Media Release

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Shadow Monetary Policy Committee Votes to Raise Interest Rates Further

Details of SMPC vote

At its latest meeting, the IEA's Shadow Monetary Policy Committee (SMPC), a group of leading monetary economists that monitors developments in UK monetary policy, voted to raise interest rates by seven votes to two. No members voted to reduce interest rates and two of the members who voted for a rise would have preferred a 0.5% rise.

Money supply concerns

Many members were increasingly worried about sustained increases in the measures of monetary growth, particularly broad money. SMPC Chairman, David B. Smith commented that broad money was growing rapidly and the economy was demonstrating all the indications of an excess supply of money. As a consequence, he believed that there was now an overwhelming case for raising interest rates by 0.25% *and that further increases would probably be needed subsequently*. Gordon Pepper, one of the members voting for a 0.5% rise, believed that given inflationary time lags are long and variable, there is a strong case for a "double rate rise". It is important, argued Pepper, to avoid the risk of doing too little too late. A number of members also expressed concern about the supply side of the economy, given the recent big rise in the minimum wage and an apparent slowdown in immigration.

Case for waiting

Those voting against an increase in interest rates felt that the Bank of England should allow time to see the effects of the previous rate rise. It was felt by the two members voting for "no change" that there was little sign of inflationary expectations increasing and that we should wait for further developments both in inflation and in the real economy, before moving interest rates.

Note to Editors

Availability of minutes

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**.

SMPC schedule

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 17 October 2006

Attendance
Philip Booth (IEA Observer), John Greenwood, Ruth Lea, Andrew Lilico, Gordon Pepper, Ann Sibert, David B Smith (Chair), Peter Warburton (Acting Secretary).

Apologies
Roger Bootle, Tim Congdon, Kent Matthews, Patrick Minford, Peter Spencer.

Chairman's comments

Publicity arrangements

David B Smith welcomed the members of the committee. He discussed the publicity given to recent monthly e-mail polls and mentioned the new arrangement whereby he hoped to pre-record an interview for Bloomberg Television each month setting out the SMPC vote, having already done one such interview in October. It was noted that *The Business* was no longer published on Sundays but had adopted a weekly magazine format, published in the middle of the week. This meant that its publication schedule was now out of kilter with that of the SMPC minutes. *The Business* has a website and it was hoped that the SMPC might still attract publicity with Allister Heath's help. David B Smith alerted members to the fact that the IEA was to profile the SMPC on its website and had requested a photograph of the committee to be taken that evening.

David B Smith then asked Andrew Lilico to introduce the economic situation.

The economic situation

The International Economy

Korea and oil uncertainties

The response to issues in the Korean peninsula seems relatively mild at this stage, the Hurricane season appears to have been milder this year, and the risk of a disruption of supplies from Iran appears to have faded in the short-term. However, there are some suggestions that the seasonal pattern may be becoming more pronounced, perhaps partly as a consequence of shortages in refining and storage capacity. In the futures market, oil for delivery in December 2007 is at $68/barrel.

US housing market

In the US, much attention appears to focus on the housing market. New home sales have fallen in the past year, and prices of both new and second-hand homes have stopped rising. Earlier this month, US Fed chairman Bernanke predicted that the US housing slowdown would cut US GDP growth by 1%. Third quarter GDP growth appears likely to have been below trend.

US Budget deficit improving

The budget deficit was down to a four-year low of $247.7bn in the year to 30 September, (22% down on the corresponding 2005 figure) – causing some commentators to suggest the US Budget experience since the 2004 tax cut was a strong vindication of the claims of supply-side economics. Also, wage growth is relatively strong (8%). In the year to August, consumer price inflation was 3.8% (up 0.2% on the month).

FOMC decisions

At the latest meeting (20 September), the FOMC held interest rates (federal funds) at 5.25%. A number of participants emphasized continuing concerns about inflation, and took the view that recent rates of core inflation were not consistent with price stability (and there was one vote for raised rates).

ECB rate decisions

On 5 October, the ECB raised Eurozone interest rates to 3.25%. 'Headline' Eurozone inflation was 1.8% in September. Growth is forecast to be 0.4-0.8% in the three months to September, and 0.2-0.7% in the three months to December – implying growth for 2006 at around 2.5%, the best performance since 2000.

Japan

In Japan, GDP growth was 1.0% (quarter-on-quarter at annualised rate) in the second quarter. Wholesale prices rose 3.4% in the year to August, the highest rate of growth for 25 years. In July, the Bank of Japan raised interest rates to 0.25%, ending six years of zero rates. There is speculation that the Bank of Japan will raise rates again either later this year or early next year.

Discussion of International Background

New Japanese CPI has reduced reported inflation

John Greenwood expressed the view that nothing has changed for the Bank of Japan despite the lower reported rates of CPI inflation. He reminded members that the CPI was rebased from 2000 to 2005 and this had reduced the headline annual rate from 0.6% to 0.2%, prompting fears that Japan was slipping back into deflation. John pointed out that what had happened was a shift from one price trajectory to another of equivalent slope and that the implications for Bank of Japan policy were undisturbed.

Prospects for Germany

David B Smith alluded to the impact of forthcoming VAT rate increases in Germany next year. He was concerned that there had been some anticipatory bringing forward of consumers' expenditure – as would be expected according to supply-side theory – and that the German economy might slow down sharply in 2007. Anne Sibert pointed out that German unit labour costs had fallen significantly relative to other Eurozone countries. Peter Warburton suggested that Germany had benefited from strong credit growth in other Eurozone countries, particularly Spain and Italy.

US uncertainties

John Greenwood drew attention to the wide dispersion of views about the outlook for the US economy next year. He identified four distinct views:

Recession or…

- First, there was a minority view that the US would have an outright recession in 2007. This, he associated with the views of Professor Roubini and others who are obsessed with international imbalances.

…extended slowdown.

- A second and more popular view was for the US to enter an extended slowdown. Goldman Sachs have promoted this view which entails GDP growth falling into the range 2%-2½% for the second half of this year and all of 2007. This view is based on a negative impact on consumption from a reduction in mortgage equity withdrawal and slow growth of after-tax personal incomes.

Soft landing or…

- The third view, which he supported, was for a soft landing, whereby GDP growth would rebound to 3% after a sluggish second-half 2006. On this reading of events, the US Fed hasn't over-tightened. Non-residential construction, currently growing at 14% p.a. provides a significant offset to the decline in house building. He also drew attention to the resilience of corporate spending and declining energy prices.

…renewed strength

- Finally, J.P. Morgan has taken the view of a renewed resurgence in the US economy next year, based on a rebound in housing, and requiring the Fed to resume its sequence of interest rate rises.

Micro to macro is wrong approach

The reason John gave for ruling out the first two views was that he considered them to be arguing from the micro to macro (i.e. extrapolating weakness from one sector to others while ignoring other offsetting factors).

UK Monetary Environment

Recent UK broad money data

The figures for August indicated that the twelve-month growth rate for M4 rose to 13.7% from 13% in July. M4 lending increased by 14.7%, seasonally adjusted, in the year to August, up from 14.1% in July. (*Editorial Note*: The September figures, released two days after the SMPC meeting, showed a further rise in M4 growth to 14.5%, and a 13.7% increase in M4 lending).

GDP and its components

GDP rose by 0.7% in 2006 Q2, 2.6% up over the twelve months. Industrial production was unchanged, with a 0.7% increase in manufacturing, a 3.9% fall in mining and quarrying, and a 2.6% fall in electricity, gas and water supply. Services rose by 0.9%, within financial and business services strong at 1.4%. Government and other services rose by 0.4%. (*Editorial Note*: The provisional 2006 Q3 estimate, published on 20 October again following the SMPC meeting, showed quarterly and annual rises of 0.7% and 2.8%, respectively).

Joblessness

The official unemployment rate was 5.5%, up 0.8% over the year. The claimant count was 950,000 in August, up 81,000 over the year.

Consumer and retail price inflation

CPI annual inflation fell to 2.4% in September, down from 2.5% in August. RPI was up to 3.6%, the highest figure for more than eight years. House prices were again a significant factor in the additional "gap" between the RPI and the CPI. The largest upward effect came from transport, particularly driven by petrol prices. RPIX inflation fell to 3.2% from 3.3%.

Producer prices

Output price inflation for manufactured products was 1.8% in the year to September. Input price inflation fell to 5.1% in the year to September from 7.9% in the year to August, mainly reflecting a fall in petroleum prices.

Average earnings

Average earnings rose by 4.4% in the year to July (3.7% including bonuses), up from 4.3% in June (3.8% including bonuses). Private sector growth stood at 4.6% compared with 3.8% for the public sector.

Discussion of UK Monetary Environment

Serious monetary concerns

Gordon Pepper was extremely concerned at the rapid and accelerating growth of the M4 measure of the money supply. He noted that broad money growth gave reassurance to policy makers when the UK economy slowed in 2005. But the economy having recovered, he was concerned that inflation would be persistently higher than the MPC's target.

Signs of suppressed inflation

David B Smith raised the issue of whether the UK was experiencing a suppressed inflation, in which excess demand leaked into the trade deficit. The deficit on net exports of goods and services averaged 4.4% of GDP in the first half of 2006 (the deficit on goods trade alone was 6.5%) while the

Demand stronger than GDP figures suggest

overall current account figures showed a more manageable deficit of only 2.5%. Many commentators had queried whether the claimed offsetting surplus on Britain's net investment income could possibly be as large as the ONS are claiming. He also suggested that the 2006 Q2 GDP figures were understating the underlying strength of activity because the run down of North Sea oil production had cut 0.3 percentage points off the growth rate (i.e. non-oil GDP had risen by 2.9% in the year to Q2) and also because of the difficulties of measuring public sector 'output'. Monetary policy can only operate on the market sector of the economy, and real non-oil market sector Gross Value Added had risen by 3.2% in the year to the second quarter, compared to the 2.7% rise in Q1 and 2.4% increase in 2005 as a whole. This was a more relevant measure than GDP and it leant further support in his view for the need for higher interest rates.

Adverse effects of minimum wage

Anne Sibert was concerned that inflationary pressures would build as a result of the 6% increase in the National Minimum Wage from 1 October. She added that a deceleration of immigration would also lead to greater tensions in the labour market. David B Smith pointed out that, if one corrected the new £5.35 hourly minimum wage for the differences in regional median earnings its value should range from £4.78 in North Eastern England to £6.90 in London. This suggested that the job destroying effects of the minimum wage were likely to be far more serious in the 'Old North', where both real productivity and the cost of living were far lower than in Southern England.

MPC credibility is endangered

Andrew Lilico was struck by the inflation fan chart in the Bank of England's August *Inflation Report*. This showed a 15%-20% probability of a CPI inflation outcome at end 2007 of more than 3%. He characterised the task of the MPC as having two aspects: the first was to employ the language of communication with the Market that the inflation targeting regime provides in order to comment on the economy through changing a price. The second aspect was to set limits of deviation from a central script that would be regarded as prompts for action. The second task can be done in many ways, and gives rise to multiple equilibria - provided that credibility is maintained. Andrew was concerned that the fan chart in August showed a clear prompt for further interest rate rises and that the delay on the part of the MPC would be costly. At some point in the future the MPC would have to pay back the credibility it had borrowed by failing to act promptly. A particularly undesirable scenario would be if the inflation target were violated, since that could lead to a sudden need to tighten policy very considerably, both to address issues at that time and to pay back credibility borrowed in the past.

Sporting metaphors

Gordon Pepper made a number of references to sporting metaphors in asserting that the MPC was in danger of ending its winning run with regard to the inflation target. He compared the MPC to a football manager - when results are good, the manager will be granted considerable license to experiment. But if results turn bad, his every decision becomes subject to close and negative scrutiny.

Need for stock, as well as flow, equilibrium

David B Smith echoed Gordon's concerns that there had been a build up of excess money. He also suggested that there was a parallel between Andrew's worry that the MPC was now overdrawn on its stock of credibility and need for the economy to be in stock as well as flow equilibrium. In particular, a period of below-average monetary growth might be necessary to restore balance between the supply of broad money and the equilibrium demand for money on the MPC's desired inflation path, following recent excesses.

Distortions to monetary aggregates

Peter Warburton highlighted the sectoral statistics on credit and monetary growth, which show that all the acceleration in M4 lending since last November has occurred in the “other financial corporations” sector. These corporations have also raised their holdings of M4 balances substantially. Given that M4 money supply has cried wolf a number of times in the past 15 years with regard to consumer price inflation, it was important to understand the nature of recent monetary developments. It is possible to argue that the recent acceleration of credit and money growth will continue to exert its primary impact on asset prices, with only modest spill-over effects on the prices of goods and services. Meanwhile nominal GDP growth, scaled back on revision to 4.8% in the year to Q2, does not seem to make a compelling case for higher nominal interest rates.

Authorities do not know how to control rapid monetary growth

Gordon Pepper expressed the view that real interest rates in terms of expected producer price inflation were positive, but that real interest rates in relation to expected asset price inflation were negative at current interest rates. He said there was no known solution to the problem of balancing the requirements of producers in the goods economy and financial institutions conducting transactions. He asserted that the authorities did not know how to control rapid monetary growth.

Labour market distortions

Ruth Lea added to the earlier comments about the undesirable characteristics of the National Minimum Wage. She also noted that £5.35 per hour was much more attractive in some parts of the country than others. The effect of raising the NMW was to place disproportionate burdens on employers in regions such as the North East and Wales. Philip Booth added that national levels of social security benefits had similar inequitable effects.

Individual votes

David B Smith then asked the members of the committee to vote on a rate recommendation.

Comment by Philip Booth
(Cass Business School and Institute for Economic Affairs)
Vote: Raise by ¼%

Consumer bad debts should not deflect MPC

Philip Booth acknowledged the escalation of bad debts in the consumer sector and attributed the problem to the welfare state creating moral hazard. However, he thought it best to wait for problems to occur rather than seeking to pre-empt them by lowering interest rates. He also favoured an immediate rise in interest rates.

Comment by John Greenwood
(Chief Economist, AMVESCAP)
Vote: Raise by ¼%

Inflationary risks for several years

John Greenwood was concerned that rapid monetary growth would pose inflationary risks for the next 2-2½ years. He contrasted the developments of the past eighteen months with those in 2002-03. In the former case low interest rates propelled capital markets, but the demand for bank lending was weak and monetary growth was moderate. More recently he believed that the equilibrium rate of interest for a 2% CPI target was higher than the prevailing rate, and that rates needed to be higher to restrain rapid credit growth.

Comment by Ruth Lea
(Centre for Policy Studies and Arbuthnot banking group)
Vote: Raise by ¼%

Robust growth

Ruth Lea expressed the view that the economy was growing robustly, the housing market looked buoyant and inflationary pressures were building up. She was especially concerned that inflationary expectations were creeping higher. In order that the MPC should not lose control of expectations, higher interest rates were needed.

Comment by Andrew Lilico
(Europe Economics)
Vote: Raise by ½%

MPC dithering means ½% hike now needed

Andrew Lilico repeated that he regarded the MPC as dithering in neglecting to raise rates in the ensuing months after the August inflation report. He thought that it would be necessary to correct the excess money supply growth and take action to make certain that the inflation target is not violated. Since this rate rise would have the function of reducing monetary growth, rather than commenting on the economy, there was little case for it to take the smallest (¼%) form. Instead, there should be a ½% rate increase. However, he believed that a ½% increase would allow the MPC to sit and wait for a while before making further changes, and that it should not be assumed that a ½% increase would necessarily indicate further rate rises in future months.

Comment by Gordon Pepper
(Lombard Street Research and Cass Business School)
Vote: Raise by ½%

Raise by ½%

Given that inflationary time lags are long and variable, there is a strong case for a double rate rise. It is important to avoid the risk of doing too little too late.

Comment by David B Smith
(University of Derby)
Vote: Raise by ¼%

'Duck test' indicates that there is an excess supply of money, and rates should go up

David B Smith said that it was only because the evidence suggested that interest rate changes were slow acting and were not powerful instruments that he had not voted for a rise in October but preferred to wait until November when a new set of *Inflation Report* forecasts would be available to the MPC; the principle being that a better informed decision was superior to a less well informed one if the precise timing of rate changes made negligible difference to the real economy. He also believed that it was difficult to control an interest bearing broad money definition with short-term interest rates, which represented the 'own rate' on money, not its opportunity cost. However, it remained possible to apply the US supply-siders' 'duck test', in his opinion. If broad money was growing rapidly and the economy was demonstrating all the indications of an excess supply of money – which seemed to be the case – this indicated that rapid monetary growth was not being passively driven by shifts in the demand for money. As a consequence, he believed that there was now an overwhelming case for raising interest rates by 0.25% in November, and that further increases would probably be needed subsequently. He added that the fiscal background was not helpful to monetary policy both because of its objective effects, and also because persistent borrowing overshoots threatened official credibility in all areas of policy making, monetary as well as fiscal.

Comment by Peter Warburton
(Economics Perspectives Ltd)
Vote: No Change

Weak case for rate rise

Peter Warburton questioned the wisdom of a further increase in interest rates notwithstanding the alarming growth rate of the money supply. He agreed with Gordon Pepper that a marginal change in interest rates would probably have little impact on financial markets activity but that it would give rise to an extension of interest rate expectations next year. This would raise the twin dangers of such an increase in interest rate expectations becoming a catalyst for a financial accident and of a serious over-valuation of sterling to occur. His vote was for no change.

Votes in Absentia

Reasons for votes in absentia

The SMPC allows a small number of votes to be cast in absentia and adds their written submissions to the record of the meeting, to ensure that exactly nine votes are cast. On this occasion only one vote was required in absentia since eight people were present at the physical meeting.

Comment by Kent Matthews
(Cardiff Business School, Cardiff University)
Vote: Hold

Wait to see results of previous increase

My inclination is not to rush into a further rise in rates until we see the effects of the last rise. My reasoning is an intermediate position between the rational expectations approach and old school monetarism. While I agree with the monetarists that broad money is an indicator of future inflationary pressure I also agree with the rational expectations view that under an interest rate-setting regime, broad money is strongly endogenous. For traditional monetarists, this is not a problem as they believe it is possible for disequilibrium to exist between the *ex ante* supply of, and demand for, money, while accepting that money is endogeneous much of the time. For the rational expectations school the endogeneity issue means that broad money is irrelevant because it is not possible for the *ex ante* supply and demand for money to get out of line in the first place.

Signal extraction problem

There appears to be a 'signal extraction' issue here that does not have to take the disequilibrium position. It accepts the equilibrium position but with forward Rational Expectations, the broad money measure is an indicator of expected shocks to the economy. However, the Bank has also indicated its willingness to act at the first sign of inflationary pressure so the Bank's action is also an indicator that provides a signal. The Bank's indication of willingness is another signal that works in the opposite direction to the broad money signal. It is a question of which of these two signals dominates inflation expectations.

Inflation Expectations

At the moment the market is relatively sanguine about inflation. There is no obvious indicator that inflation expectations are on the rise. I vote to hold.

Policy Response

1. On a vote of 7 to 2, the physical meeting of the SMPC agreed that interest rates should rise immediately.
2. Five of the members who voted for a rise wanted an increase of ¼% but two thought an increase of ½% was needed.

3. Two members voted to hold, while no one wanted a reduction.

Date of next meeting

Tuesday 16 January 2007, at 6.00pm (to be confirmed).

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 e-mail poll, conducted by the SMPC in conjunction with the *Sunday Times* newspaper.

SMPC membership

The Secretary of the SMPC is Professor Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is Professor David B Smith (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 IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that nine votes are cast.

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