
30th July 2007

IEA Shadow Monetary Policy Committee August 2007

Editorial Note

The results of the latest, and tenth anniversary, 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 2nd August. **On this occasion, a substantial minority of four SMPC members voted to raise rates by ¼% on 2nd August, but a majority of five members voted to leave rates unchanged.** Looking further ahead, there was an unusually wide spread of biases. Some SMPC members thought that Bank Rate was either at, or approaching its peak, while other members of the committee thought that a further rise, or rises, would be necessary, even if rates did go up by ¼% on 2nd August.

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 longest established such body in the UK, 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 on Wednesday 18 July (page 2). This material appears with the permission of the original authors and has not been amended by Lombard Street Research. The next SMPC meeting is scheduled for Tuesday 16 October. The SMPC's regular monthly e-mail polls, carried out in conjunction with the *Sunday Times*, will next be published on 2nd and 30th September.

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Press Release

(Not for publication before 00:01 hours Monday 29 July)

Shadow Monetary Policy Committee Votes to Hold Bank Rate in August, but only by a Slim Five/Four Majority

The Vote and conditional biases

At its latest, and tenth anniversary, meeting, the IEA's Shadow Monetary Policy Committee (SMPC) voted to hold the official Bank Rate in August by a narrow five/four majority. Looking further ahead, there was an unusually wide spread of biases. Some SMPC members thought that Bank Rate was either at, or approaching, its peak while other members of the committee thought that a further rise, or rises, would be necessary, even if Bank Rate was raised by ¼% to 6% on 2nd August.

Reasons for divergent views

The divergence of views held by the individual SMPC members mirrored an apparent similar lack of agreement on the MPC itself. The main causes seemed to depend: firstly, on how much weight should be attached to the continued rapid growth of broad money and credit; and, second, whether the slow growth of average earnings should be regarded as a more significant measure of the pressure of demand than the relatively strong figures being reported for the growth in national output and retail sales. The SMPC meeting was held on Wednesday 18 July, before the release of the 'flash' estimate of UK Gross Domestic Product (GDP) in 2007 Q2, on Friday 20 July. However, no SMPC member chose to alter his vote in the light of the new information.

Individual contributions

Among the individual contributions, Tim Congdon questioned the consensus view that inflationary pressures would ease significantly in the short-term: he thought that higher food and oil prices were likely to offset the pre-announced reduction in domestic energy costs. Patrick Minford argued that the de-regulation of the financial system meant that broad money and credit no longer had any significance, other than as indicators of the portfolio choices of individual economic agents. Peter Warburton emphasised the difference between the financial pressures on the household sector, and the far stronger position of companies, while John Greenwood preferred to wait and see the effect of the July rate increase before advocating another hike, even if he maintained a bias to rise.

Note to Editors

Contact points

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 monthly e-mail 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 18 July 2007

Attendance: Philip Booth (IEA observer), Roger Bootle, Tim Congdon, John Greenwood, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David Brian Smith (Chair), David Henry Smith (*Sunday Times* observer), Peter Warburton, Trevor Williams.

Apologies: Ruth Lea, Gordon Pepper, Ann Sibert, Peter Spencer.

Chairman's Comments

Introduction of new SMPC member and production and dissemination issues

David B Smith began by pointing out that this was the tenth anniversary of the first SMPC gathering. He then introduced Trevor Williams, the newest member of the SMPC, to the rest of the Committee. He reported that the problems associated with the production of the SMPC minutes and e-mail poll on the Lombard Street Research template appear to have been overcome, thanks to the efforts of Lombard Street Research's Pippa Courtney Sutton and Gabriel Stein. He was pleased to announce that the SMPC appeared to be getting more media recognition, with BBC radio taking an interest in addition to their established relationships with the *Sunday Times* and Bloomberg Television. Philip Booth expressed the IEA's thanks to David B Smith for his work in producing the SMPC's documents and generating greater media exposure.

David B Smith invited John Greenwood to give his assessment of the world and domestic economy.

The Economic Situation

The International Economy – the USA is still the major driver of the global business cycle

Failure of 'bottom-up' approach to predict US economic behaviour

John Greenwood referred to the circulated slides of outputs for his presentation (*Editorial Note*: John Greenwood's presentation is available from john_greenwood@ldn.invesco.com). He said that the current US cyclical expansion remains intact. Opinions about the US economy had been widely divided with some economists predicting a hard landing while others had been forecasting a renewed growth spurt. However, several of the 'Bear' forecasters had capitulated in June, abandoning their predictions for interest rate cuts, at least for 2007. The dominant view now lies somewhere between a soft landing and a renewed growth spurt. He said that the fact that the sub-prime market woes had not extended to the macro-economy represented the failure of the 'bottom-up' methodology as opposed to the 'top-down' reasoning of the macro-economic approach. One reason for expecting a resumption or continuation of growth in the US is the buoyancy in broad monetary growth.

International monetary developments

Money growth in most other developed economies is also buoyant and it is likely that the ECB will have to raise rates before long. Despite some leading indicators pointing to a slow-down, monetary growth in the OECD is pointing to renewed expansion. In China, monetary growth of 16-17% is appropriate, and, after allowing for velocity movements and

GDP growth of 10%, is compatible with an inflation rate of some 2-3%. Japan is the only exception where money growth is still too low but the basic picture for the world economy is one of buoyant growth underpinned by strong monetary growth

The Domestic Economy – monetary and credit growth still worryingly rapid

British economy remains strong, despite higher Bank Rate

John Greenwood said that there have now been five successive rises in Bank Rate but broad money and bank lending still continued to grow strongly. The inverted yield curve is not signalling a monetary tightening because of special factors such as the global savings glut and trends in pension funds' asset allocation. Asset markets remain strong and economic activity is firm. Admittedly there are signs of slowdown in personal borrowing and housing market activity. But manufacturing remains strong and investment intentions are firm.

Interest rates have been too low for too long

It is clear that the Bank has not done enough to slow the economy down. This is a classic case of rates remaining too low for too long. Personal sector credit demand has weakened but corporate and financial sector borrowing is growing strongly. The main question is how important is the growth of money held by Other Financial Institutions (OFI's)? He invited the committee to examine a chart of M4 growth held by households, OFIs and Industrial and Commercial Companies (ICC's), and RPI inflation. There were only two episodes when a surge in OFI and corporate M4 did not result in a rise in RPI inflation – 1980/83 and 1995/98. However these two episodes were the exception rather than the rule.

Order books and investment intentions

His slides 14 - 16 show that the economy is growing at capacity, retail spending is high on a year-on-year basis and only secured borrowing has shown signs of easing because of the increased burden of mortgage interest and principal payments. However, the industrial sector is unaffected. Investment intentions and order books are firm.

The labour-market debate

The main debate, and particularly within the MPC, concerns the state of the labour market. The 'Doves' point to the weak earnings data and the slowing growth of employment as evidence of a subdued labour market, and are concerned about policy overkill. The 'Hawks' point to falling unemployment and argue that official data on employment probably understate the true picture because they do not fully capture new immigration. The inflation risks are therefore on the upside. One participant pointed out that public sector earnings growth is actually unsustainably low, and it is this that is holding the overall earnings figures down – in effect an informal incomes policy.

UK summary

In summary the British economy remains buoyant supported by easy money. However, except for residential property it is hard to say there is overheating in many other sectors.

Discussion and Policy Response

Bank's Hopes of falling utility prices may be dashed

Roger Bootle said that he had to leave the meeting early and wanted to register his vote at this stage (*Editorial Note*: all the votes are arranged alphabetically below).

Adverse factors in short-term inflation outlook

Tim Congdon said the Bank has been expecting utility prices to fall out of the inflation figures. The wholesale price of milk has doubled. The price of wheat, bread and seasonal foods due to our ghastly summer has risen sharply, as has oil prices. The Bank's hopes might be dashed. Business surveys indicate that companies' intentions to raise prices remain well above the average of recent years. Inflation could well be back above 3% by this autumn. The growth of pay is remarkably low but nominal GDP growth has accelerated in the last few quarters. Profits have been rising. The government cannot continue to squeeze the public sector, implying that the rise in the average earnings index will increase.

Households are over-stretched

Peter Warburton said total hours worked have not changed. The household sector is very stretched. If the data is correct real personal disposable income is flat. We know that a tax increase is coming and the drag from mortgage rates will hit the personal sector hard. Projecting the aggregate demand and supply indicators over the next eighteen months will be particularly difficult.

Increased public spending discipline

Andrew Lilico said that the possible reason for the two instances of surges in OFI money holding not translating into higher inflation is because of its coincidence with a tightening of public sector spending.

Earlier episodes of rapid monetary expansion

Tim Congdon said that the 1980-83 figures were erratic because of re-intermediation. He said that the explanation for subdued consumer inflation in the 1995-98 episode was the exchange rate appreciation in this period, but acknowledged this was somewhat *ad hoc*. (He pointed out that asset prices were strong in these years.) Trevor Williams said that in both episodes the peak and descent of personal sector M4 seemed to coincide with inflation.

Sluggish wage inflation indicates weak demand

Patrick Minford said that *ad hoc* explanations of the periods when money did or did not explain movements in inflation, is unsatisfactory. He said that Peter Warburton was right. He made two points. The first point is that the household sector is getting squeezed. The second point is that wages are not increasing above 3 – 4%. Furthermore M0 is increasing at a rate consistent with a slowdown in the household sector.

Investment follows consumption

Kent Matthews said that order book and intentions data are very volatile and that investment will respond quickly to household spending which is the dominant trend in economic activity.

Spending off the boil

Trevor Williams said that the mortgage rate effects have not fully come through but secured lending is responding, consumer credit growth is

falling and house prices are showing signs of slowing down. There are clear signs of spending coming off the boil. The strength of the corporate sector is illusory and depends on growth in the rest of the sector. OFI money holdings are caused by private equity activity increasing both sides of the balance sheet.

At this point, Tim Congdon had to leave the meeting and subsequently registered the vote set out below.

Further discussion of the lessons of the 1990s

Andrew Lilico said that it would be interesting to examine inflation expectations and subsequent outturns for the 1980-83 and 1995-98 periods. Kent Matthews said that it was a pity that Tim Congdon had left because he wanted to ask him if he thought that the 1995-98 episode was a special case because in many ways it is exactly matched by what is happening now. OFI money is rising fast but personal sector money growth is growing steadily and growth of retail deposits, which is old-fashioned M2, is falling.

David Brian Smith (Chairman) then asked David Henry Smith (*Sunday Times* observer) whether he wanted to make any comments before the vote was called

Comments by *Sunday Times* observer

David Henry Smith thanked the SMPC for its monthly e-poll. He said that Bank was exercised by the monthly poll of inflation expectations. These figures showed a remarkably stable picture. The MPC was also stuck with the idea that mortgage equity withdrawal did not feed into consumer spending. He said that in his view that if inflation was to rise because of external factors, this represented one-off factors that shouldn't affect the MPC's decision on monetary policy but the experience of writing a letter has rattled them and they would probably respond and squeeze the economy further.

Individual Votes

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

**Comment by Roger Bootle
(*Deloitte*)**

Vote: Raise by ¼%

Bias: Tightening

Danger of a hard landing

Roger Bootle submitted that John Greenwood's Chart 17, which showed mortgage obligations, was particularly striking. Roger Bootle then added that there was a possibility of a nasty landing for the economy. The Bank's view is that energy prices will fall, but energy prices have rebounded so we cannot expect a sharp fall in inflation. If inflation gets lodged in the high 2% or 3% figures, expectations will react. He said that rates will have to go up further. He voted to raise bank rate by a ¼% on 2 August with a bias to further rises.

Comment by Tim Congdon
(*London School of Economics*)
Vote: Raise by ¼%
Bias: Tightening

Short-term pressures on consumer prices this autumn

In his submission, Tim Congdon stated that the CPI had risen by 0.6% in the four months to October 2006. The MPC has been confident that falling utility prices will bring the annual increase in the CPI towards 2% this autumn. But the concentration of several adverse food prices increases, and the latest jump in oil prices, raised the possibility that the annual CPI will again go through 3%. That would happen if the CPI were to rise by more than 1.2% in the four months to October. (Tim Congdon added that the CPI numbers for July and August will be hit by a sharp rise in seasonal food prices associated with the floods but even he would not blame this on M4!)

Money/GDP puzzle

Over the medium term the puzzle is to reconcile the current rates of growth of money (i.e., M4) and credit with any half-way sensible prognosis for nominal GDP growth and inflation. The rises in interest rates so far, plus another ¼% to 6%, ought to reduce M4 growth to an annual rate of, say, 9% - 11%, but he had difficulty seeing it fall to, say, 6% - 9%. (It might do, in which case not much more medicine – perhaps, no more medicine – is needed. But see below.) With 6% growth of nominal GDP (the current figure), a 10% growth rate of M4 implies that the ratio of money to GDP rises by 4% in 2008. On the history, that would mean further buoyancy in asset prices and domestic demand, which in turn would imply a serious inflation problem in 2009.

UK output is above trend

His view was that UK output is currently about ½% to 1% above trend, and that the positive output gap will rise to about 1% - 1½% by early 2008. To stop inflation rising, a period of beneath-trend growth will be needed, and strictly that requires M4 growth down to, say, 4% - 7% a year. So, probably, base rates will need to go above 6%. (There is a period out there – say, spring 2008 to autumn 2009 – when financial sector money will be static. Asset prices will do badly, with – for example – house prices off by perhaps 10%.)

Comment by John Greenwood
(*Invesco Asset Management*)
Vote: Hold
Bias: To Raise

Wait to see effects of earlier rate increases

John Greenwood said that, following the previous month's increase in Bank Rate, he preferred to wait and see if there was any reaction in household behaviour, so he was voting for a hold but with a bias to raise. He said that the economy is now close to the point when interest rates should be beginning to bite.

Comment by Andrew Lilico*(Europe Economics)**Vote: Raise by ¼%**Bias: Neutral***Case for one more hike**

Andrew Lilico said that in recent years the Bank has erred on the side of caution and allowed the base rate to be lower than it should. He said that he expected the rate to rise to 6%. He voted to raise the Bank Rate with no particular bias thereafter.

Comment by Kent Matthews*(Cardiff Business School, Cardiff University)**Vote: Hold**Bias: To cut***Counter-inflation policy remains credible**

Kent Matthews said that there was information content in the monetary aggregates and the narrow measures are consistent with a slowdown. Inflation expectations extracted from indexed linked have not shown a sudden rise consistent with a loss of credibility. He voted to hold with a bias to cut.

Comment by Patrick Minford*(Cardiff Business School, Cardiff University)**Vote: Hold**Bias: To cut***Money has lost its meaning in a de-regulated financial system**

Patrick Minford commented that the controversy over M4 broad money growth continues to suggest to some MPC and SMPC members that interest rates should go up some more. However in a deregulated financial system the various money supply definitions (MSD's) form part of an industrial equilibrium in the intermediary sector that is volatile and hard to interpret. It is like asking how many chips go into a computer; it depends!

Expectations are the prime mover under inflation targeting

Under inflation targeting these issues are bypassed so that, provided the target is credible, the inflation is delivered essentially through expectations of agents in the labour and product markets. Then we can observe the velocity of the various MSD's from their accompanying growth; of course it was largely because these velocities were so hard to predict that the inflation targeting system evolved.

Demand is cooling and a rate hold is justified

The problem for the MPC is to determine where interest rates should be allowed to go so as to keep output close to its equilibrium supply path (if the Bank got this systematically wrong it would undermine its inflation target). From present data it looks as if the growth of aggregate demand is cooling under the pressure of mortgage costs on stagnant household real disposable incomes. So I think a hold is justified and interest rates may well need to fall from here in coming months.

Comment by David B Smith
(University of Derby and Beacon Economic Forecasting)

Vote: Raise by ¼%

Bias: Neutral

August rate decision will be informed by new Bank of England quarterly forecasts

David B Smith said that the 2nd August rate decision was important because it would be informed by the new set of forecasts generated by the Bank of England's Quarterly Econometric Model, which would subsequently be published in the 8th August *Inflation Report*. He thought that the financial markets would not prove sympathetic if the new forecasts implied a rate rise was needed to hit the inflation target, and the Bank again chose to leave rates unchanged. He was also concerned that annual CPI inflation would bounce back next year from the low-point likely to be observed in the final quarter of this year, and that the inflation prospects at the end of the Bank's ten quarter forecasting horizon looked worse than they were likely to be only one or two quarters ahead. He thought it unlikely that the MPC would want to engage in two consecutive increases in Bank Rate – and had some reservations about doing so himself - but thought that they should on this occasion. The somewhat anomalous strength of sterling suggested a need to tread fairly lightly, however, and he could see the case for a pause, once base rates had reached 6%.

Comment by Peter Warburton
(Economic Perspectives Ltd)

Vote: Hold

Bias: To Cut

Danger of interest-rate overkill

Peter Warburton's view was that, for those who concern themselves only with aggregates, the UK economy appears remarkably robust and its growth consistently strong. Yet, marked disparities of experience between the household and corporate sectors have driven borrowing to extraordinary heights and saving to extraordinary depths. The key issue is whether and when the inconsistencies and divergences beneath the surface translate into fractured outcomes for the aggregates. The most significant context of concern is the behaviour of employment. There has been a downward tendency in the growth of employees over the past ten years and a particular weakness in 2007. With the pace of average earnings growth for the whole economy slowing to just 3.5% in the year to May 2007 and households facing a higher tax burden in 2008, there is a grave danger of interest rate overkill.

Companies are doing better than households, but this cannot go on forever

Companies, on the other hand, seem relatively untroubled by the Base Rate increases of the past year. To disregard this glaring discrepancy between the household and the corporate experiences of economic growth would be foolhardy. Plainly, households will not be able to sustain their rate of purchases if their real after tax incomes fail to recover and this must detract from corporate performance in short order. Large food stores reported an increase in the value of retail sales of only 3.6% in the June quarter and there is accumulating evidence of budgetary constraints on households. Either the weakness of employment and

average earnings is a statistical distortion, or it is a valid and substantial reason for deferring, if not cancelling, any further upward moves in policy interest rates.

Comment by Trevor Williams
(Lloyds TSB Corporate Markets)
Vote: Hold
Bias: To Cut

**Slowdown is
under way**

Trevor Williams said that the slowdown is underway and that the indebtedness of households will reinforce this process. The monetary factors are that borrowing and consumer credit is slowing. The next move in the base rate is downwards. He voted for a hold with a bias to cut.

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 no votes were required in absentia since nine SMPC members were present at the physical meeting.

Policy response

1. On a vote of five to four at the physical meeting there was a recommendation for interest rates to remain on hold.
2. Four members voted to hold rates with a bias to ease in the future.
3. One member voted to hold with a bias to a rise.
4. Two members voted to raise rates by ¼% with a bias to raise further.
5. Two member voted to raise rates by ¼% with no bias for further rises.

Date of next meeting

Tuesday 16 October 2007

Note to Editors

What is the SMPC?

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 Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (University of Derby and Beacon Economic Forecasting). Other current members of the Committee include: Patrick Minford (Cardiff Business School, Cardiff University), Tim Congdon (London School of Economics), Gordon Pepper (Lombard Street Research and Cass Business School), Anne Sibert (Birkbeck College), Peter Warburton (Economic Perspectives Ltd), Roger Bootle (Deloitte and Capital Economics Ltd), John Greenwood (AMVESCAP), Peter Spencer (University of York), Andrew Lilico (Europe Economics), Ruth Lea (Centre for Policy Studies and Arbutnot Banking Group) and Trevor Williams (Lloyds TSB Corporate Markets). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that a full set of nine votes is always cast.

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