

**Given that weak growth and financial instability has been caused by mis-conceived regulation and over-loose monetary policy the logical solution is to stop doing that**

It is against this background that monetary ease has become totally entrenched. Yet the irony is that the situation is caused directly by government regulative action. The logical way forward would be to dismantle this excess regulation and to move monetary policy back to normal. Instead we have a moribund banking system, increasingly being replaced by a new banking order via the internet- but like all such 'shadow' systems we cannot discover exactly how fast it is developing. Monetary policy is desperately trying to stimulate bank activity, but instead is feeding a whole substitute financial system. The outcome of this process is highly unpredictable.

**Move to normality**

Accordingly, once again I urge that monetary policy move back towards normality, with a small initial rise in interest rates and a bias to continue raising in small steps. Similarly I would like to see the QE stimulus gradually withdrawn, say in monthly steps of £25 billion for the first year.

## Vote by Peter Warburton

**(Economic Perspectives Ltd)**
**Vote: Raise Bank Rate ¼%. QE restructure by £50 billion.**
**Bias: To raise rates to 1½% over 12 months.**

## Vote and Comment by Trevor Williams

**(Lloyds TSB Corporate Markets)**
**Vote: Hold base rate. Hold QE.**
**Bias: Neutral**

**Absent inflation pressure and with global risks, this is no time to be changing policy**

Nothing has changed in the big picture my view. Low inflation will persist for some while. Low wage inflation will persist as well, despite the Bank of England's expectation of an acceleration as price inflation picks up. In my view, pay rises offered by employers will slow along with inflation. The supply of workers, from higher participation rates and net migration, still outweighs demand. Europe remains in the doldrums, albeit temporarily boosted by lower oil prices. Low and negative short term rates in Europe and elsewhere, and well below long run average long term rates, are sending worrying signals about long term trends in advanced economies. Divergence from US policy change later in the year poses a big financial market risk. Reliance on domestic demand in the UK poses a risk for the trade and current account deficit, at a time when productivity is poor. This is not a time to be changing the policy stance, especially with so many global risks.

## Policy response

1. On a vote of six to three the committee agreed to hold Bank Rate. Three members voted for rise.

2. All three rate risers expressed a bias to raise rates further.

3. There was a mixed recommendation regarding QE. Some members recommended that QE be reversed. Others recommended that no further QE be deployed but the mix might change. Others said that QE should be held in reserve if the euro crisis worsens.

## Date of next e-mail poll

**5 April 2015**

# 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 Andrew Lilico (Europe Economics and IEA). Other members of the Committee include: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), Patrick Minford (Cardiff Business School, Cardiff University), Gordon Pepper (Cass Business School), David B Smith (Beacon Economic Forecasting), 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 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 exactly nine votes are always cast.

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