Williams de Broë

30 April 2006

The Shadow Monetary Policy Committee Quarterly Meeting and E-Mail Poll:

May 2006

Embargo: Not For Publication Before 00:01 hours Monday 1 May

Editorial Note

The results of the latest Shadow Monetary Policy Committee (SMPC) quarterly meeting (in conjunction with the *Sunday Times*) are set out below. The rate recommendations are made with respect to the Bank of England's REPO rate decision to be announced on Thursday 4 May. **On this occasion, seven SMPC members voted to hold rates, while two voted for a ¼% reduction**. The SMPC itself is a group of independent economists drawn from academia, the City and elsewhere, which gathers once a quarter at the Institute of Economic Affairs (IEA) in Westminster, to monitor UK monetary policy. The inaugural SMPC meeting was held in July 1997, two months after the Bank of England was granted operational independence, and the Committee has met almost every quarter since.

The Secretary of the SMPC is Professor Kent Matthews of Cardiff Business School, Cardiff University, and its present Acting Chairman is David B Smith (Williams de Broë Plc and University of Derby). Other current members of the Committee include: Professor Patrick Minford (Cardiff Business School, Cardiff University), Professor Tim Congdon (Visiting Fellow, London School of Economics), Professor Gordon Pepper (Lombard Street Research and Cass Business School), Professor Anne Sibert (Birkbeck College), Dr Peter Warburton (Economic Perspectives Ltd), Professor Roger Bootle (Deloitte and Capital Economics Ltd), John Greenwood (AMVESCAP), Professor Peter Spencer (University of York), Dr Andrew Lilico (Europe Economics) and Dr Ruth Lea (Director, Centre for Policy Studies and Non-Executive Director, Arbuthnot Banking Group). Professor Philip Booth (Cass Business School and the IEA), who also regularly attends physical SMPC meetings, is technically a non-voting IEA observer. However, he is awarded a vote on occasion to ensure that exactly nine votes are cast.

The document that follows reproduces the **IEA Press Release** (page 2) and the **Minutes of the SMPC meeting** held at the IEA on **Thursday 20 April** (page 3). This material appears with the permission of the original authors. It has not been significantly edited by Williams de Broë, apart from the addition of margin notes and some minor amendments to achieve consistency with our 'house style' (the main exception being that it was not possible, for technical reasons, to incorporate the Charts that accompanied John Greenwood's presentation in Appendix I on page 7; these are available on request from **david.smith@wdebroe.com**). The opinions expressed in this document are, correspondingly, the views of the individuals concerned, and do not represent a Williams de Broë house view. The next SMPC meeting is provisionally scheduled for Tuesday 18 July 2006. The SMPC's regular monthly e-mail polls, carried out in conjunction with the *Sunday Times,* will continue to appear in the interim and will next be published on 4 June and 2 July.

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Press Release

Not For Publication Before 00:01 hours Monday 1 May

Shadow Monetary Policy Committee Votes to Hold Interest Rates

At its latest meeting, the IEA's Shadow Monetary Policy Committee, a group of leading monetary economists that monitors developments in UK monetary policy, voted against changing interest rates by seven votes to two when Britain's REPO rate is next set, on 4 May.

Most members of the SMPC felt that the arguments for and against a change in interest rates were finely balanced. There has been a significant rise in energy prices, but overall inflation was still subdued. Against this, there is evidence that economic activity is recovering again, while the continued high level of UK money supply growth concerned a number of members. There were few risks arising from the international economic background unless energy prices continued to rise.

Although the majority of members voted for no change in interest rates, and no members voted for an immediate increase, several members felt that interest rates would have to rise in the future, as a result of the medium-term impact of rapid broad money growth.

Tim Congdon said "The choice is between a modest rise in rates now or a more drastic one later", but he believed that rates should be left where they were this month. David Smith, Chief Economist at Williams de Broë, suggested that he would not be surprised if rates had to rise before the year end. John Greenwood, Chief Economist at AMVESCAP, said "There is no case for a rate cut, but rates should be held at the current level for the current time." However, two members, Andrew Lilico of Europe Economics and Peter Warburton of Economic Perspectives, wanted an immediate rate reduction of ¼%.

Members of the SMPC were concerned that policymakers and commentators are focusing on 'core inflation' and therefore omitting from consideration key parts of price indices that relate to the underlying cost of living. This is particularly problematic when energy prices are rising rapidly for reasons that are not cyclical; in such circumstances, core inflation may understate underlying inflation and the policy stance will be too loose.

Note to Editors

The minutes of the meeting are attached below. Minutes of all recent Shadow Monetary Policy Committee meetings are available from the **Articles Section** of the IEA website at **www.iea.org.uk**.

The Shadow Monetary Policy Committee, which has shadowed the MPC since its creation, meets quarterly but also conducts a regular e-mail monthly survey of members' views on monetary policy. It normally publishes this, together with a poll on the Committee's view on interest rates, on the Sunday before the meeting of the Bank of England's Monetary Policy Committee.

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Minutes of the Meeting of 20 April 2006

Attendance

Professor Philip Booth (IEA Observer), Professor Tim Congdon, John Greenwood, Dr Ruth Lea, Dr Andrew Lilico, Professor Kent Matthews (Secretary), Professor Anne Sibert, David B Smith (Chair), Dr Peter Warburton.

Apologies

Professor Gordon Pepper, Professor Roger Bootle, Professor Patrick Minford, Professor Peter Spencer.

Chairman's comments

David Smith asked John Greenwood to present his analysis of the world and UK economies.

The economic situation

World Economy: Low inflation and growth at potential

Monetary policy has been normalised

John Greenwood referred to the circulated notes and charts (Appendix I). The overview of the international economy is that monetary policy in some major countries has now been normalised, particularly the Anglo-Saxon economies, resulting in flat or slightly inverted yield curves. The European Central Bank (ECB) has started to raise rates and the Bank of Japan (BoJ) has indicated an end to quantitative easing. Monetary growth in the US is not excessive. The likely result is growth at or near potential, and low inflation.

Inflation expectations remain low

Market measures of inflation expectations from indexed-linked bond yields suggest that long-term inflation expectations remain low in the US. Allowing for the distortion caused by recent institutional demand for index-linked gilts in the UK, inflation expectations remain anchored at low levels.

Consensus forecasts indicate benign outlook

Even in emerging markets, inflation remains under control, except for oil-producing economies, where there is evidence of overheating. The consensus forecasts for the world economy are remarkably benign, with the Euro-zone economies and Japan at last joining the rest of the developed world, and growing at a satisfactory rate.

US: Healthy corporate profits

Anglo-Saxon housing markets have been boosted by low real rates of interest

In the US, the major concern is with the housing market. However, in the UK and Australia, house prices have plateaued rather than crashed. The common factor in all three house price booms was the decline in the real rate of interest caused by the excess of global savings over investment. The continuation of low real rates implies that we are likely to see a flattening of house prices in the US also. In the UK, equity withdrawal has not boosted consumption, but resulted in balance sheet adjustment through the acquisition of financial assets. In the US, only 20-30% of mortgage withdrawals have gone to fund consumption. Thus the flattening of house prices will not result in a major downturn in consumer spending, and there is unlikely to be any obvious slowdown in the economy.

US monetary policy

Healthy internal funds in the US corporate sector have resulted in share buy-backs and muted corporate borrowing, but business investment is expected to rise. There is little pressure for rates to rise from corporate borrowing. However, the expectation is that the Fed will raise rates further on 10 May. Money growth (M2) in the 5-7% range is not excessive. Bank credit is growing at a steady rate, mostly driven by real estate loans. The basic picture is benign, with core inflation at around 1.9%, provided the yield curve is flat and interest rates roughly match nominal GDP growth.

Euro-zone interest rates

Confidence indicators show a pick-up in the Euro-zone. Rapid money supply growth remains a concern for the ECB, and therefore rates could rise to 3-3½% over the next year, ending with a flat yield curve but at a lower level than in the UK or the US.

Japan

Japan shows some improvement in economic activity. The Bank of Japan is using open market operations to soak up excess reserves, which will push up rates. The economy will recover, but if there is any danger of faltering, the Bank of Japan will hold off from raising rates.

UK Economy: Recovering slowly

British growth is returning to trend, obviating need for rate cuts

Narrow money growth has remained steady at 5-6% but sterling M4 broad money has shown strong growth of over 12%, driven largely by the growth in wholesale deposits. M4 and nominal income growth have been moving in different directions. The economy has been recovering slowly. Retail sales and consumer spending have shown signs of revival. Exports have improved, due to increased Euro-zone economic activity. Inflation has fallen back below the target - the March CPI figure was 1.8% year-on-year - and is likely to remain marginally below it for the rest of the year. As growth gets back towards trend, there is no compelling case for a cut in rates. The official REPO rate will remain at 4.5% for most of 2006.

Discussion and policy response

Eastern European immigrants

Anne Sibert asked about the likely effect of immigration into the UK from Eastern Europe. She said that the effects on demand are faster than the effects on supply. John Greenwood replied that he expected immigration to affect only long-term growth, not the cyclical pattern of growth, while Peter Warburton said that the low-skilled jobs taken up by immigrants help to explain falling productivity.

World growth driven by developing, not mature, economies

Tim Congdon said that John Greenwood's commentary did not mention developing economies. The buoyant growth in the world economy is not being driven by the mature economies but the developing economies. Inflation is coming through oil, other energy and commodity price inflation. Focusing on core inflation underestimates actual inflation.

Energy costs

Kent Matthews asked for clarification on what he saw as a one-off relative price effect caused by real factors, rather than an inflation effect. Tim Congdon explained that continuously rising energy and commodity prices must feed into inflation. Anne Sibert said that there was no disagreement that continuously rising oil prices does have an overall inflation effect.

Monetary growth has accommodated increased energy costs

David Smith said that monetary accommodation was needed to convert energy price rises into a permanent inflation effect, but that this had been happening, to some extent, with OECD broad money growth having accelerated to 6¾% over the past year.

Rate debate

Andrew Lilico said that it was not clear that the oil prices would continue to rise, but that he would prefer to use a broad measure of inflation. He added that it was not clear why the present situation did not warrant a rate cut. GDP is below trend and inflation is low. In response, John Greenwood said that the improving external environment was pushing the UK back towards trend output.

Bearish bonds

Peter Warburton said that the global bond market was in a serious bear phase. There are technical reasons why the long-term rate of interest is low. The government was able to borrow at low rates because of the overseas take-up. He expected government borrowing to continue for sometime.

Individual votes

David Smith asked the committee to make its recommendation.

Comment by Professor Philip Booth (Cass Business School and Institute for Economic Affairs)

Vote: No change

Misleading opinion polls on inflation

Philip Booth said that the Bank of England should not take notice of opinion polls on the views of members of the public on inflation expectations: market-based measures are more reliable. He said that there was no reason for a rate cut. He was concerned about the monetary aggregates, but a rate rise now would be fine-tuning for the sake of it. He voted to hold.

Comment by Professor Tim Congdon (Visiting Fellow, London School of Economics)

Vote: No change

Money has gone into asset prices

Tim Congdon said that the high rate of broad money growth is associated with asset price inflation. The puzzle is that domestic demand remains weak. The choice is a modest rise in rates now or a more drastic one later. He said that rates should be left where they are at this time.

Comment by John Greenwood (Chief Economist, AMVESCAP)

Vote: No change

Bias to raise

John Greenwood said that there was no case for a rate cut, but that the rate should be held at its current level with a bias to raise.

Comment by Dr Ruth Lea (Director, Centre for Policy Studies and Non-Executive Director, Arbuthnot Banking Group)

Vote: No change

Economy returning to trend growth

Ruth Lea said that the economy is returning to trend growth. Also, the trend growth rate is likely to be lower because of negative supply effects. She said that she was unhappy that the Bank of England was using a National Opinion Poll (NOP) survey of inflation expectations. She voted for no change.

Comment by Dr Andrew Lilico (Europe Economics)

Vote: Cut REPO rate by ¼%

Cut now, but be prepared to raise REPO rate later

Andrew Lilico said that rates would have to be raised higher than the present, and indeed higher than the market expects, at some time in the fairly near future - perhaps starting later this year. Such rises would tend to limit growth's returning to trend within the forecast horizon. Inflation is below target, so there is scope for a small cut now and then to raise rates later. He voted to cut rates by ¼%.

Comment by Professor Kent Matthews (Cardiff Business School, Cardiff University)

Vote: No change

Rapid monetary growth implies rates will have to rise in future

Kent Matthews said that although market-based expectations signal low inflation, he was not convinced by the argument that the credibility of the Monetary Policy Committee anchors inflation expectations. Both narrow and broad measures of money are too high but, in particular, double-digit broad money growth warrants interest rates be raised in the future. He voted to hold with a bias to raise.

Comment by Professor Anne Sibert (Birkbeck College)

Vote: No change

GDP is at trend

Anne Sibert said that there was no new news that had persuaded her to change her views. GDP is returning to trend. Although the oil price effect is matter of concern inflation has fallen. She voted for no change.

Comment by David B Smith (Chief Economist, Williams de Broë and University of Derby)

Vote: No change

New research finds money is a predictor of long-run inflation

David Smith said that new research from the Bank for International Settlements and the Bank of England confirmed the view that output gaps affected short-run inflation, but that long-term inflation was governed by money supply growth*. At some point in the future interest rates will have to rise. The question is, should this be pre-empted by raising rates now or later? Joblessness is rising, and the economy faces further negative supply-side problems with a loss of competitiveness due to higher taxes. He said that he would not be surprised if rates had to rise before the year end, in part because of higher rates overseas. He voted to hold.

Comment by Peter J Warburton (Director, Economic Perspectives Ltd)

Vote: Cut REPO rate by ¼%

Cut and hold

Peter Warburton questioned whether there had been a meaningful upturn in the UK economy since the last SMPC meeting in January, particularly in light of negative developments in external trade. While some housing indicators had strengthened, there was no evidence of a national improvement in market conditions. Rightmove's index of asking prices for April remains just 4% higher than a year ago. Given that the global real bond yield environment has become more restrictive since the start of the year, and with nominal GDP growth still sub-4%, he thought it prudent to reduce the REPO rate by 25 basis points, but this reduction should not been seen as the first of a series.

Votes in Absentia

Written submission

The SMPC sometimes allows a small number of votes to be cast in absentia and adds their written submissions to the record of the meeting, particularly where it avoids the possibility of a tied vote. However, on this occasion there was no need to include votes in absentia since nine people were present at the physical meeting. We have, however, included Professor Gordon Pepper's written submission in Appendix II as a contribution to the wider monetary debate.

Policy Response

1) On a vote of 7 to 2, the physical meeting of the SMPC agreed that interest rates should remain on hold.

2) Two members voted for a ¼ per cent cut and hold, with one suggesting that rates would then have to raise later.

3) Five members voted to hold rates but expected rates to rise in the future.

Date of next meeting

Tuesday 18 July 2006, at 6.00pm (to be confirmed).

***Editorial Note:** The papers concerned are Assenmacher-Wesche K and Gerlach S *Interpreting Euro Area Inflation at High and Low Frequencies,* Bank for International Settlements BIS Working Paper No 195, February 2006, **www.bis.org**; and Benati L (2006), *UK Monetary Regimes and Macroeconomic Stylised Facts,* Bank of England Working Paper No 290 (March 2006), **www.bankofengland.co.uk**.

Appendix I

Economic Review & Monetary Background
John Greenwood (Chief Economist, AMVESCAP)

Despite large-scale macroeconomic imbalances due to the global surplus of savings over investment, and despite the high level of energy prices, the progressive normalisation of interest rates, together with improvements in the conduct and communication of monetary policy around the world, have set the stage for a sustained period of economic growth, with low inflation in most of the major economies. The environment is similar to that prevailing in 1995, after the US Fed had normalised rates in 1994-95. Risks remain, but the prospects for sustainable economic growth at low rates of inflation are unusually good compared with many previous cycles.

Introduction

Global monetary policies are becoming normalised

As economic growth has broadened across the developed world, monetary policies are gradually being normalised. For example, in the US, the UK and Australia, this means that yield curves have become flat or slightly inverted as central banks have raised interest rates to neutral levels - ie levels that are considered consistent with steady, sustainable growth and low inflation. The Euro-zone and Japan are still somewhat lagging the recoveries of the Anglo-Saxon economies, but now there are growing signs of improved economic performance in both these areas. Despite the advent of flat yield curves (historically a signal of monetary tightening and economic slowdown), we believe that the current business cycle expansion has several more years to run - as it did in the 1990s after the Fed had completed raising (normalising) rates in 1994-95, and that economic growth should be able to continue at close to potential growth rates with low inflation. Evidence from break-even inflation rates (the difference between nominal and inflation-protected bond yields) suggests that long-term inflation expectations are well-anchored at around 2.5% in the US. (The 3.2% figure for the UK may be temporarily distorted by the downward pressure on index-linked gilt yields.) Inflation expectations do not appear to have been seriously disrupted, either by the oil price hikes of the past two years, or by the risk that wage inflation may become more prevalent as labour markets tighten. These conditions provide a very favourable backdrop for equity and real estate investment in the medium term.

Emerging market economies

In the emerging economies of Asia, Latin America and the Middle East, growth has been almost universally vigorous and, for the most part, inflation has been kept well under control. The main exception is that signs of significant overheating are evident in some of the oil-producing economies of the Middle East (Dubai, Saudi Arabia, Jordan, Egypt and Tunisia), where the flood of revenues from higher oil prices had pushed up equity and property markets, and these are now seeing abrupt downturns.

Currency outlook

On the currency front, the prospective ending of rate hikes by the Federal Reserve Bank will pose questions about the stability of the US dollar over the next two years, as interest rates in the Euro-zone and Japan are normalised. We expect a modest weakening of the US dollar, particularly against the euro, the Japanese yen and the Chinese Yuan.

Table 1: International Economic Prospects

(%)	2005 Actual		2006 Consensus Forecasts	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	3.5	3.4	3.3	2.9
Euro-zone	1.4	2.2	2.1	2.0
UK	1.8	2.1	2.2	2.0
Japan	2.7	-0.3	2.9	0.4

United States

Solid growth performance, but US demand components need rebalancing

The US economy recorded a solid performance of 3.6% real GDP growth in 2005. However, a number of forecasters are now predicting a significant slowing of US growth in the second half of 2006 or in 2007, stemming mainly from the peaking out of the housing market and from the reduced home equity extraction that this will imply. These forecasters argue that borrowing against increased house values will decline, and this, in turn, will slow consumer spending. We disagree with this view on two grounds. First, the experience in the UK and Australia suggests that with long-term real rates remaining low, house prices are more likely to plateau rather than fall significantly. Second, the relation between home equity extraction and consumer spending is not nearly as direct or important as most people appear to think. The data from the UK, Australia and the US suggests that most home equity withdrawal went into the acquisition of financial assets, and only 20-30% went into consumption expenditure. Moreover, the traditional drivers of consumption spending - income and employment growth - are strengthening at this stage in the business cycle, and should be able to support consumer spending in the future, as they did in the past before Mortgage Equity Withdrawal became significant. Nevertheless, with US household savings near zero and likely to start to rise in 2006, consumer spending is likely to contribute less to GDP growth in 2006. My forecast for US real GDP growth in 2006 is therefore 3.4%, only marginally slower than in 2005.

Strong corporate cash flow

In the corporate sector, profit margins and cash flows continue to be very buoyant, and should encourage firms to spend more on business investment during 2006. The recovery of overseas economies should enable US exporters to benefit from a strengthening global economy. I therefore see business investment and export growth starting to play a larger role in overall GDP growth.

Bernanke's US Federal Reserve

I expect the Fed's FOMC, under Ben Bernanke, to raise rates to 5.0% on 10 May, and, after that point, to amend the language of the FOMC statement by indicating a more balanced set of growth and inflation risks going forward. At this stage, rates will be roughly neutral, ie neither stimulative nor restrictive. Thereafter, any further rate rises will depend critically on the overall tone of the published economic data. Monetary policy will only need to turn restrictive if there is evidence that core inflation is accelerating, for example due to increases in energy prices being built into wages or corporate pricing.

US CPI inflation

In fact, there has been little sign so far of increases in energy prices feeding into the general level of wages or into core consumer prices. Nevertheless, I expect headline CPI inflation to remain at an elevated 3.0-4.5% level (year-on-year), at least through the first half of 2006, largely reflecting the impact of oil price hikes during last year. For the year as a whole, I expect the headline CPI to fall modestly from 3.5% to 3.2%, while the core CPI slows from 2.1% to 1.9%.

Euro area

The Euro-zone is recovering

In recent months there have been several data releases showing that industrial activity and consumer spending in the Euro-zone have been picking up. This is confirmed by data on exports and investment in 2005 Q4, as well as by EU Commission surveys of consumer and industrial confidence. This is consistent with my view that the weakening of the euro last year helped to stimulate exports and investment, and that economic recovery would be possible in spite of high oil prices. It is nevertheless a fact that unemployment remains as high as 8.3% across the Euro-zone as a whole, and consumer spending and consumer confidence could be undermined by the German government, for example, raising VAT by 3% in 2007. On the inflation front, consumer prices increased by 2.3% year-on-year in February, and the European Central Bank (ECB) clearly sees a further round of wage increases as a threat to price stability over the next year. Based on this hawkish view (which includes concern about rapid money growth), the ECB has therefore further raised interest rates, lifting its refinancing rate to 2.5% from 8 March. Market expectations imply at least two further rate hikes of 25 basis points during 2006, taking the ECB's refinancing rate to 3.0%. Even with these rate increases, the consensus is forecasting a real GDP growth rate of 2.1% for the Euro-zone in 2006, and inflation to moderate to 2.0% as a result of the strengthening currency.

Japan

Belated signs of economic upturn in Japan

The Japanese economy has finally started to show signs of a more sustained recovery, following its prolonged deflation and recession in the 1990s and the early years of the new century. Real GDP grew by 2.5% in 2005, with consumer spending, non-residential investment and inventory accumulation contributing strongly. This was underpinned by strong corporate profits and a reversal of the declining trend in employment and wages. The rapid aging of the population and a decline in the labour force will inevitably limit growth in the future, perhaps restraining the economy to a growth rate of around 1.8% on a longer term basis. I forecast 2.4% real GDP growth in 2006, compared with a consensus figure of 2.9%.

Shift from deflation to inflation

The key change in the economy in 2006 will be the shift from deflation to mild inflation. Already, the early signs of the end of deflation - the CPI registering small increases on a year-on-year basis for four successive months since November - and the strength of the economic recovery have prompted the Bank of Japan (BOJ) to adjust its monetary stance. On 9 March the BOJ abandoned 'Quantitative Easing' and returned to a zero interest rate policy (ZIRP). In practice, this shift is likely to be smaller than the markets currently expect, and therefore the BOJ may be compelled to continue with ZIRP for most of 2006 - a development that should continue to encourage the equity and real estate markets, since it would imply a shift to negative real interest rates. Monetary growth (M2+CDs) has remained low (below 2% year-on-year), and lending has only just started to recover, so a rapid recovery in monetary growth is not to be expected. My forecast is for a CPI increase of just 0.2% for the year as a whole, implying only a small margin of error for the Japanese authorities on the downside.

International summary

Exogenous dangers

This outlook is perhaps unduly benign. Of course, risks remain, but mostly these are not susceptible to economic forecasting. They would include the outbreak of a human version of the avian flu pandemic; a serious dispute between Western nations and Iran that results in armed conflict and a major disruption of oil supplies; or further natural disasters such as hurricanes that drive oil prices sharply higher again.

A prolonged low-inflation expansion is possible

Within the arena that economists are capable of forecasting, the overall outlook is unusually positive. The improved transparency and conduct of monetary policy by independent central banks has set the stage, at least in the Anglo-Saxon economies (the US, the UK, Canada and Australia) for a prolonged, low-inflation expansion similar to that of the 1990s. Aside from the temporary inflation scare between July and October 2005, due to the rise in oil prices, expectations of low inflation look to be very much intact. Not only are interest rates now at or near neutral levels in these four economies (after being at unusually low levels), but also they have been followed by rate hikes in the economies of East Asia, Latin America and some non-Euro-zone European economies, and most recently by the ECB. Even the Bank of Japan has terminated its quantitative easing, following signs that the economy is at last entering a period of sustainable growth and the prospect that deflation might end in 2006. Therefore, for the developed world as a whole, the growth outlook for 2006 is both stronger and more balanced, particularly as the euro-zone and Japan begin to emerge from extended periods of structural weakness. The revival of Japan would also have huge implications for the Asian region, which has recently gained a second strong locomotive economy in the shape of China, with a third potential locomotive looming in India.

United Kingdom

Monetary background

Broad money and GDP have diverged in recent years

The Bank of England's Base Rate has now been held unchanged at 4.5% since August 2005. During that time, growth of M0 has continued at a fairly steady rate of close to 6% pa, while sterling M4 has accelerated from 10% to over 12%. All of the acceleration of M4 has been due to the growth of wholesale deposits, while retail deposits have grown steadily at around 9% on the year. On the other side of banks' balance sheets, bank and building society lending has decelerated mildly since mid 2004, to an annual 10.5% in February. It has to be said that M4 growth and nominal GDP growth have been moving in opposite directions for over two years.

Economic activity & growth

UK growth may be recovering again

After slower growth in 2005, there are signs that UK economic growth may be recovering again. House prices have been rising according to most recent surveys. Until February, mortgage approvals had been climbing steadily since November 2004, reaching 121,000 per month in December and January before declining modestly to 115,000 in February. A partial revival in retail sales and consumer spending appears to be under way, with recoveries in official retail sales volumes, supported by BRC and CBI survey data showing upturns. With recovering exports (due to the strengthening of growth in the Euro-zone), the consensus of economists expects growth to pick up from 1.8% in 2005, to 2.2% in 2006 and 2.5% in 2007.

Inflation

No compelling case for rate cuts

During 2005, inflation moved above the Bank of England's targeted rate of 2%, reaching 2.5% in September, mainly due to oil price increases, but has subsequently shifted back below the 2% target. In March, the CPI headline figure was +0.2% month-on-month, or 1.8% year-on-year. The core CPI was 1.3% year-on-year. Looking forward, I expect inflation to remain marginally below target as energy price increases from last year fall out of the year-to-year comparisons, giving a figure of 1.9% for 2006. In view of the return towards trend growth during 2006-07 and the moderation in inflation, there is currently no compelling case for a further cut in interest rates. I therefore expect the Bank of England's base rate to remain at 4.5% for most of 2006.

Appendix II

An Argument for Raising Base Rates by ½%
Professor Gordon Pepper (Lombard Street Research and Cass Business School)

Britain has an excess supply of money…

The monetary aggregates have been growing significantly faster than GDP during recent months. This indicates that the supply of money has been exceeding demand. When this happens, the excess can be spent on goods and services, or on assets. In the former case, economic activity rises and product-price inflation follows once the economy has reached full capacity. In the latter case, the short-run effect is asset-price inflation. Currently, expenditure on goods and services has been less than usual, whereas that on assets has been greater.

…but the real economy has been weaker than this suggests

Recently, the behaviour of the real economy has been better than some commentators were forecasting, but it has not, at least in the short run, been as good as monetarist forecasts indicated. Monetarists stress that the time lag between the growth of the money supply and the response of the economy is long and variable. The question is whether the time lag is especially long this time, or whether the relationship has broken down.

Pension fund deficits have diverted corporate funds into financial assets

The time lag is indeed long when expenditure is on assets. There is a delay before the increase in wealth and confidence, of both industrialists and consumers, feeds through into expenditure. Nevertheless, the length this time requires further explanation. An obvious one is the behaviour of industrial and commercial companies. Currently they have strong balance sheets and ample liquidity. A rise in industrial investment would normally follow, in new factories. For example, this time surplus funds are being used to reduce deficits on pension funds. This is a clear example of money being spent on assets, rather than on goods and services.

Asset *vs* producer prices

Overall, there appears to be little current risk of product-price inflation exceeding target in the short run. This suggests that interest rates should be left unchanged, as the MPC will almost certainly decide, but some economist are suggesting that central banks should target asset prices as well as product prices. Should a central bank take action to deflate a bubble in asset prices? I have argued elsewhere that they should not *in general* do so[1]. The main reason is that people expect asset prices to rise when a financial bubble is building up. Expectations of asset price-inflation can be very different from those of product-price inflation. This means that the expected real rates of interest can differ. Interest rates that are sufficiently high to curtail asset-price inflation, can be far too high for the real economy and cause a recession.

Case for a temporary rise in the REPO rate

I also argued that it might be possible to arrest asset-price inflation before expectations of rising asset prices became ingrained. A rise in interest rates *that lasts for some time* affects expenditure on goods and services and raises industrial costs. A rise *that is reversed quickly* has less effect on industry but, in contrast, can have a substantial effect on confidence in financial markets.

House prices

Currently, the prices of all categories of assets in the UK are high by the valuation standards of the past, and there is a danger of another surge in prices, particularly of house prices. Having prevented house prices from falling last year, the Bank must be careful about making people think that it will always prevent house prices from falling. The Bank would be wise to teach people early on that buying a house is not a one-way bet. In these particular circumstances, a ½% surprise rise in the REPO rate that could be quickly reversed might be the best course of action.

Message for Mervyn

Message for Mervyn King - Maradona was successful because he did the completely unexpected - he ran straight. He would not have succeeded if he had frequently run straight before. The unexpected can be very effective

[1]See Chapter 10 of *Issues in Monetary Policy*, Matthews, Kent and Booth, Philip, eds., Wiley/IEA, 2006.

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