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The Shadow Monetary Policy Committee Quarterly Meeting and E-Mail Poll: August 2008

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Bank Should Hold Now, but be Ready to Cut Later, says IEA's Shadow Monetary Policy Committee

Following its latest quarterly meeting (carried out in conjunction with the *Sunday Times*) the Shadow Monetary Policy Committee (SMPC) voted to leave Bank Rate unchanged on Thursday 7th August. In particular, six members of the shadow committee voted for rates to remain on hold, while three members voted to cut the official interest rate by ¼%. The bare vote understates the underlying 'dovishness' of the shadow committee, however, since all three cutters had a bias towards further reductions, three of the holders had a bias to cut aggressively in future months, and a further holder had a bias to ease. In contrast, only two of the SMPC members who voted to hold Bank Rate on 7th August had a bias to tighten in subsequent months.

The SMPC itself is a group of independent economists, who assemble quarterly at the Institute of Economic Affairs (IEA) in Westminster to monitor UK monetary policy. The inaugural SMPC meeting was held in July 1997 and the Committee has met regularly since then. That it is the longest established such body in Britain, and that it meets physically to discuss the deeper issues involved, distinguishes 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 Monday 14th July (page 2). 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 14th October and its minutes will be published on 2nd November. The SMPC's regular monthly e-mail polls will appear next on 4th September and 9th October.

For Further Information Please Contact:

David B Smith +44(0)1923-897885 xxxbeaconxxx@btinternet.com

Philip Booth +44(0)20-7799-8912 pbooth@iea.org.uk

Lombard Street Research
www.lombardstreetresearch.com

Press Release*(Not for publication before 00:01 hours Monday 4th August)***Shadow Monetary Policy Committee Votes by Six Votes to Three Not to Cut Interest Rates in August but with a Bias to Ease Subsequently****Bank of England's worsening dilemma**

At its latest meeting, the IEA's Shadow Monetary Policy Committee (SMPC) voted by six votes to three to keep UK Bank Rate at 5% on 7th August. All the members of the SMPC were concerned about the current UK economic situation. Rising inflation and collapsing indicators of real activity presented the MPC with a difficult dilemma – though most members regarded this as a dilemma largely of the MPC's own making. The grim prospects for future inflation led most members to want to hold interest rates. However, there was a significant minority who wanted to cut rates now as a result of the worsening situation. One of the “cutters”, Patrick Minford described the Bank of England as showing a “total lack of leadership”.

An immediate rate cut would dent official credibility

The majority who wanted rates to be held were concerned at the signals a cut in interest rates would send to the markets when the inflation outlook was worsening. A cut in interest rates now, it was argued, would lead to inflationary expectations rising and, if this in turn led to a rise in wages, any recession would be made worse. Trevor Williams, Chief Economist, Lloyds TSB Corporate Markets, argued strongly that the Bank needed to restore credibility and keep rates at their current levels.

Collapsing money numbers will justify future rate cuts

Most of those who wanted to hold interest rates now wished to cut Bank Rate in the near future – some of them aggressively. Collapsing monetary aggregates, after making appropriate adjustments for problems in the inter-bank market, were viewed with great concern by several members of the committee. This view was summed up by John Greenwood, Chief Economist at Invesco, who commented, “*The money numbers are starting to fall. Bank Rate should remain unchanged in August but with a bias to cut aggressively further out.*”

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 gathers once a quarter but also conducts a regular e-mail poll in intervening months. It normally publishes this, together with a poll of the committee's view on interest rates, on the Sunday before the Thursday Bank Rate announcement.

For further information, please contact:**David B Smith****+44(0)1923 897885****xxxbeaconxxx@btinternet.com****Philip Booth****+44(0)20 7799 8912****pbooth@iea.org.uk****Richard Wellings****+44 (0)20 7799 8919****rwellings@iea.org.uk**

Minutes of the Meeting of 14 July 2008

Attendance: Philip Booth (IEA observer), Tim Congdon, John Greenwood, Ruth Lea, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David Brian Smith (Chair), Peter Warburton, Trevor Williams.

Apologies: Roger Bootle, Anne Sibert, David Henry Smith (*Sunday Times* observer), Peter Spencer.

Chairman's Comments

Growing media interest in SMPC's work

David B Smith said that the SMPC continued to achieve regular coverage in the *Sunday Times* and on Bloomberg Television. In addition, both BBC radio and television appeared to be taking a growing interest in the work of the committee, as could be seen from the large number of broadcasts made by individual committee members in recent weeks. He said that there were still some residual production problems involved in putting the minutes together and thought that it would perhaps be a good idea if Kent Matthews and Philip Booth maintained the Lombard Street Research templates on their own systems as a back up in case he fell under the proverbial bus. He had nothing further to report and invited John Greenwood to give his assessment of monetary conditions.

The Monetary Situation - *Balance sheets in repair in the USA – inflation now but deflation next.*

Faltering US credit supply

John Greenwood referred to the presentation charts (*Editorial Note*: these are available from john_greenwood@ldn.invesco.com). He said that in the USA non-bank credit had grown faster than bank credit from 2002 until it started to unravel last year. It is difficult to get a higher frequency picture. However, by aggregating weekly commercial paper issues with weekly bank credit growth it can be seen that - while bank balance sheets continue to grow - total credit growth including non-bank credit has experienced a sharp fall since last August. The latest data show that the credit crunch has migrated from capital markets to banks with bank credit growth showing an absolute decline of 8% (at a thirteen weeks annualised rate). However, the conventional monetary aggregates omit much of what is going on. Base money has not been increasing despite the Fed having allegedly pumped in more liquidity. MZM growth (money of zero maturity) has been rising rapidly as a result of the re-intermediation of funds back into the banking system after August 2007.

Commodity prices and de-leveraging

Commodity price inflation is not new. It is another bubble triggered by the same past monetary ease. Deflationary conditions will dominate in the USA and it would be wrong to raise interest rates even as commodity price inflation rises. A shift from stagflation back to a 'Goldilocks' steady state can only occur after the economy passes through a period of slower growth which may take eighteen months. What was the cause of the credit expansion in the first place? A positive feedback loop started the cycle with banks increasing leverage, increasing balance sheets,

which then encouraged further leverage. What we are now witnessing is the process in reverse with banks reducing leverage, contracting balance sheets, asset price declines, weakening balance sheets and further de-leveraging. There are only three ways to repair balance sheets. The first is to raise capital. The second is to sell assets and use the proceeds to repay debt. The third way is to earn your way out. We are in a classic balance sheet recession and all three approaches to balance sheet repair take time.

**US house prices,
Europe and Asia**

John Greenwood added that house prices in the USA have fallen by 15% as a result of lending tightness and look set to fall by a further 15%. The outlook for the USA is grim for the next eighteen months. The slowdown in the USA will spread to the Euro-zone. Sentiment in Europe is weakening with black spots showing up like the build up of capacity in the Spanish property market. Many emerging economies have a fixed or quasi-fixed exchange rate with the US\$ so monetary policy is being imported. The money supply is growing rapidly in India and Turkey. China has not raised rates and has responded by a mixture of appreciation of the exchange rate and sterilisation. Inflation in the emerging economies has been rising sharply. Central banks in these economies are behind the curve and need to tighten more. The slowdown in the developed economies will be followed by some slowing in the emerging economies. High oil prices have taken their toll on domestic consumption and are now at unsustainable levels. Oil prices will possibly fall back to around US\$80 to US\$100. The global situation is one of balance sheet repair and de-leveraging which is inherently deflationary.

The Domestic Economy – UK at the onset of recession

**UK economic
conditions**

The UK banks are tightening credit standards. As in the USA, non-bank credit had grown rapidly in recent years. Excess balances remain in the system and it is not clear where this will end up but it may cushion the impending downturn. A rise in the saving ratio must occur but it has not happened as yet. The latest Royal Institution of Chartered Surveyors (RICS) house price survey show that 92.9% of estate agents expect house prices to weaken, in contrast with 65.3% in June 1990. Unsecured borrowing growth continues to rise but this likely to be short term. Household mortgage interest and repayments as a percentage of personal disposable income reached a peak of 18.5% in 2007 Q4. This was higher than the peak of 17.8% recorded in 1990 Q3 following the Lawson boom. Investment intentions and capacity constraints surveys indicate a sharply cooling business sector. The labour market remains a lagging indicator. While import and materials prices have increased sharply, wage costs have remained under control. Unemployment remains remarkably low. Consumer Price Index (CPI) inflation is being driven by past excess money growth and will take another year to properly unwind.

**John
Greenwood's
summary**

In his summary, John Greenwood stated that the effects of the credit crunch were now moving into the wider economy. The real economy was showing signs of contraction. De-leveraging was fundamentally a deflationary process. Money and loan growth was slowing rapidly. Although inflation is showing up in commodity prices, input prices and import prices, the problem facing the Monetary Policy Committee (MPC)

was how to deal with deflation, not inflation. The MPC will have to think about rate cuts soon if they are to avoid overkill.

David B Smith thanked John Greenwood for his presentation and opened the meeting for discussion.

Discussion – Balance sheet repair

City forecasters may be ‘behind the curve’ of accelerating inflation

The Chairman started by asking Tim Congdon to cast his vote as Tim had to leave the meeting early. (*Editorial Note:* this appears with the votes in the next section). In his introduction to the debate, David B Smith said that the June producer price figures released that morning (14th July) had been well ahead of market expectations, with input costs up 30.3% on the year rather than the expected 28.4% and output prices up 10% rather than the anticipated 9.7%. In his experience, City forecasters usually underestimated the speed with which inflation pressure built up once these were rising. He suspected that the next morning’s June CPI release would also show higher inflation than the consensus forecast of 3.6% (*Editorial Note:* the outcome was 3.8%). The world economy was more integrated now than previously and global monetary pressure has been the main driver of world inflation. There was no sign that OECD broad money growth was collapsing. Indeed, the reverse applied and there had been a marked acceleration to around 8¾% to 9% annual growth in the recent data. Furthermore, the attempts of countries such as China and the Middle-Eastern oil producers to hold down their currencies against the weakening US\$ meant that they were losing control of their monetary aggregates in an upwards direction. Patrick Minford agreed that the emerging economies were sitting on their currencies and will go on trying to stop their currencies from appreciating. With their money growth continuing at the current fast rate, they are not sterilising in the traditional sense.

China and US financial strains

Trevor Williams said that capital inflows to China are \$132 billion. It would be difficult to sterilise that magnitude of inflow. John Greenwood said that the US\$ has stopped falling because of tightened credit conditions. The emerging economies are tied to the US\$ which will soon be a strengthening currency. Andrew Lilico raised the rescue of Indy Mac and the problems relating to Freddie Mac and Fannie Mae. He asked to what extent policy action can do anything in such circumstances. John Greenwood said that most business cycle slowdowns have been caused by central banks tightening to stop inflation but UK inflation has not really got out of control compared with past episodes. The problem is that households and financial firms were over-leveraged. Financial institutions had made strong attempts to de-leverage. But cutting interest rates will not help households repair balance sheets. This was the situation of Japan in the 1990s and USA in the 1930s. They were not periods of high inflation but situations of balance sheet adjustment.

Illiquid households

Peter Warburton said that what was different this time was that in the past households and businesses had precautionary balances to fall back on. This buffer no longer exists. Unused credit facilities have been

withdrawn. Households are illiquid and trying to cope and often had to pay exorbitant rates of interest rates in consequence. David B Smith said that lenders offering so-called ‘log-book’ loans secured against the value of a vehicle were currently charging an APR of 298% (*sic*) which was an indication of the financial stress some people were under. Andrew Lilico said that if agents are rebuilding their balance sheets, which will drive down economic activity, perhaps the rate of interest should stay at 5% so it can be cut aggressively when the downturn comes. Patrick Minford said that as far as the ordinary punter is concerned credit conditions are already tight. Ruth Lea said that the bubble in oil prices will collapse at some stage. She said that she was looking for threads of optimism in the discussion so far. If oil prices fell to the levels suggested by John Greenwood, then producer price inflation will fall. She said that she cannot see interest rates being reduced while inflation continues to rise. It was important to hold rates as a signal to pay settlements.

Emerging markets are not yet slowing down

Patrick Minford said that there was no indication of a slowdown in emerging markets. He asked in what sense will oil demand slowdown. Kent Matthews said that much of the export sector of China operates on very thin margins. Any slowdown in world demand will have a strong effect on exports and growth in the emerging economies. John Greenwood said that Indonesia, Malaysia, India and China have started to raise oil prices by reducing their subsidies. Now there is a more realistic relative price of oil in these economies which will create stronger responsiveness.

Votes

David B Smith then asked the members of the committee apart from Tim Congdon, who had voted earlier, to vote on a rate recommendation. On this occasion there was no requirement for *votes in absentia*, since nine full SMPC members had been present at the meeting as well as Philip Booth, who is technically a non-voting IEA observer but is awarded a vote when numbers are short. The votes are listed alphabetically rather than in the order in which they were cast, since the latter was on a round the table basis that simply reflected the arbitrary seating arrangements at the meeting.

Comment by Tim Congdon
(*Financial Markets Group, London School of Economics*)

Vote: Hold

Bias: To ease

Widening UK output gap will reduce inflation pressures

Tim Congdon said that output will go sideways or fall for one or two quarters in late 2008 and early 2009, so that the level of output would be below trend by spring 2009. Non-oil inflation will then be on a declining trend, while the effect of the increase in the oil price to mid-2008 will be dropping out of the index. (Indeed, oil prices may well fall over the next year or so.) If so, the Governor might – by, say, spring 2010 – have to write a letter explaining why inflation has fallen more than 1% below target! However, the short-term perspective is that inflation will rise

sharply in the next few months. Following that, the MPC should cut aggressively. He said that base rates (and hopefully inter-bank rates) should be at least 100 basis points (i.e., 1 percentage point) lower by spring 2009. While he had (correctly) been very pessimistic about macro outcomes in 2008 because of the excessive money growth of 2005-07, two unexpected shocks had made matters worse than he had envisaged. First, some banks had been taking undue risks in asset selection and, secondly, the price of oil had soared by far more than had seemed plausible in 2006 or early 2007. He voted to hold rates, with a bias to cut aggressively once the current hump in inflation had passed through.

Comment by John Greenwood
(Invesco Asset Management)

Vote: Hold

Bias: To cut

**Hold in August
but cut in the
following three
months**

John Greenwood said that it was not right to cut at this point in time. The money numbers are starting to fall but he would not advocate waiting for inflation to peak. He said that a cut should come in the next three months. He voted to leave Bank Rate unchanged in August but with a bias to cut aggressively further out.

Comment by Ruth Lea
(Arbuthnot Banking Group and Global Vision)

Vote: Hold

Bias: to ease

**See how inflation
develops and re-
evaluate in the
autumn**

Ruth Lea said that she agreed with the concerns of people such as Trevor Williams (see below). She said that it would not be right to cut now but that it was preferable to see how inflation develops and to re-evaluate in the autumn. She voted to hold immediately with a bias to ease.

Comment by Andrew Lilico
(Europe Economics)

Vote: Hold

Bias: To Cut

**Hold Bank Rate
until CPI
inflation has
peaked**

Andrew Lilico said that he wished that there had not been a rate cut in 2007, but that we are where we are. Inflation is likely to rise above 4%. He said that interest rates should stay on hold until inflation measured by CPI has peaked. Two months after inflation has steadied or started falling. He said that a cut in December was appropriate. He voted to hold Bank Rate at its present 5% this month with a strong bias to cut for subsequent months.

**High wage
demands cost
jobs but do not
boost inflation**

He added that the importance of preventing inflationary expectations leading to wage rises is *not* that this might lead to higher inflation (as if we believed in the cost-push theory of inflation), but, rather, that this would lead to higher *unemployment* as, for a given level of money stock not determined by salaries, the primary impact of higher salaries is upon the attractiveness of labour as a factor of production. It seemed to him

that there was a great deal of confusion in the press on this point at the moment – as if we were back to the 1970s in terms of economic theory as well as many other things

Comment by Kent Matthews
(*Cardiff Business School, Cardiff University*)

Vote: Cut by ¼%

Bias: Towards further easing

Tight monetary conditions

Kent Matthews said that there were two real interest rates and they were both strongly positive. The real interest rate faced by the financial institutions is the funding rate less the expected rate of asset price inflation, which is - and expected to be - negative. So the real rate of interest faced by the financial companies is massively positive. The other real rate of interest is faced by households. Mortgage and credit costs have been rising for those who can get credit but we are now in a classic situation of credit rationing. In a rationed market there is a shadow price and this price is a very high real rate of interest. Credit market tightness is an endogenous response and has not been governed by policy. But conditions are bad and it is incumbent upon the Bank to take measured action by cutting rates in stages explaining the reason at each stage. He voted to cut Bank Rate to 4¾% in August and had a bias to further cuts.

Comment by Patrick Minford
(*Cardiff Business School, Cardiff University*)

Vote: Cut by ¼%

Bias: To ease

Global monetary policy is too loose but UK is too tight

Patrick Minford said that he was concerned with world commodity price inflation but nothing could be done in the UK about it. There is a case for tightening of monetary policy in the global economy as a whole but the UK is already too tight. The Bank needs to loosen monetary policy. He said that the Bank of England had been pathetic in showing a total lack of leadership. He voted for a reduction of ¼% with a bias to further cuts.

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

Vote: Hold

Bias: Tightening

Weak pound indicates that UK has relatively loose monetary stance

David B Smith said that he disagreed with Patrick that nothing could be done in the UK to avoid world commodity price inflation. The 11½% drop in the sterling index over the past year was a major independent source of inflationary pressure that indicated that Britain was pursuing relatively laxer monetary policies than other countries, at a time when global monetary conditions were excessively loose in any case. More generally, he thought it was worth recalling why the MPC's post-1997 mandate was framed in the way it was in the first place. That was because the consensus amongst economists was that there was no long-run trade off between output and inflation, and that high and volatile inflation was damaging, so that a central bank's best contribution to

activity and employment was to maintain low and moderate inflation, despite the possible output costs in the short-run.

Rate cuts could threaten the entire UK monetary framework

He was concerned that the people advocating rate cuts at a time when inflation was accelerating to an as yet unknowable peak were implicitly saying let us junk the whole monetary framework – by reducing the inflation target to no more than a pious aspiration – and revert to neo-Keynesian monetary fine tuning. The history of previous inflation upturns suggests that central banks are often in denial about the extent to which they have let the inflation monster loose until it is too late for there to be any benign options left available.

Advocates of price level targeting had been right all along

With hindsight, he realised that his SMPC colleague Andrew Lilico had been correct in long arguing the case for price level rather than inflation targeting. This was because it would be easier to accept quite a long period of inflation overshoots over the next few quarters if it was known that there would be offsetting undershoots subsequently. As it was, private citizens would be quite rational in believing that inflation was being allowed to drift further and further away from its target, in part because of the political pressures ahead of the putative 2010 general election. It had taken seven years of feckless fiscal policy and three years of lax monetary policy to create the present unpleasant economic situation. Symmetry suggested that there were now no quick or easy solutions available, especially as Britain (together with Poland) is running the second largest structural budget deficit in the Organisation for Economic Co-operation and Development area after the USA. He voted to hold Bank Rate for the time being but had a strong bias to tighten at the first opportunity, especially if real money-market interest rates were reduced any further by accelerating inflation.

The importance of oil

However, he did want to include one caveat about the price of oil. In running the Beacon Economic Forecasting (BEF) macroeconomic forecasting model he had assumed that the oil price would stick at US\$130 for a barrel of Brent Crude until the end of next year (*Editorial Note*: it was US\$143.9 on 14th July but had eased to US\$125.8 on 28th July). On this basis, he would expect annual CPI inflation to be not quite 4½% in the final quarter of this year, still 4% late next year, and 3½% in late 2010. However, an alternative scenario, in which the oil price fell by US\$10 per quarter from 2008 Q4 onwards until it stabilised at US\$90 in 2009 Q4, would give annual CPI inflation of 4¼% in 2008 Q4, 2¾% in the final quarter of next year, and 3¼% in late 2010. Unfortunately, it was surprisingly difficult to know what other people were assuming, often implicitly, about the future price of oil. One example was that less than half the economic forecasting groups whose predictions appear in HM Treasury's monthly forecast comparison publish their oil price assumptions. However, it was probable that much of the divergence of views about the economic outlook implicitly rested on different assumptions about the price of oil, rather than reflecting more profound disagreements. The MPC's reputation would escape relatively unscathed if the oil price did fall to the widely touted US\$80 during the next few quarters but the MPC no longer had any effective control over events.

Comment by Peter J Warburton
(Economic Perspectives Ltd)

Vote: *Cut by ¼%*

Bias: *To ease*

Bank Rate cuts have not eased credit conditions so far

Peter Warburton said that past cuts in Bank Rate have not materially affected domestic credit conditions. Nor has the Bank of England's Special Liquidity Scheme succeeded in unblocking the interbank market. In recent months, there had been a significant downshift in the perceptions and activity of households as a result of credit tightness and the implied real income squeeze from higher food and energy prices. There is every likelihood that real household consumption and real GDP will fall in 2009; monetary policy should be directed to mitigating these outcomes.

Short-term inflation prospects are outside MPC's control

Plainly, the external factors driving the short-term evolution of the CPI lie beyond the influence of the MPC. To tighten policy – as one member voted to do in July – or even to refrain from easing until CPI inflation has peaked, would be to fight yesterday's battle. Now that the credit crunch has disabled the wholesale finance and capital market credit mechanisms, it is unnecessary for monetary policy to reinforce these contractionary pressures. To the extent that UK economic activity is far more credit-dependent than at the outset of the last contraction, in 1990, the scope for a deeper and more painful correction requires that interest rates be cut immediately, with a bias to further easing.

Comment by Trevor Williams
(Lloyds TSB Corporate Markets)

Vote: *Hold*

Bias: *To tighten*

Rates should not be cut until inflation has peaked

Trevor Williams said that he advocated a hold for the same reasons advanced at this meeting. Rates cannot be cut when inflation is rising, especially as it is accelerating with no good idea of where, or when, the peak is going to be. The Bank has suffered a credibility loss which needs to be restored. The UK cannot be divorced from the global economy but cutting rates is not going to solve the problem of money growth that began in 1998. He said that he did not want the Bank to repeat the mistake of cutting rates in the past. Real interest rates had to stay positive and high for credibility to be restored. He said that there was no scope for cuts in rates at all. He voted to hold with a bias to rise.

Policy response

1. On a vote of six to three the committee voted to hold Bank Rate at its current position.
2. Three members voted to cut Bank Rate by ¼% with a bias to further cuts.
3. Of the six members who voted to hold Bank Rate at its present 5%, three had a bias to cut aggressively and another one had a

- simple bias to ease.
4. Two SMPC members had a bias to raise rates

Date of next meeting

Tuesday, 15 October 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 nine votes are cast.

For further information, please contact:

David B Smith	+44(0)1923 897885 xxxbeaconxxx@btinternet.com
Philip Booth	+44 (0)20 7799 8912 pbooth@iea.org.uk
Richard Wellings	+44(0)20 7799 8919 rwellings@iea.org.uk

