Embargo: Not for publication before 00:01 hours Monday 7th May

Editorial Note

The results of the latest Shadow Monetary Policy Committee (SMPC) quarterly gathering (carried out in conjunction with the *Sunday Times*) are set out below. The rate recommendations are made with respect to the Bank of England's decision about the official Bank rate paid on commercial bank reserves to be announced on Thursday 10 May. **On this occasion, four SMPC members voted to raise rates by ½% - with two believing that it was then appropriate to 'wait and see', but two expressing a bias towards further rises – while three SMPC members wanted a ¼% increase, two voted for a hold, and nobody voted for a reduction.**

The SMPC itself is a group of independent economists, 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 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 1) and the Minutes of the SMPC meeting held at the IEA on Tuesday 17 April (page 2). 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, tenth anniversary, SMPC meeting is scheduled for Wednesday 18 July. 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 3 June and 1 July.

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Press Release

(Not for publication before 00:01 hours Monday 7 May)

Shadow Monetary Policy Committee Votes to Raise Interest Rates, but Rejects 0.5% Increase by a Slim Margin

The 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. A vote to raise rates by 0.5% was lost by five votes to four.

Money supply risks

The majority of SMPC members were concerned about the medium-term growth in broad money, which, they believed, has caused the recent rise in CPI inflation to above 3%. It was noted that inflation as measured by the old RPIX target measure was even higher than CPI inflation.

Need to restore credibility

Members believed that the Bank of England risked a serious breach of credibility if it did not act decisively to steer inflation back towards the 2% target. Though, in the short run, inflation would fall, the current lax monetary conditions did not bode well for the medium term. Professor Anne Sibert, in voting for a 0.5% rise said, "Most of the recent news has pointed in the direction of higher inflation. A 0.25% rise was justified last month; given that did not happen, there needs to be a 0.5% rise now." Gordon Pepper argued that the monetary authorities had done too little, too late and commented that the Bank should now act decisively.

Reasons to hold

Both Patrick Minford and Peter Warburton wanted interest rates to stay on hold. They believed that less attention should be paid to current inflation and the monetary background and more to potential weaknesses in the economy. They felt that the occasional breach of the inflation target should not be regarded as constituting a crisis.

The Governor's letter

The Governor's letter to the Chancellor of the Exchequer also came in for criticism. John Greenwood, Chief Economist at Invesco, commented that the letter stressed changes in *relative* prices and gave comparatively little attention to the underlying medium-term causes of inflation.

Note to Editors

More on the SMPC

The minutes of the meeting are attached below. Minutes of all recent SMPC meetings are available from the SMPC section of the IEA website at **www.iea.org.uk**. The SMPC 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. **For further information, please contact:**

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Minutes of the Meeting of 17 April 2007

Attendance: Tim Congdon, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David Brian Smith (Chair), David Henry Smith (*Sunday Times* observer), Peter Warburton.

Apologies: Philip Booth, Roger Bootle, John Greenwood, Ruth Lea, Gordon Pepper, Ann Sibert, Peter Spencer.

Chairman's Comments

Need for new members…

David B Smith said that the growing long-range travel and other commitments of some SMPC members meant that it was becoming increasingly difficult to get a full set of votes for the monthly e-poll report and that there was now a fairly pressing need to increase the membership of the SMPC. He added that the first step should be to add another City based economist to assist with the *Economic Situation* briefings at the physical meetings, as well as helping to keep the SMPC in touch with the financial markets. David B Smith then proposed that Trevor Williams, Chief Economist, Lloyds TSB Corporate Markets, should be invited to join the committee.

…and for a balanced membership

Patrick Minford said that there was a danger of creating an imbalance between academic economists and non-academic economists and we should also invite academic economists on to the committee. David B Smith agreed that there was a need to maintain a balance, and stated that a wide range of backgrounds enhanced the quality of the discussion. He added that, after almost ten year's service, some of the more mature SMPC members might wish to stand down in the foreseeable future and that it was a good idea to plan ahead and phase in new members one at a time. It was agreed to enrol Trevor Williams onto the SMPC and to re-visit the issue of new members at future meetings.

David B Smith then invited Tim Congdon to give his assessment of the world and domestic economy.

The Economic Situation

The International Economy – no slowdown in 2007

World monetary growth remains strong, despite Japanese and US concerns

Tim Congdon said that since mid 2003, the world economy has experienced an extraordinary growth of 4% - 4.5% a year. The main drivers in the world economy have been strong energy and commodity prices and subdued wage inflation. Tim Congdon referred to the chart of world broad money growth produced by Peter Warburton, which showed money supply growth still rising indicating no slowdown in 2007. Except in the case of Japan where money supply growth is falling, in the rest of the world money supply growth continues to rise. The USA is different. There the sub-prime crisis could affect bank capital but banks are not likely to collapse. However, he was not certain about this.

The Domestic Economy – rapid monetary growth but output is not much above trend

The Governor's open letter, and the monetary transmission mechanism

Tim Congdon referred to the open letter by Mervyn King in which the Bank recognised that the rapid growth in money and credit contributed to inflationary pressure. The Bank has argued elsewhere that M4 holdings by the financial sector did not matter to the transmission mechanism. Tim Congdon rejected this and said that the real balance transmission was working fine through to asset prices. Share prices have risen rapidly and yields on property have fallen with rising property prices. Two things have not fitted with the monetary explanation. First, domestic demand has not been as strong as expected. Second, the output gap is not much above trend. There has also been not much acceleration in wage inflation.

Real balance effect and unemployment

Tim Congdon referred to an estimated 'real balance effect' equation and there was a short discussion about the residuals of the equation. He said that if output is currently ½% above trend, then next year it will be 1½% above trend. The natural rate of unemployment is rising and actual unemployment is below the natural rate. Leaving aside the effect of oil prices there is inflationary pressure building up from demand. The question is how to control the rate of growth of real money balances so as to reverse the gap. This means that real balances will have to grow at very low rates. For this to happen, we need to see a halving of the rate of growth of bank credit.

Discussion and Policy Response

Money growth still too high

The monetary debate

Kent Matthews said that the UK has had high monetary growth for some years now. Tim Congdon said high monetary growth has been around for only just over two years. Patrick Minford said that the basic relationship between broad money growth and output has broken down and this was not just in the UK but also in other countries where inflation targeting has been used. Tim Congdon said that the econometric relationship had not broken down and added that the residuals of the basic equation are not out of the ordinary.

Why the MPC should have raised earlier

Andrew Lilico said that according to the fan chart produced by the Bank, there was a 15% probability of a breach of the inflation upper range but they did not act on it. As a pre-emptive step they should have acted earlier. Now that inflation has breached the upper range, the Bank will be viewed as not credible. They have to act decisively to restore credibility. Patrick Minford said that the bank had to hit the target on average, why get excited about it breaching the range now and again. Andrew Lilico's position was discussed and a clarification of his argument is presented as an annexe to the minutes.

Government has boosted inflation

Peter Warburton said that government induced inflation has raised the RPI. But for this fiscal action, such as university tuition fees and air passenger duty, inflation would be a few points lower and inside the

range. Tim Congdon said that the rise in university fees is to cover staff costs, which have seen a decline in real earnings, and it was responding to accumulated inflation pressure. Patrick Minford said that the message he took from Peter Warburton's assessment is that there are a number of temporary elements in price inflation. The difficulty with this is that changes in relative prices should not affect inflation but can give an impression of a crisis. The volatility of inflation has fallen dramatically in the last ten years. The occasional breach of the range does not constitute a crisis.

How the media view the inflation overshoot

Patrick Minford then asked David Henry Smith (*Sunday Times* observer) to comment on whether the media is viewing the breach as a crisis. David Henry Smith replied that the event was seen as a stick to beat Gordon Brown and the government. He said that when the MPC was originally set up, the expectation was that a letter would be written every fifteen months. Also the discussion in the Bank is about pricing power and the ability of the utilities and large companies to restore profits by raising prices during strong demand situations.

Asset prices and other inflation issues

Patrick Minford said that broad money growth has been strong in the Eurozone and in the USA without the inflationary effects Tim Congdon is predicting. Tim Congdon said that asset price inflation has been strong in Europe. Patrick Minford said that there may well be an inflation premium in the world economy but that the UK can protect itself through having a floating exchange rate. The real issue is if real rates of interest are appropriate for this stage of the business cycle. Clearly there are pricing power issues that have to be considered. Andrew Lilico said that if the Bank does not react when inflation breaches the upper range, when should it react?

Inflationary expectations

Kent Matthews said that, since the policy of inflation targeting works through the expectations mechanism, what indicators are there that expectations of inflation have deteriorated? Tim Congdon said that gilt yields have increased. Patrick Minford said that indexed linked yields were indicating a long-term RPI inflation rate of 3 per cent or below 3% on the CPI measure. Wage inflation has remained moderate. The Bank is worried about wage inflation and pricing power but they are paid to be worried.

Individual Votes

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

Comment by Tim Congdon
(Visiting Fellow, London School of Economics)
Vote: Raise by ½%
Bias: Further rises will be needed beyond 5¾%

Tim Congdon said that his position is well known. He voted to raise rates by ½%.

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

Raise to restore credibility

Andrew Lilico said that the restoration of credibility is urgent and that he voted to raise rates by ½%.

Comment by Kent Matthews
(Cardiff Business School, Cardiff University)
Vote: Raise by ¼%
Bias: If inflation falls below the range the next move in rates should be to cut

Inflationary expectations have not deteriorated, but there is a case for a precautionary hike

Kent Matthews said that inflation expectations appear not to have been shaken by the breach in the upper range. The gap between gilt yields and indexed linked suggest a RPI inflation rate of around 3%, wage growth has not accelerated and sterling remains firm. However, to not act when inflation has been climbing steadily, and breached the range, is to send the wrong signal. As a precautionary strike he said that rates should be raised by ¼%. If the Bank is right that inflation will move down towards the 2% target in the next few months, the following movement in interest rates should be for a cut.

Comment by Patrick Minford
(Cardiff Business School, Cardiff University)
Vote: Hold
Bias: Hold until matters become clearer

Rate stability is needed

Patrick Minford said that he felt compelled by the current situation to defer his recommendation that rates should fall. A period of stability is needed and he voted for rates to remain on hold.

Comment by David B Smith
(University of Derby and Beacon Economic Forecasting)
Vote: Raise by ¼%
Bias: Tighten, if inflation does not fall away sharply in the next few months

Stitch in time saves nine

David B Smith said that there was a parallel between unpopular base rate changes and dental treatment. If one went to the dentist at the first sign of trouble the treatment was a minor filling and a bill for £100 but if one procrastinated the outcome was likely to be root canal work and a bill for £1,000. The MPC's failure to raise rates in April meant that the eventual peak in rates was likely to be higher, and the collateral damage worse; in other words, the MPC had forgotten Lord George's famous 'a stitch in time saves nine'. He remained concerned that the so-called 'return of pricing power' was a consequence of the excessive growth in broad money. In addition, there was evidence of a strong suppressed inflation in the form of the large trade deficit. Countries like China have been

investing in reserve currencies, such as sterling, and have buoyed their value, but these positions can be unravelled quickly if the Asian nations allowed their exchange rates to move more freely.

A quarter or a half?

He had thought of advocating a ½% increase but was anxious not to over-steer and was sufficiently worried by the consequences of the strong pound for the sector of the economy engaging in international trade to only advocate raising rates by ¼%. He had a bias to increase bank rate further, and thought that the MPC would be well advised to talk tough - in order to help consolidate inflation expectations around the target level - if it chose to go up by no more than ¼% on 10 May. The latest Beacon Economic Forecasting macro-economic projections suggested that CPI inflation would ease to 2% by the fourth quarter of this year, but would then start accelerating to 2½% in late 2008, before averaging 2½% in 2009 and 2010. This was on a scenario where bank rate rose to 5¾% by the final quarter of this year, and spent most of next year at 6%, before easing to 5¾% in late 2009 and 5½% in late 2010.

Comment by Peter Warburton
(Economic Perspectives Ltd)
Vote: No Change
Bias: Neutral - unless CPI inflation fails to revert to 2.5% in the coming months

US sub-prime mortgage crisis

Peter Warburton said that he attached much greater significance to the USA sub-prime mortgage crisis. If it unfolds and broadens, as seems likely, this would lead to a tightening of credit conditions with potentially strong spillovers into the international economy. He also had reservations about the UK scene. GDP growth is 3% but real household disposable income is growing at 0%. He was not sanguine about the outlook for the household sector and was also concerned about the pessimistic message delivered by inventory-sales ratios. He voted for no change.

Votes in Absentia

Reason 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 three votes were required in absentia since six SMPC members were present at the physical meeting.

Comment by Anne Sibert
(Birkbeck College)
Vote: Raise by ½%
Bias: Neutral

Surprising that MPC has not raised rates already

The Bank of England's February inflation forecast implied that at least one further ¼% interest rate increase would be necessary to attain inflation of less than 2% in two years' time. It is surprising that, since this increase was expected to be necessary, it had not been implemented already. Since February, most of the news has been consistent with higher future inflation. March factory gate price inflation was higher than

expected. Retail price inflation (on the RPI index), on which many pay deals are based, rose more than expected to 4.8%. The CPI, on which the Bank of England's official 2% target is based, was 3.1%, prompting the first open letter to the Chancellor by the Governor of the Bank of England since the Bank's operational independence in May 1997.

Low global inflation may be past

It is likely that the recent inflation 'surprises' reflect both an overestimation of the amount of slack in the product markets and an underestimation of the importance of the global economic environment in the determination of domestic inflation. Not only have oil and other energy costs shot up again in recent months, but the low, or even negative, global inflation for manufactured goods has become a thing of the past.

Failure to raise earlier implies ½% now

If an immediate 25 basis point interest rate increase was justified on the basis of the February inflation forecast, a 50 basis point increase is called for today.

Comment by Gordon Pepper
(Lombard Street Research and Cass Business School)
Vote: Raise by ½%
Bias: Then wait and see.

Danger of too little, to late

In past cycles monetary policy has often been tightened by too little, too late, the result being that interest rates have eventually had to be raised higher than would otherwise have been necessary. The same mistake has just been made. Avoiding too little, too late is most important and it is worth making three general points.

Political economy reasons why rate changes are not made soon enough

Firstly, the CBI has a vested interest in keeping rates down and has a record of protesting against rises in rates that turn out to have been absolutely essential. The record has been so bad that, arguably, there should be special scrutiny before an industrial economist is appointed to the MPC. Secondly, there is the bureaucratic instinct to have smooth changes in rates, which makes too little, too late more or less inevitable. Thirdly, a rise in rates is nasty medicine. Whereas businessmen are used to taking nasty decisions in the best interest of their businesses, academics are perhaps not so worldly. Their instinct may to be to indulge in wishful thinking and hope that the medicine will not be necessary. When the case for a rise is proven to their satisfaction the medicine can easily be too late.

Inflation overshoot should shock MPC into decisive action

The discipline of the Governor having to write a letter to the Chancellor should help to guard against a repeat of too little, too late. It should shock the MPC into acting decisively. They will damage their reputation much more if they again do too little, too late than if they raise rates by too much and quickly reverse the rise if it turns out to have been unnecessary.

Comment by John Greenwood
(Invesco Asset Management)
Vote: Raise by ¼%
Bias: Tighten

Governor's open letter was complacent, and over emphasised relative prices

The Governor's open letter of 16 April was somewhat complacent, and stressed changes in relative prices (energy prices, food prices, - even furniture and furnishings, and milk prices made an appearance!) as well as short-term cyclical factors (capacity pressures, corporate pricing power) to the detriment of the broader, underlying monetary causes of the current inflation.

No admission of monetary roots of inflation

While the letter admitted that spending in the UK economy was "associated with continuing rapid growth of money and credit" (para 5), there is no admission that the same rapid growth of money and credit (1) has an impact on a range of asset prices that in turn creates the wealth or purchasing power that will bid up goods and service prices in the future, or (2) that double digit rates of growth of money and credit needed to be slowed to single digit growth rates.

Paul Tucker's arguments

Paul Tucker has defended the Bank's attitude to £M4 growth by arguing in the Roy Bridge lecture that:

Money is in hands of Other Financial Institutions

1**.** *Most of the excess money was in the hands of OFIs etc, and therefore not an immediate inflationary threat***.** RESPONSE: There are very few cases where excess funds do not first go to financial institutions, before percolating to the rest of the economy. This is a perfectly normal feature of the transmission mechanism.

OFIs have increased demand for money

*2. Much of the excess money was probably associated with OFIs such as hedge funds and investment banks holding more deposits than in the past in order to be able to meet margin calls etc against some of the new, exotic derivative instruments they are holding nowadays***.** RESPONSE: If this is the case, why do we not see a similarly rapid growth of money growth in the USA where there is an equal mushrooming of such investment in derivatives? (US M2 grew 6.1% in the year to March.)

Rate spreads have increased OFI demand for money

3. The Bank has also argued that a narrowing of the spread between deposit and lending rates faced by OFIs may have led to a rise in equilibrium holdings of money balances. RESPONSE: Market-driven capital requirements of some financial institutions may have increased in recent years, and no doubt some of that additional capital would have been held in the form of additional money balances, but it seems unlikely that those changes would have been concentrated *only in the last two years* when M4 growth has accelerated into double digit growth. (Between January 1999 and December 2004 OFI holdings of M4 balances grew at only 5.7% p.a. compared with 24.4% p.a. in the period since January 2005.)

Underlying rates of growth of money and credit are too high for comfort and need to be brought down. Interest rates must rise to accomplish this.

Policy response

Four SMPC members voted to raise rates by ½%, with two believing that it was then appropriate to wait and see the result but two expressing a bias to further rises.

Three SMPC members voted to raise rates by ¼% with two expressing a bias to rise further, but one believing that rates could subsequently be cut if inflation eases as expected.

Two members voted to hold.

Date of next meeting
Wednesday 18 July 2007

Annexe: Further Comment by Andrew Lilico

Why the 3% upper inflation limit matters

I have been reflecting a little on why I seem to be an outlier in thinking it matters that the upper end of the 3% threshold for the inflation target has been breached. Colleagues seemed to be divided between those that place no great significance upon inflation targeting as a regime in any event (e.g. Tim - who wants to raise rates more aggressively for overwhelmingly monetary reasons) and those that felt that inflation reaching 3.1% did not represent any real breach of the inflation target but merely entry into a letter-writing phase (e.g. Patrick).
I want to explain why I think it really does matter.

MPC had both point and range targets for inflation, but is now ignoring the range one

First, as to whether it is really a breach of the target and what are the roles of the letter. In his letter, King argued that hitting 3.1% did not mean that he had failed to meet his target, a view endorsed at last night's SMPC meeting. I consider this a misinterpretation of the framework. Here is how I understand matters. There was a debate, in the early period of inflation targeting, concerning whether one should have a range target (as per New Zealand) or a point target (as per Australia). The UK initially went for a range, but then in 1997 it produced the innovation of a mixed target, including both an explicit point and an explicit range. The point about the +/-1% not being the "target" is merely that the target is 2%, not 3% or 1% or a range between them. It is not that there is no policy asymmetry between outcomes just inside the top of the corridor (e.g. 2.9%) and those just above (e.g. 3.1%) - as per last night's suggestion that the MPC ought not to have reacted to a 20% risk that inflation would go above 3%. On this interpretation, what we have in the UK is really simply a point target - as per Australia in the original debate - and the key point of our policy innovation (incorporating elements both of a point and a range) would be lost.

The New Zealand example

But what of the provisions for writing letters, then? What are those about? Well, in the case of New Zealand's inflation target, for example, there were a series of explicit provisions whereby the target was permitted to be breached in respect of first-round shocks (with policy merely reacting to prevent second-round pass-through). As set out in Bernanke et at (1996) These included:

Rate changes

? A movement in interest rates that causes a significant divergence between the change in the CPI and the change in the CPI excluding the interest costs component. This clause of the third PTA replaced the earlier provision for a significant divergence between the CPI and a price index treating housing costs on an internationally comparable basis.

Terms of trade

? Significant changes in the terms of trade arising from an increase or decrease in either import or export prices.

Indirect Tax

? An increase or decrease in the rate of the goods and services tax (GST) or a significant change in other indirect taxes.

? A crisis such as a natural disaster or a major disease-induced fall

Natural disasters

in livestock numbers that is expected to have a significant impact on the price level.

Government levies

? Significant price-level impact arising from changes to government or local authority levies.

The New Zealand letter

Furthermore, under the New Zealand regime there was also provision for the government to require an explanation from the Reserve Bank if the inflation target was to be breached (as in 1995), and in 1996 the Reserve Bank took the initiative, with Brash writing a letter to the government to explain another breach.

How to interpret UK letter writing regime

In my view, the proper way to understand the UK letter-writing regime is clearly in this context - as an explicit and formalized mechanism whereby the MPC explains breaches of its threshold range. Thus the letter writing provisions are in no way to be understood as indicating that inflation outside the +/-1% thresholds are not breaches of the target or that there is no appropriate asymmetry in policy response between expected outcomes just within and just outside the thresholds.

Monetary policy has been too slack for too long

Further, it seems quite clear to me that the point of the letters is (a) to explain what *force majeure* has driven inflation outside the required band (In this case, none! It is simply that policy has been too slack for too long and that the MPC appears not to have cared whether inflation went above 3%, feeling that a 20% chance of its doing so was not enough to warrant a policy response.); and (b) to explain what it intends to do about it so as to bring inflation back within the band (In this case, nothing! King's letter appears to indicate that the MPC feels that it has already done plenty and that its intended-anyway rise in May is quite sufficient.).

Breaches of inflation target are not harmless

I don't doubt that it was thought that, in the first few years after May 1997, there might be a number of letters written - after all, breaches of the inflation target had happened in every other developed country that used them. But that is not to say that such breaches should have been thought a harmless part of the system, or that once the system had bedded down they could not be avoided.

Communication and fundamental aspects of monetary policy

These issues are particularly important to me because of the way that I think monetary policy should be used. As I have set out before, I believe that there are two key elements to monetary policy - a medium-term monetary growth element, and a short-term "communications" element. The communications element arises from the classic critique of demand management from Lucas and others of the New Classical school: if private agents are well-informed then they can make privately optimal decisions, and unexpected monetary policy movements can only damage welfare unless those changes reflect superior information on the part of the policy-maker; but a superior response by the policy-maker would be simply to tell the private agents what he knows and let them re-optimize. I take this critique very seriously, but believe that the task for the policy-maker in giving up his informational advantage is non-trivial. It won't work to release a statistic or give a speech, particularly when such an advantage is interpretative, rather than factual, and even more so when

the advantage is vested in a group (e.g. a committee) rather than an individual. In a market economy, the way for the policy-maker to communicate with the Market is by changing a price - the short-term interest rate.

There need to be limits to the MPC's discretion if credibility is to be maintained

However, in order for communication to work, we need to understand the language that the policy-maker is speaking when he changes that price. That, to my mind, is the function of a regime of constrained discretion such as inflation targeting (or, incidentally, price-level targeting). The UK's point inflation target and threshold range provide an excellent basis for interpreting the MPC's policy decisions. We can (often enough to be useful) understand what it must collectively be thinking when it sets rates. But if we abandon the significance of the thresholds, then inflation targeting ceases, really, to be a regime of constrained discretion - in one sense there are no straightforward limits to discretion at all, merely a general aspiration to meet the point target; in another sense discretion is almost entirely eliminated as policy is focused entirely on a point, not a range of discretion.

Inflation expectations will take off if people believe that monetary laxity will continue indefinitely

In my view, a number of the factors mentioned at 17 April SMPC meeting reflect the high credibility the regime has had, whilst others indicate that the credibility of the regime is already under material threat. Take the (modest-but-important) gap between the modelled predictions of the impact of broad money growth on demand and the actual growth in demand. On my understanding there is no great mystery here. If I credibly promise to give you £100,000 in cash every year you will react differently from if I give you £100,000 this year but promise to give you only £1000 next year. It seems to me that the limited response of demand to broad money reflects just this: the MPC has, through the language of inflation targeting, been promising the Market that it would tighten policy considerably at some later stage, and the Market has believed it - so the response of demand has been more muted than if it had expected this monetary growth to continue indefinitely. In contrast, take the observation that "pricing power has returned". This seems to me to follow naturally from a slippage in credibility in the context of the above. If people start to believe that they are going to have their cash indefinitely, they will become more willing to spend it and less inclined to put it into assets or savings, so their willingness to pay will rise, so firms will be able to raise prices.

The liquidity overhang poses a threat

Of significant concern would be if people stop believing that policy will eventually tighten and that inflation will always stay within the required band. For then they will start to spend the vast sums policy-makers have given them, and the degree of tightening required to bring inflation back within target might become much higher. The risk is thus that even quite minor violations of the inflation target might have a feedback effect leading to much larger violations.

MPC slackness

I consider the MPC to have been slack - not because it did not listen to me (why should it care what I think?), but because it did not listen to itself. It said that there was a 15-20% chance that its target would be breached, and it sat on its hands as if that didn't matter.

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, 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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