2nd November 2008

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

Cut Bank Rate by Another ½% in November, States IEA's Shadow Monetary Policy Committee

Following its latest quarterly meeting the Shadow Monetary Policy Committee (SMPC) voted to cut Bank Rate by a further ½% on Thursday 9th November. In particular, six members of the shadow committee voted to cut Bank Rate by ½%, with an easing bias for future months in every case, while one member voted for an immediate reduction of 1%, and two members preferred to leave Bank Rate at the 4½% announced on Wednesday 8th October for the time being. There was a general view that changes in the official REPO rate were too weak an implement on their own to be useful in current circumstances. This explains and justifies the liquidity and re-capitalisation measures introduced by several central banks in October. Some SMPC members believed that further alternative policy approaches, including a possible deliberate underfunding of the Budget deficit, also needed to be considered.

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 Tuesday 14th October (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 13th January 2009 and its minutes will be published on 1st February. The SMPC's regular monthly e-mail polls will appear next on 30th November 2008 and 4th January 2009.

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Press Release

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Shadow Monetary Policy Committee Votes to Cut Rates by ½%

Base rate cuts may be ineffective on their own

At its latest (14th October) meeting, the IEA's Shadow Monetary Policy Committee (SMPC) voted overwhelmingly to cut Bank Rate by ½% from its current 4½% level. Though the committee supported an immediate reduction in rates, several members expressed concern as to whether rate cuts on their own would have a significant affect on the real economy. It was suggested that other monetary implements should have been available to the Bank of England at an earlier stage and that the tripartite dismemberment of the Bank in 1997 was one cause of the problems facing the authorities. The Bank is trying hard to stave off a recession but its official REPO rate has apparently turned out to be unfit for purpose. However, most of the other potential policy implements, including funding policy, had been taken from the Bank in 1997.

Adjusted broad money supply is contracting

Adjusted broad money supply measures, which had been growing strongly as a precursor to the lending boom and subsequent inflation, were now declining. Members were extremely pessimistic about the medium-term prospects for the economy and expected inflation to fall quickly. Those who voted for the ½% cut had a bias to cut further in the future or wanted a bigger immediate cut in rates.

Fiscal concerns and credibility of the official framework

There was some dissent from the majority position and much concern about both the government's fiscal position and current inflation. The Chairman, David B. Smith, advising caution in cutting rates further, commented: '*By easing monetary policy at a time inflation was above target, accelerating, and had consistently proved higher than the Bank of England had anticipated, we were coming dangerously close to junking the inflation targeting framework without putting anything in its place."*

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 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 14 October 2008

Attendance: Philip Booth (IEA observer), Roger Bootle, Tim Congdon, Andrew Lilico, Kent Matthews (Secretary), Gordon Pepper, Anne Sibert, David Brian Smith (Chair), Peter Warburton.

Apologies: John Greenwood, Ruth Lea, Patrick Minford, David Henry Smith (*Sunday Times* observer), Peter Spencer, Trevor Williams.

Chairman's Comments

SMPC Contacts List for the media

David B Smith said that the media coverage of the SMPC and its individual members had verged on the manic in recent weeks. This exposure had added significantly to the credibility of the SMPC. He encouraged members to e-mail out copies of the SMPC Contacts list for the media when they could not appear in person so that other committee members had the opportunity to stand in for them. In his introducary comments, he said that the coordinated cuts in central bank discount rates announced on 8th October seemed not to have passed along the money market yield curve in most cases. A comparison of the three-month rates prevailing on 6th October at the start of last week with those reported the previous day (i.e. 13th October) showed a marked fall in Canada, but no significant change in the Euro-zone or Britain, and increases in Switzerland and the US. This suggested that the leverage exerted by the central bank discount rate in isolation was limited. It also explains why the enhanced official liquidity support and the government sponsored re-capitalisation of the banking system were welcome and necessary steps if monetary policy was to re-gain any traction, even if one might have serious reservations about the precise details. The chairman then asked Andrew Lilico to present his analysis of the monetary situation.

The Monetary Situation

Less aggressive lending in the future and lower growth.

Three causes of the financial crisis

Andrew Lilico referred to his chart of the London Inter-Bank Offered Rate (LIBOR) ***minus*** Bank Rate wedge and agreed that the coordinated ½% cut had not had any impact in the UK. Of the list of factors that have brought the economy to this position, he highlighted three. Firstly, there had been genuine and valuable financial innovation in the sense of volatility and risk reduction. The second factor was so called 'hubristic regulatory badging'; in other words, the provision of a regulatory badge to enhance market confidence in the soundness of institutions and products, when in fact the regulator is in no good position to comment upon the soundness of those institutions or products. The third was the flaw in inflation targeting that resulted in Bank Rate being changed too late. The result was large bank losses due to mispricing of financial products and a situation where the unwillingness to allow financial institutions to collapse has stunted the information revelation process. The incompetence and prevarication of the regulatory authorities have stifled the prospect of the market healing itself. There has been large scale government intervention but success can only be measured in terms of the reopening of the inter-bank market. The outcome is that there will

House prices have fallen

in the future be less aggressive lending and less financial innovation which as a consequence will produce reduced growth rates globally. House prices have fallen 13.8% from their peak according to the Halifax index and new mortgage lending in August was only 2% of the August 2007 figure. The latter makes a mockery of the target to restore lending to 2007 levels by government directive. If the equilibrium house price earnings ratio was 4.15, house prices have a further 18% to fall. However, a further 30% fall would be required if the equilibrium price-earnings ratio was more like 3.5.

Small cuts in rates likely to be ineffective

Inflation has risen, but is now likely to drop

Inflation has been rising but is likely to drop rapidly henceforth to probably below 1%. There are powerful deflationary forces at work with real demand falling. Gross Domestic Product (GDP) growth is negative in many economies. In the UK, the Confederation of British Industry (CBI) distributive trades survey points to sharp slowdown. Oil prices have peaked. Importantly, corporate sector money holdings have fallen. In this environment, rate cuts may not be effective. There may even be a liquidity trap of sorts in that reductions in Bank Rate have not impacted on short-term rates. The signalling power of small cuts in Bank Rate will be weak and there is a case of stronger action in the order of ½% or more.

Discussion – *Falling money supply and debt deflation*

Inflation has persistently exceeded official and market expectations

David B Smith said that inflation had persistently turned out to be higher than the financial markets had expected in recent months. The September consumer price index (CPI) released that morning (i.e. 14th October) was a typical example and showed an annual rise of 5.2% compared with a market expectation of 5%. He speculated whether people were in denial about the extent of the UK inflationary pressures associated with the weak pound. Nevertheless, he thought that inflation would almost certainly ease over the next year or so now that the oil price was well under US$80 for a barrel of Brent Crude. Thus, the questions with respect to inflation were how far this easing would go and how long it would take for inflation to be back within its target band. Tim Congdon queried the view that that reducing interest rate would be ineffective. He said that cuts in rates would aid the process of recapitalisation by increasing bank profitability through wider spreads. Deposits rates tend to be linked to Bank Rate whereas loan rates follow LIBOR. Roger Bootle questioned the conclusion that less aggressive credit growth implies lower economic growth. He said the likely situation is that low growth was due to weak aggregate demand which in principle can be stimulated by fiscal policy. He said that it was unlikely that economic growth was going to be lower because of the removal of multi-leveraged financial products. There are two possible scenarios. If lending is to match 2007 levels, then there will be no increase in aggregate demand. The alternative is the Armageddon scenario. The reality is likely to be somewhere between the two. There is no political desire to allow lending to return to 2007 levels. Hence bank lending will be conservative but not too conservative.

Corporate bill and bond markets have seized up

Peter Warburton said that recent events have blown the corporate bond market out of the water and the implication for aggregate demand will be negative. David B Smith added that the corporate bill market had also seized up and this posed even more pressing problems because the finance was needed to support current activity, not just future investment plans. Andrew Lilico said that bank lending is likely to be weak and that we may need to dust off our Keynesian textbooks and think about fiscal policy and government borrowing as adding to the solution. Tim Congdon countered that the empirical evidence for the effect of fiscal policy on changes in nominal income is weak. Roger Bootle said that it may be better to contemplate an Austrian solution, of allowing failures and letting house prices fall so that the banking system could eventually heal itself.

Budget deficits crowd out private sector activity, and US and UK may be going ex-growth

David B Smith said that British government borrowing was already huge before the recession had had time to affect tax receipts and add to welfare bills. He said that this left little scope for an activist fiscal policy. He added that there was considerable empirical evidence that budget deficits crowded out at least a commensurate volume of private activity, although he was agnostic as to whether this was because of Ricardian-equivalence or for other reasons. He also added that the government share of GDP in the USA had already risen to 38.3% under President Bush, although this is still well below the UK figure of 45.1%. The US public spending ratio was likely to reach Continental European levels if Mr Obama managed to implement his spending pledges. A US government spending ratio significantly over 40% was likely to stifle the US's growth and exacerbate its structural unemployment just as it had done in Europe. International studies had consistently found over the past three decades that adding 1 percentage point to the government spending ratio reduced the sustainable growth of national output by some 0.15% to 0.2% each year, other things being equal. He suspected that the US and Britain were now experiencing supply withdrawls and that some of the problems in the financial markets were because both countries were going *ex-growth.*

Danger of debt deflation is real

Gordon Pepper said that credit will be sluggish and the danger of debt deflation is real. He said that it was important that the money supply be not allowed to fall. He advocated a policy of under-funding which required the government to borrow from the banking sector. Anne Sibert asked how the coordination between monetary policy from the Bank and government borrowing by the Debt Management Office could be done. Roger Bootle expressed scepticism that increasing the money supply by underfunding would have the desired effect, although he could not see it doing any harm. He asked Gordon Pepper and Tim Congdon what other policies could be conducted to boost the money supply. Gordon Pepper said that interest rate cuts alone would be ineffective. Tim Congdon said that interest rate cuts would be effective as they were means by which the banks can rebuild profits and recapitalise by widening spreads.

Arguments against rate cuts

Roger Bootle asked what the possible arguments against a large interest rate cut are. One possibility is that it signals a panic measure. Another argument would be the possible effects on the exchange rate. Peter

Do'nt hit the wall!

Warburton used the analogy of a car speeding towards a wall and where the driver has lost control of the wheel. The imperative is to avoid the wall before we do anything else. Andrew Lilico said that one argument about a large interest rate cut is about timing and that once done there was nothing left in the armoury. Another argument is that it may be necessary to leave something behind for a coordinated international cut.

Votes

SMPC voting procedures

David B Smith then asked the committee apart from Anne Sibert who had departed earlier and had already voted, to vote on a rate recommendation. On this occasion there was no requirement for *votes in absentia*, since eight full SMPC members had been 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 reflected the arbitrary seating arrangements at the meeting. By tradition, the chairman votes last.

Comment by Philip Booth
(Cass Business School)
Vote: Cut by 1%
Bias: Neutral

Little point in waiting

Philip Booth said that, if there was an argument to cut rates aggressively then there was little point in waiting. Thus, he wanted an immediate cut of 1% with no bias thereafter.

Comment by Roger Bootle
(Deloitte and Capital Economics Ltd.)
Vote: Cut by ½ %
Bias: To ease

Cut in November, and again later

Roger Bootle voted to cut Britain's official discount rate by ½% with a bias to further cuts.

Comment by Tim Congdon
(Founder, Lombard Street Research)
Vote: Cut by ½ %
Bias: To ease

Underfund the Budget deficit

Tim Congdon voted to reduce Bank Rate by ½% with a bias to further cuts. He added that he was also in favour of a policy of underfunding.

Comment by Andrew Lilico
(Europe Economics)
Vote: Cut by ½%
Bias: To ease

Keep cuts in reserve

Andrew Lilico voted to cut by ½% with a bias to further cuts. He wanted to keep some reserve shots in the locker and to be in a position to employ

an additional ½% in internationally-coordinated cuts. His vote for a mere ½% cut in November was correspondingly predicated on the assumption that there will be an additional internationally coordinated cut of ½% in late October or November.

Comment by Kent Matthews
(Cardiff Business School, Cardiff University)
Vote: Cut by ½%
Bias: To ease

Lower pound will not have major inflation effects

Kent Matthews said that an open economy which faced a collapse in demand for financial services will face a terms of trade adjustment that will manifest itself in a depreciation. Therefore he was sanguine about the inflationary effects of the lower pound. He voted to cut by ½% with a bias to cut by a further ½%, preferably as part of an internationally coordinated package of rate cuts.

Comment by Gordon Pepper
(Lombard Street Research and Cass Business School)
Vote: Cut by ½%
Bias: To ease

Cut and underfund

Gordon Pepper voted to cut by ½% with a bias to cut further. Like Tim Congdon, he also thought that the authorities should be ready to conduct a policy of underfunding to boost the money supply.

Comment by Anne Sibert
(Birkbeck, University of London and CEPR)
Vote: Hold
Bias: Wait and see

Let the dust settle

Anne Sibert said that she wanted the dust to settle following the recent ½% cut and to gauge the implications for the economy. She voted to hold for the time being.

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

No point in ¼% cuts, so choice is hold or down ½%?

David B Smith said that a ¼% reduction would be a pointless gesture that would have no discernible impact on the wider economy. The question therefore was whether there should be a cut of ½% or even 1% or, alternatively, a hold? He said that in the act of fire-fighting the market panic it was easy to lose sight of longer-term considerations. By easing monetary policy when inflation was above target, accelerating, and had consistently proved higher than the Bank of England had anticipated, we were coming dangerously close to junking the inflation targeting framework without putting another nominal anchor in its place. In addition, the scale of the public borrowing overshoot already this financial year – before the recession or the costs of the latest bank bailout

Potential fiscal disaster and run on sterling

have had had time to bite in the published statistics – meant that the fiscal policy framework had also been effectively thrown away. Giving a government that already had serious 'form' in the area of fiscal irresponsibility a blank cheque to let public spending rip ahead of a general election risked a potential fiscal disaster and a collapse in overseas confidence in the currency. Most economic modellers had known for three decades that budget deficits crowded out at least an equivalent volume of private activity, and that hyper crowding out could occur if interest rates were set purely to hit an inflation or exchange rate target. He also thought that modern cliometricians had come to the view that the measures in Roosevelt's much vaunted New Deal had either been too small to be effective or even perverse in their effects and that this was not an example to follow.

Collapse of due process in policy making

David B Smith was also concerned that immediate pressures had led to a collapse in due process in policy making that had potentially serious constitutional implications – just as some modern US historians claim that Roosevelt's New Deal programme effectively destroyed the constitution bequeathed by the founding fathers and over-concentrated power on the Federal government and the presidency. It should be inconceivable in a democracy subject to the rule of law for the Prime Minister and a clearing bank chairman to suspend the nation's monopoly and mergers framework at a cocktail party, as has been alleged happened in the case of the proposed Lloyds TSB/HBOS merger. Such decision making processes, while understandable in a panic, smacked of crony capitalism at its worst.

Was the economy heading for meltdown?

He said that the question was whether the economy is moving towards a total meltdown? If not, we risked over-reacting and were in danger of doing permanent long-term damage that outweighed the gains from stimulating demand in the short term. He voted to hold in November. However, he would be happy to cut by ½% as part of a coordinated international action. This was predominantly on a good neighbour basis. However, he also believed that this would give 'more bangs per buck'.

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

Benefit of rate cuts will become more obvious as LIBOR settles

Peter Warburton voted to cut by ½% with a bias to further cuts. He noted that the impact of rate reductions would soon become more obviously beneficial as sterling LIBOR settled back to a more modest premium to Bank Rate. He was deeply concerned that other things – for example, the Commercial Paper and REPO markets - could go wrong in the coming weeks and that it was important to hold something in reserve.

Corporate liquidity

Peter Warburton next warned the committee that corporate sector M4 holdings had shrunk by 2.8% in the year to August. In his view, there was an urgent need to re-liquify the corporate sector before the liquidity crisis translates into a bankruptcy crisis.

Policy response

1. On a vote of seven to two the committee voted to cut Bank Rate immediately.
2. Two members of the committee voted to hold with one saying that any cut should be coordinated internationally.
3. Six of the seven rate cutters voted for an immediate ½% reduction while one wanted a full 1% cut.
4. Six of the seven rate cutters expressed a bias for further cuts.
5. Two of the seven rate cutters said that the cut should be complemented with an active policy of under-funding.

Date of next meeting

13 January 2009

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 (Founder, Lombard street Research), Gordon Pepper (Lombard Street Research and Cass Business School), Anne Sibert (Birkbeck, University of London and CEPR), 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 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.

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