

**4th February 2007**

**Institute of Economic Affairs' Shadow Monetary Policy Committee Quarterly Meeting:  
February 2007**

## **Editorial Note**

The results of the latest Shadow Monetary Policy Committee (SMPC) quarterly meeting are set out below. The rate recommendations are made with respect to the Bank of England's decision with respect to the official Bank rate paid on commercial bank reserves to be announced on Thursday 8 February. On this occasion, five SMPC members voted to hold rates at the 5¼%, announced on 11 January, three SMPC members voted for a ¼% increase, one voted for a ½% rise, and nobody voted for a reduction. The bare vote gives a slightly misleading picture of the overall degree of hawkishness involved, however, because several of the holds had a bias to raise, and some of the ¼% hikers wanted further increases subsequently.

The SMPC itself is a group of independent economists drawn from academia, the City and elsewhere, who assemble 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 every quarter bar one since then. That it is the first such body in the UK (having been inspired originally by the US Shadow FOMC, which was founded in the early 1970s) and that it meets regularly to discuss the deeper intellectual issues involved, help distinguish the IEA's SMPC from the similar exercises now carried out by a number of publications.

The document that follows reproduces the IEA Press Release (page 2) and the Minutes of the SMPC meeting held at the IEA on Tuesday 16 January (page 3). This material appears with the permission of the original authors and has not been amended by Lombard Street Research, which has been disseminating the SMPC's deliberations since August 2006. The next SMPC meeting is scheduled for Tuesday 17 April. 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 March and 1 April.

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## Press Release

*Not for publication before 00:01 hours Monday 5 February*

### Shadow Monetary Policy Committee says: “hold interest rates for now” in knife-edge 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 hold interest rates by five votes to four. Three members wanted to raise rates by ¼% and one member wanted to raise rates by ½%.

A number of SMPC members were concerned about the recent rise in CPI inflation to 3%, expressing the view that the Bank of England had risked its credibility by allowing inflation to rise so rapidly and by not being sufficiently active, at an early enough stage. There was therefore a general welcome for the recent rise in interest rates as it was essential that the markets continued to believe that the Bank of England would hit the inflation target. If it did not then wage settlements would begin to rise.

Those members who wished to raise rates were concerned by signals from monetary data and asset prices that suggested inflation might rise further in the future. The five members who wished to hold rates believed it was desirable to wait to see the effects of the rises in interest rates in recent months because it is known there are long and variable lags between a tightening of monetary policy and a reduction in inflation. **However, several of the five members who voted in favour of holding rates had a bias in favour of raising rates later in the year.** There was also a feeling amongst those who wished to raise rates that there may be a need for monetary policy to tighten even further in the near future. Andrew Lilico of Europe Economics summarised that view saying: “there is a reasonable probability that inflation has peaked but if it goes any higher then there would be a serious breach of credibility.” He continued: “Rates should rise by ¼% now but rates should rise further if there is another rise in inflation.”

#### *Note to Editors*

The minutes of the meeting are attached below. Minutes of all recent Shadow Monetary Policy Committee meetings are available from the Shadow Monetary Policy Committee section of the IEA website at [www.iea.org.uk](http://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 16 January 2007

### *Attendance*

Roger Bootle, Tim Congdon, Andrew Lilico, Kent Matthews (Secretary), David Brian Smith (Chair), Peter Warburton.

### *Apologies*

Philip Booth, John Greenwood, Ruth Lea, Patrick Minford, Ann Sibert, David Henry Smith (*Sunday Times* observer).

## Chairman's comments

### Media and membership

David B Smith noted the coverage given to the SMPC by the *Sunday Times* and discussed other means of raising the SMPC's media profile. The committee also debated extending the membership to include another City economist to help with the presentation of the economic situation, and ease the burden on those who did it regularly.

David B Smith then asked Peter Warburton to introduce the monetary situation.

## The economic situation

### *The International Economy – Modest Stagflation*

### Global overview

Peter Warburton said that the consensus of forecasts for 2007 was for a slowing of the pace of economic growth in the US and Japan but an improvement in the EU. In the US and Canada, there was a sharp deceleration in nominal GDP in the second half of last year, but in Europe, nominal GDP growth is increasing. The outlook for inflation has brightened superficially in recent months, due to falling oil prices, but core inflation pressures remain a concern. Western import prices have softened recently as Asian manufacturers have de-stocked, but the inventory cycle is expected to turn up again in the Spring, bringing firmer pricing conditions.

### Receding oil price

The interpretation of the receding oil price is important. Some have argued that this will give US consumer spending a boost by releasing discretionary income. However, a more persuasive argument is that a weaker oil price is signalling a slowing of the world economy. In Europe, corporate sector credit, much of it linked to Merger and Acquisition (M&A) activity, has been strong with clear indications that a European Central Bank (ECB) REPO rate of 3.5% is insufficient to restrain asset-linked borrowing. Germany, in particular, has outperformed growth expectations.

### World money supply

Data for the weighted world broad money supply constructed for 50 countries showed money growth settling at 9-9.5% a year. Corporate borrowing has grown strongly in the context of global M&A activity. Credit spreads have been falling indicating greater risk tolerance. In Japan there has been a significant interruption of the recovery with slowing bank lending and a drift back to a deflationary situation. Overall, the world economy is in a growth deceleration phase but with a modest tightening of inflationary pressure.

### *The Domestic Economy – Stress in the System*

#### **Households under pressure**

The robust growth of GDP has not been reflected in the broad experience of the household sector. A rising corporate profit share has combined with increasing tax-take to weaken growth in real disposable income. Unemployment has risen by about 200,000 in the past year and dramatically higher insolvencies indicate increased stress in the system. By output, the deal-driven business service and financial sectors account for roughly half of the growth of the whole economy. There is a huge growth dichotomy with the remaining 80% of the economy growing at an average of 1.6% per annum. Peter Warburton discussed a chart of real GDP growth and the change in net international investment, which traditionally had strong positive co-movement. A sharp decline in net international investment over the past three years suggests an adverse wealth effect. Peter Warburton suggested that this was explained, in part, by the deterioration of the public sector balance sheet.

#### **RPI decomposition**

A decomposition of the RPI inflation rate showed a sharp rise in core private sector generated inflation (private goods & services excluding fuel & light) but this was still well below public sector generated inflation (administered, housing, duties, commodities).

#### **M4 broad money**

Turning to money growth, there has been an upward trend in M4 growth, which has accelerated from 6% in 2003 to current rates of 13-14%. (*Editorial note*: the December data released three days after the SMPC meeting showed a deceleration to 12.8%, compared with 13.1% in November, 14% in October, and 14.4% in September). M4 lending saw a more abrupt rise in growth. The growth of retail deposits has remained steady and moderate but the impetus to growth of broad money has come from the rapid growth of wholesale deposits at 25-30%. An increasing share of M4 lending to individuals has been securitised, leaving a wide discrepancy between the adjusted (11%) and unadjusted (5%) annual growth rates.

#### **Roy Bridge lecture**

Peter Warburton concluded his presentation by referring to the transcript of the Roy Bridge lecture given by the MPC's Paul Tucker in December 2006, in which some of the increase in wholesale money was attributed to higher margin calls and securitisation activity of the Special Purpose Vehicles.

### *Discussion and Policy Response*

#### **Discussion and Policy Response**

#### **Excess money and low real rates**

Tim Congdon said that even allowing for increased money holding by the Other Financial Corporations, there is still excess money within the corporate sector. Roger Bootle added that the real rate of interest measured by the REPO rate and actual inflation is very low.

#### **MPC's damaged credibility**

Andrew Lilico suggested that the MPC had traded on its credibility by allowing inflation to rise from around 1% to 3% and still maintain inflation expectations at the target level. By avoiding activism they will have damaged credibility. He suggested that the SMPC should not fall into the mistake of non-activism and that it should be considering a more aggressive recommendation with more than ¼ point changes at a time.

#### **Wage inflation**

Roger Bootle said that there has been no mention of wage growth, which tends to follow the retail price index, while Tim Congdon stated that various agencies were reporting that wage settlements were 1% higher than a year

ago. Andrew Lilico added that wage negotiations are influenced by inflation expectations and that the Bank of England has traded on its credibility by allowing broad money supply to grow rapidly without it severely affecting inflation expectations.

**MPC's public relations skills may have masked inflationary policies**

David B Smith suggested that the Bank had done a brilliant public relations job in persuading the populace that it was committed to its inflation target, and so tethering inflationary expectations, but at the same time had pursued monetary policies that were looser than they should have been. Credibility does not last forever under these circumstances and there were worrying signs that inflationary expectations might be starting to take off. He was also concerned that the Bank had repeated the policy mistakes of the early 1970s and late 1980s, and too readily dismissed rapid monetary growth as being the result of institutional change, rather than its own lax policies.

**Output gap**

Tim Congdon was of the view that the output gap is not much above trend and that the increased unemployment is explicable in terms of an increase in the natural rate of unemployment caused by a reversal of the labour market policies of the 1980s.

**Sterling uncertainties and dogs in the night**

David B Smith said that 'the dog that had not barked in the night' was sterling. With large trade and fiscal deficits, UK monetary growth in the teens, fiscal policy in a mess, and Britain becoming a high tax-and-spend economy by international standards, he was surprised that the pound had not fallen before now. He speculated that overseas central banks' purchases were a possible reason for the pound's strength. This was because Asian and Middle Eastern central banks were already massively long of US\$, and were looking for alternative outlets for their FOREX reserves. However, he would expect a sharp drop in the value of sterling if overseas central bank purchases were reduced, or private investor sentiment turned negative.

## Individual votes

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

***Comment by Roger Bootle  
(Economic Adviser, Deloitte)***

***Vote: Raise by ¼%***

***Bias: To tighten***

**Core inflation and asset prices**

Roger Bootle said that core inflation may not be high but it has doubled. The behaviour of asset prices is the key to understanding this. The investment environment is one of low risk income gain from assets. He voted to raise rates by ¼% with a readiness to go up by a further ¼% if asset markets did not respond.

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

***Vote: Raise by ¼%***

***Bias: Tighten further***

**Case for rate rises**

Tim Congdon said that there was no need to go over his arguments again. He favoured increasing rates by ¼% with a bias to further rises.

**Raise rates and  
monitor inflation**

***Comment by Andrew Lilico***  
***(Europe Economics)***  
***Vote: Raise by ¼%***  
***Bias: Tighten, if inflation rises further***

Andrew Lilico said that there was a reasonable probability that inflation has peaked but if it goes any higher then there would be a serious breach of credibility. He voted to put up rates by ¼% in February and raise rates again if inflation went up any further.

**Long and  
variable lags  
make it easy to  
over-steer, hence  
case for caution**

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

Kent Matthews said that all the empirical work on money and credit demand that he was aware of showed long adjustment lags. The impact effect of an interest rate change on the money and credit aggregates are minor but could be significant in the medium run. He said that in the context of the Friedman destabilising intervention policy, he was cautious about raising interest rates to high and too fast. If Tim Congdon is correct about the gap being only a little above trend, the sudden acceleration in inflation cannot be blamed on the output gap but on inflation expectations or other factors. There is little evidence from the bond markets that inflation expectations have worsened significantly and it is more likely that these special factors would unravel in the coming months with inflation returning to target on its own. He voted to hold with no bias to rise or fall at present.

**Sterling strength  
suggests that  
monetarists may  
be wrong, or the  
pound could be  
an accident  
waiting to happen**

***Comment by David B Smith***  
***(University of Derby and Beacon Economic Forecasting)***  
***Vote: Hold***  
***Bias: Tighten, at first sign of sterling weakness***

David B Smith said he was concerned that the Bank had repeated on a smaller scale the mistakes of the 1970s Heath-Barber and 1980s Lawson booms. He also said that there were insufficient monetary instruments to deal with the task at hand, and that it was now time to look at the institutional arrangements afresh, after ten years of operational independence for the Bank of England. If sterling holds up, then the prospects for an easing of inflation are good. But the bogeyman lurking in the shadows was the potential for a run on the pound. However, he also had to admit that the continued strength of sterling casts doubt on the weight he was attaching to broad money and, in a sense, his whole theoretical approach. He thought that there was a need to raise rates further but he would be reluctant to do so while the sterling index was above 105 (January 2005=100). On the information available on 16 January, he voted to hold rates in February, because of the strength of the pound, but would react rapidly and aggressively, perhaps with a ½% increase, if sterling showed incipient signs of falling out of bed. This left him with a bias to tighten by a further ¼% in March, subject to any unforeseen developments.

**Comment by Peter Warburton**  
*(Economic Perspectives Ltd)*

**Vote: No Change**

**Bias: Raise only if annual CPI and RPIX inflation rates continue their ascent**

**Stopping asset bubble may require 7% base rate, but goods and service inflation may be near its peak**

Peter Warburton said that a single instrument is not sufficient to deal with the requirements of rapid credit-driven growth in a few sectors and modest growth elsewhere. However, the frenzied activity in financial and property markets may not be deterred by even a 7% base rate. If asset markets continue in this vein, with declining credit spreads and asset price volatility, then there would be no option but to raise rates. However, benign oil price movements suggest that inflation is at or near its short run peak. He voted to hold with a readiness to raise rates only if the December inflation rates are exceeded.

## **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 three votes were required in absentia since six people were present at the physical meeting.

**Comment by Ruth Lea**

*(Director, Centre for Policy Studies, and Non-executive Director of Arbuthnot Banking Group)*

**Vote: Hold**

**Bias: Towards further tightening**

**Strong retail sales**

The latest real numbers continue to show firm growth. Retail sales were especially strong in December despite the annual ritual of cries of despair from the retail sector over the Christmas period. Of course, even the seasonally adjusted data for the months of December and January can be very erratic as the seasonal factors cannot always accurately accommodate the very bumpy non-seasonally adjusted data at this time of the year. The December figure should, therefore, be treated with some caution. But the figures suggest firmness.

**RPI more relevant to wage bargainers than CPI**

The Bank's "shock" ¼% increase in interest rates in January was, of course, in the right direction given the very poor inflation figures for December - which they knew about at the January meeting. And, as I have emphasised before, the Bank must be especially concerned that the higher prices inflation figures will feed into higher pay settlements in the forthcoming pay round. Indeed there are already indications from the Income Data Services that this is happening. Though the targeted CPI inflation jumped to 3.0% in December - far more worrying from a pay settlements standpoint was the jump in RPI inflation to 4.4%.

**Hold in February but raise rates if sterling weakens**

I would recommend holding rates in February but my bias is towards further tightening. Tightening would be all the more appropriate if sterling, which is currently firm against the euro and even more so against the dollar, shows signs of weakening.

***Comment by Gordon Pepper  
(Lombard Street Research and Cass Business School)***

***Vote: Raise by ½%***

***Bias: Increase rates until the FTSE index falls below 6000***

**Base rate is a weak tool**

The Monetary Policy Committee's mandate is to control inflation but it has only one weapon and this is a weak one. Changes in short-term interest rates by a ¼% are sufficiently powerful to correct only minor fluctuations in inflation.

**Inflationary momentum has built up**

It is early days yet but it appears that the MPC has currently allowed some upward inflationary momentum to build up. There is a danger that rises of ¼% will be too little too late. More harm is done to economic growth if interest rates carry on rising and then stay at a high level for some time than if there is a sharp rise in rates that can be reversed quite quickly. The bureaucratic instinct to change rates gradually should be resisted.

**Stock market can be used as an indicator of monetary tightness**

How can one tell whether interest rates have been raised by enough in time? Financial markets react more quickly to changes in the amount of money about than does the real economy. A change in policy to arrest rising inflation is unlikely to be successful if it is insufficient to produce a fall in asset prices. There is currently a case for shock treatment. Interest rates should be raised until the FTSE index falls by about 5%, that is, until it falls below 6000. We can then, hopefully, look forward to the next move in rates being downward.

***Comment by Peter Spencer  
(University of York)***

***Vote: Hold***

***Bias: Raise later this year***

**Demand is being driven by buoyant money and credit growth**

Demand is being driven by buoyant monetary and credit market conditions. Bank lending for property investment, M&A activity and private equity has been particularly aggressive. This monetary expansion has been clearly reflected in asset prices and transactions, explaining why managers in business and financial services are so confident about prospects at the moment. Service sector activity and recruitment is at a ten year high and will support earnings and employment this year. Nevertheless, the base rate was raised in January and there is a good argument for waiting to see what effect this has before raising again.

## **Policy Response**

1. On a vote of 5 to 4, the SMPC decided that interest rates should be held in February. However, several of the holds thought that a further increase would be required, and had a bias to raise base rate in subsequent months, although this depended on specific conditions being met in some cases.
2. Three of the members who voted for a rise wanted an increase of ¼% but one thought an increase of ½% was needed. All those who voted for a rise also thought that a further increase or increases would be necessary.
3. No one wanted a reduction.

## **Date of next meeting**

Tuesday 17 April 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 and Beacon Economic Forecasting). 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, Arbutnot 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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