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IEA Shadow Monetary Policy Committee Meeting and E-Mail Poll: February 2008

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Shadow Monetary Policy Committee Votes by Five Votes to Four to Cut UK Bank Rate

At its latest quarterly meeting (carried out in conjunction with the *Sunday Times*) the IEA Shadow Monetary Policy Committee (SMPC) voted narrowly to cut UK Bank Rate on Thursday 7th February. Five SMPC members voted to cut the official interest rate, while four members voted for rates to remain on hold. As happened last month, the rate cutters were not unanimous, with four wanting a ¼% reduction, and one a cut of ½%, giving a ¼% reduction overall. Looking further ahead, the four ¼% rate cutters had a neutral bias thereafter, but the ½% cutter and one of the 'holds' had a subsequent bias to ease, two holders had a neutral bias, and one 'hold' had a bias to tighten.

The SMPC 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 Tuesday 15 January (page 2). The vote was re-opened following the 22nd January US rate cut and one member changed his vote in response. The SMPC material appears with the permission of the original authors and has not been amended by Lombard Street Research. The next SMPC meeting will be held on Tuesday 15 April 2008. The SMPC's regular monthly e-mail polls will appear next on 3rd March and 7th April.

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Press Release

(Not for publication before 00:01 hours Monday 4th February)

Shadow Monetary Policy Committee Votes by Five Votes to Four to Cut Interest Rates

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 narrowly to cut the UK Bank Rate by ¼%, rather than hold it at its current level.

Earlier policy laxity limits scope for cuts

All members of the SMPC were concerned by the problems that had arisen with sub-prime lending, the consequent impact on the property market, and the softening of economic activity. However, a substantial minority felt that earlier policy mistakes, which had led to British interest rates being kept too low for too long, meant that a reduction in rates should not take place now.

Reasons to hold

Those wishing to hold rates were concerned about a number of trends in the UK economy including: strong broad money growth; the large balance of payments deficit; the depreciation of sterling; the lax fiscal background; and output appearing to be above trend. The holders consequently felt that the Monetary Policy Committee (MPC) had to stay focused on its core inflation objective. This view was summed up by David B. Smith, Chairman of the Shadow Committee who said, *'The December rate cut was an error because it risked de-stabilising sterling…Furthermore, inflation expectations had been rising, both in Britain and overseas…There is a real danger of global "stagflation"'.*

Reasons to cut

However, the majority view, which was held by the five SMPC members who wished to cut rates, was that the deteriorating credit market conditions would lead to a serious slowdown in the economy. John Greenwood, Chief Economist at Invesco summed up the views of those wishing to cut rates commenting, *'Events in the market for credit are sufficiently severe to create a significant downturn in economic activity.'* **The SMPC meeting was held on 15 January. However, all committee members were given the chance to re-consider their vote following the 22nd January US rate cut. One switched from a 'hold' to 'down ¼%' as a result.**

Note to Editors

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, which has shadowed the MPC since its creation, meets quarterly but also conducts a regular e-mail poll in intervening months. It normally publishes this, together with a poll on the Committee's view on interest rates, on the Sunday before the Thursday Bank Rate announcement.

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Minutes of the Meeting of 15 January 2008

Attendance: Philip Booth (IEA observer), Tim Congdon, John Greenwood, Ruth Lea, Andrew Lilico, Kent Matthews (Secretary), David Brian Smith (Chair), Peter Warburton, Trevor Williams, Melanie Powell (Derby University observer), Eugen Mihaita (Derby University observer).

Apologies: Patrick Minford, Gordon Pepper, David Henry Smith (*Sunday Times* observer), Alistair Heath (*The Business* observer).

Chairman's Comments

External observers

David B Smith welcomed Melanie Powell and Eugen Mihaita from the University of Derby as observers to the meeting and reminded members to complete the mini-biographies for the media contacts list.

David B Smith invited Peter Warburton to give his assessment of the world and domestic economy.

The Economic Situation

The International Economy – increased risk environment and softening of economic activity.

Early indicators suggest that world activity is slowing

Peter Warburton referred the committee to the briefing charts and began by stating that world economic activity in the third quarter of last year, when much of the published data expires, was not a good guide to what is to follow. The third quarter figures confirmed that growth of world economic activity was solid. However, a composite leading indicator is signalling a sharp downturn in the seven largest developed economies. Another indicator of world trade was the Baltic Freight index which was showing a severe downturn, even after allowing for seasonal effects. Similarly, exports from the three major far Eastern exporters - China, Korea and Taiwan - were also showing a growth slowdown.

Signs of US weakness

Peter Warburton added that US consumer spending in the third quarter was still strong but unemployment had edged up with layoffs in the financial sector showing the largest rise. Non-financial corporate profits growth has turned negative.

But world money supply growth remains strong

Even so, a weighted measure of broad money supply for fifty of the largest nations had accelerated in October. One interpretation was the repatriation of credit market debt back onto bank's balance sheets. But global core and headline inflation has risen in recent months. Indicators of US inflationary pressure picked up in November but worsening inflation indicators have not prevented ten-year yields in US Treasury bonds from declining. The riskier environment is reflected in corporate bond spreads which have widened and credit default spreads which have increased markedly. Fed funds futures indicate further cuts in interest rates. The market is currently expecting a further 60 basis points (0.6 percentage points) reduction by the end of January.

The Domestic Economy – A softening outlook

UK consumer confidence has fallen

Peter Warburton began his discussion of the economic outlook for Britain by stating that: indicators of consumer confidence had shown a sharp decline, despite the fact that the spread of the London Inter-Bank Offer Rate (LIBOR) over the official Bank Rate had settled down to a more familiar level; mortgage lending was running at a slower pace than in the previous year and growth in retail sales had softened in recent months; and overall house price inflation had softened with commercial property values showing a sharp decline.

UK broad money and sterling

M4 growth slowed sharply in October and November, although the latter figure was subsequently revised upwards. The year-on-year growth of M4 broad money was reported as 11.7% for November and the rate of growth of M4 lending remained steady at recent levels. A significant portion of bank assets are unaffected by interest rate cuts because of securitization. Cuts in rates are not being fully passed on to customers as financial intermediaries seek to restore margins. Sterling has depreciated suddenly in response to market expectations of future interest rate cuts.

Growth and inflation

The recent national accounts figures confirmed that the British economy suffered from serious imbalances. The third-quarter current account deficit, at 5.7% of Gross Domestic Product (GDP), was one of the worst on record. Credit tightening will weaken activity in the private business and financial service sectors, which together generate 60% of GDP growth. Consumer Price Index (CPI) inflation is at 2.1%, close to the 2% reference rate, and core CPI inflation at 1.4%. Headline Retail Price Index (RPI) inflation is 4% and RPI excluding mortgage interest (RPIX) runs at 3.1%, showing no change over the last three months. The decomposition of RPI shows that it has been externally-determined and administered prices that have been growing sharply in recent times while the rate of private sector generated price inflation has been falling.

David B Smith thanked Peter Warburton for his presentation and opened the meeting up for discussion.

Discussion and Policy Response

Discussion

Growth slowdown in 2008

Distortions to commercial banks' balance sheets

Trevor Williams started the discussion by asking for clarification on the US broad money supply figures. In replying, Peter Warburton said that financial innovation has created synthetic demands for short term assets that have created shifts in both the demand and supply of money. The potential for this type of money to migrate to consumer spending is low. Tim Congdon agreed that, in the case of US broad money, there had been some artificial inflation of bank balance sheets but China and India have strong money growth as indicated in the world broad money figures. He said that he expected world economic growth to slow to 3% against a traditional 4%.

Present global situation is more like 1970s than 1930s

David B Smith said that to him the current economic situation felt more like the period in the late 1960s and early 1970s, after Richard Nixon had broken the US$'s link to gold and world inflation was taking off, than it did to a re-run of the Great Depression. People who wanted to cut rates aggressively in the UK were doing so on the basis of the, as yet untestable, hypothesis that the global credit crunch was going to drive down UK growth very sharply indeed. He did not deny that this could happen. However, there was no evidence in the data that it was happening so far, or that money and credit growth were turning sharply negative. David B Smith added that, if one was discussing the 1930s slump, it was worth bearing in mind that not one bank in the then British Empire had gone bust during this period, whereas several thousand had gone under in the US, and that the severity of the inter-war recession in Britain was only approximately half that recorded in the US and Germany. He did not deny that the US may be heading into recession, but he thought that the UK was already so far into the overheating zone that it should not simply follow US monetary initiatives. He reminded the committee that the size of the balance of payments deficit in relation to GDP was a prima facie indicator of the excess of domestic demand over home supply in a small open economy, such as Britain's.

Interdependent risks

Andrew Lilico asked to what extent are the downside risks interdependent and to what extent are the inflation risks interdependent? Peter Warburton said that, if the tightness of credit continues, he believed that things will go badly wrong for the economy. The UK is more highly geared than the USA so if credit gets re-priced the impact is stronger in the UK. He also added that while the spread between LIBOR and Bank Rate has fallen back to normal levels this could widen again in the future. He said that the increased risk would be priced into spreads as hidden losses emerge. Ruth Lea said that central banks might now respond faster - if that were to happen - and make liquidity available, while Tim Congdon said that banks use write-offs strategically. He added that the extent of write-offs may be overdone and that write-backs may occur. Trevor Williams suggested that spreads are like speculative bubbles which eventually burst.

Importance of non-bank liquidity

John Greenwood stated that there are huge amounts of liquidity outside the banking system. When the Japanese bubble collapsed, non-bank finance imploded which resulted in strong effects on the real economy. The avoidance of Basle regulations had led to the fast development of non-bank credit. Peter Warburton agreed that the proliferation of credit channels has confused the operation of monetary policy. Philip Booth said that he was sanguine about the cycle. Low rates of interest, strong credit growth, and fast house price inflation that had not as yet fed into goods price inflation had to be slowed and that is what is happening.

Genuine uncertainties

David B Smith stated that this was one of the most interesting SMPC meetings that he could recall – in large part because of the genuine uncertainties involved and the fact that the standard macroeconomists toolkit had little to say on issues such as credit rationing – but that time was now running out, unfortunately.

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 of Economic Affairs)
Vote: Cut by ¼%
Bias: Neutral

Past errors limit future options

Philip Booth said that previous unduly low UK rates of interest, strong credit growth, and fast house price inflation had arisen partly because the Bank of England had been asked to target a price index – the CPI - that excluded the cost of housing and gave greater than proportionate weight to goods whose relative price was falling, such as tradables. This has had inevitable consequences that must be allowed to unwind.

Cut once, but no more

Loosening monetary policy to deal with the consequences of the losses from sub-prime etc. was not the right approach.However, a fall in rates might well be justified if there were an abrupt weakening in consumption and a rise in the savings ratio. Given the downward international pressure on interest rates, and Britain's status as a small open economy, he thought that a ¼% cut would seem to be in order now, but no more.

Comment by Tim Congdon
(London School of Economics)
Vote: Hold
Bias: Neutral

Weaker sterling has changed the situation

Tim Congdon said that during the credit crisis he had asked for a ½% cut, but the situation has changed with the fall in the value of sterling. The UK economy has a positive output gap of perhaps ½% to 1%, which argues that a relatively mild slowdown will be sufficient to keep inflation on target. At current rates there will be a sharp slowdown in broad money growth. Asset price weakness has been severe in some areas (such as commercial property, and property, financial, retail and cyclical sectors of the stock market). But – given the apparently ample money balances – this seemed to be best explained as a shock to confidence (i.e., a rise in the desired ratio of money to assets). He voted to hold, with a neutral bias.

Comment by John Greenwood
(*Invesco Asset Management)*
Vote: Cut by ¼%
Bias: Neutral

Credit constraints

John Greenwood said that events in the market for credit were sufficiently severe to create a significant downturn in economic activity. He voted to cut by ¼% in February with a neutral bias thereafter.

Comment by Andrew Lilico
(Europe Economics)
Vote: Hold
Bias: Neutral

Inflation target should take priority

Andrew Lilico said that the December cut in rates was due to credit market conditions and was clearly an error. The Bank of England had not allowed interest rates to rise high enough and therefore the possible extent of any rate reduction is limited. The inflation target is more important than slowing growth. The dominant risk to growth comes from falling house prices leading to weakened consumption. He voted to hold in February and had a neutral bias subsequently.

Comment by Ruth Lea
(Arbuthnot Banking Group and Global Vision)
Vote: Hold
Bias: To ease

Signs of slowdown but...

Ruth Lea said that the Bank faced a clear dilemma. On the one hand, there were signs of slowdown and the housing market seemed to be turning down. But it was worth remembering that an overheating economy (and housing market) was the reason for the Bank to raise rates from mid 2006 to mid 2007 and indeed, before August's 'credit-crunch' crisis, it was widely expected that official interest rates would be raised further. The surprise was that the housing market was as resilient for as long as it was.

...inflationary pressures rising

On the other hand, inflationary pressures were intensifying reflecting high commodity prices exacerbated by a weakening currency – which may, in turn, help Britain's appalling trade data. Too little attention had been paid to the falling pound. Under these circumstances, the Bank should behave cautiously and, on balance, hold rates in February. Bank Rate at 5½% was, however, on the high side and her bias was towards cuts.

Comment by Kent Matthews
(Cardiff Business School, Cardiff University)
Vote: Cut by ¼%
Bias: Neutral

Staged rate cuts are the right strategy

Kent Matthews said that he was persuaded by the argument that credit market conditions would translate into a significant slowdown in the economy. However, it is also clear there are dangers in cutting interest rates too rapidly. Therefore the Bank's policy of cutting interest rates in stages is the correct policy. Bank Rate cuts are unlikely to be translated into cuts in lending rates on one-for-one basis and therefore the cuts in rates are a means of shoring up declining consumer confidence and housing market pessimism. He voted to cut Bank Rate by ¼% in February with a bias to hold thereafter.

Comment by David B Smith
(University of Derby and Beacon Economic Forecasting)
Vote: Hold
Bias: Tightening

Current account concern

David B Smith said that the December rate cut was an error, in his view, because it had risked de-stabilising sterling, and wondered whether the Monetary Policy Committee (MPC) would have sanctioned a rate cut had they known the size of the current account deficit in the third quarter and the adverse revisions to earlier data. Broad money growth in the UK and the OECD had been rapid, and in the case of the OECD area as a whole had been accelerating. This was not at all like the collapse of around one quarter in the absolute levels of bank credit and money seen in the US in the early 1930s. Furthermore, inflation expectations had been rising, both in Britain and overseas. This meant that, not only was the supply of real broad money balances growing rapidly in the world as a whole, but the demand for money might well be falling, because of the reduced real return from holding interest bearing deposits caused by lower money-market rates and higher inflation.

Irresponsible fiscal policy seriously constrains MPC's options

There was also a serious issue of policy inconsistency in Britain, with fiscal policy already far too lax and likely to be relaxed further in the next few years because of the postponed general election. The risk was that people believe that a 1930s type slump was imminent when the real danger was a global 'stagflation', similar to the one observed after Nixon went off gold. He voted to hold Bank Rate in February with a bias to raise rates in the future. David B Smith added that a necessary pre-condition for easing monetary policy in Britain, without taking undue inflation risks, was the implementation of a 'Type 1' fiscal retrenchment package, in which government spending was reined back, there was no increase in the tax burden, public capital formation was not cut, and labour market regulations were reduced. From a political perspective, he could see no prospect of that. Rather, he feared that a surreptitious, but highly damaging, 'Type 2' package of tax-raising measures would be attempted by the present government. He was surprised that more people were not concerned by the fiscal constraints on the MPC's freedom of action.

Comment by Peter Warburton
(Economic Perspectives Ltd)
Vote: Cut by ½%
Bias: To ease

Action needed to forestall the downturn

Peter Warburton said that the credit crisis has tightened monetary conditions, as borne out by the Bank of England's relatively new 'Credit Conditions' survey. An adjustment of 50 basis points is needed to allow for a widening of banks' margins. Otherwise retail and commercial borrowers will find little relief. He expected a sharp slowing of economic growth. He said that action is needed now to forestall the downturn and voted to cut by ½% with a bias to further easing. He thought that Bank Rate had scope to fall to 4½% during the course of this year.

Comment by Trevor Williams
(Lloyds TSB Corporate Markets)
Vote: Cut by ¼%
Bias: Neutral

US bubble correction

Trevor Williams said that rapid broad money growth remained a worry. The world economy is reacting to a bubble correction in the US economy, in housing and credit market. From the British perspective the higher inflation path occurs because of the openness of the economy. The output gap is not the sole driver of inflation and other factors, such as the exchange rate, also matter. This argues for interest rates to be held, as a weaker currency may drive up inflation pressure. But immigration in recent years has made the capacity of the economy a lot more flexible. Thus the output gap measure may be positive, but increased immigration had increased the capital stock though this was not yet being fully factored into measurements of the output gap. This link explains the current low rate of wage inflation, even as unemployment continues to fall modestly. He voted for a cut with a bias to hold if the economy did not slow down but he believed that the economy will slow down.

Votes in Absentia

Reason for votes in absentia

The SMPC sometimes allows a small number of votes to be cast in absentia and adds their written submissions to the record of the meeting, to ensure that exactly nine votes are cast. On this occasion no such vote was required since nine SMPC members were present at the physical meeting.

Policy response

1. On a narrow vote of five to four the committee voted to cut Bank Rate by ¼% in February.

2. In particular, four members voted to cut the base rate by ¼% and one voted for a cut of ½%.

3. Of the five who voted for a cut in February, four had a neutral bias from March onwards and one had a bias to further cuts.

4. Four members voted to hold Bank Rate at its current position, with two having a neutral bias, one having a bias to cut, and one having a bias to raise interest rates.

Date of next meeting

Tuesday 15 April 2008

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 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 (Invesco Asset Management), Peter Spencer (University of York), Andrew Lilico (Europe Economics), Ruth Lea (Arbuthnot Banking Group and Global Vision) 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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