Shadow Monetary Policy Meeting

Minutes of the Meeting of 19 April 2005

Institute of Economic Affairs

Attendance: Professor Philip Booth (IEA Observer), Professor Roger Bootle, Professor Tim Congdon, Dr Andrew Lilico, Professor Kent Matthews (Secretary), David B Smith (Chair),

Apologies: John Greenwood, Professor Patrick Minford, Professor Gordon Pepper, Professor Peter Spencer, Professor Anne Sibert, Dr Peter Warburton.

Media Observer: David H Smith (*The Sunday Times*)

Chairman's Comments

Britain's fiscal policy is the main concern, and monetary policy is a second order problem

David B Smith began the meeting by welcoming David H Smith of *The Sunday Times* as an observer to the meeting. David B Smith then said that, although they had gathered to discuss monetary policy, the main problem facing the UK economy seemed to be the profligacy of fiscal policy, and its possible consequences for aggregate supply and the ability to create real jobs in the longer run. This posed the question of what a responsible monetary authority should do when the fiscal authorities behaved irresponsibly. He said that almost 1 percentage point of the growth of UK GDP in 2004 was officially attributed to questionable productivity improvements in the public sector, and that increased government employment had masked the serious job losses in manufacturing. There were signs in recent figures that both the claimant and survey-based measures of unemployment were rising now that labour shedding in manufacturing was no longer being outrun by job creation in the expanding public sector.

David Smith then invited Tim Congdon to present his analysis of the world and domestic economy.

The Economic Situation

World Economy: Boom of 2004 Will Not be Followed by Bust in 2005

Effects of higher oil price on world economy

Tim Congdon referred to his circulated notes and charts. When oil was US$25 a barrel, the oil-producing sector accounted for 2% of world GDP. At US$50 a barrel, there is a 2% additional transfer from oil consumers to oil producers. The overall effect on world demand and implications for the UK economy is neutral. OECD output is at trend for the major industrial economies and OECD money supply growth is in the region of 5-6%, which is consistent with low and stable wage and price inflation - so nothing apocalyptic for the world economy.

International monetary developments

Money growth in the US has slowed down, possibly due to a collapse in company sector borrowing. The rate of interest in the USA applies to a wider US$ area. Partly because of low interest rates, Asian economies continue to grow rapidly. Higher oil prices have seen countries like the UAE and Saudi Arabia experiencing a credit boom. In the Euro-zone, money growth is at 6% per year, which is above the unofficial monitoring range of 4.5%, but there is no argument for raising rates, given the slow growth in the Euro-zone economy. In sum, the world economy is rather settled and the boom of 2004 is unlikely to be followed by a bust in 2005.

UK Economy: Double-Digit Money Supply Growth

Britain's excessive monetary growth

The growth of broad money is nearly into double digits. Output is slightly above trend. Manufacturing surveys show skill shortages, and pay growth has moved up slightly. The message from the real economy is somewhat mixed. Employment growth has remained solid, despite the previous rise in interest rates. Retail sales have clearly slowed down, but one must bear in mind that this only constitutes 20% of GDP. Corporate liquidity is very strong, which is usually associated with high growth in domestic demand. Monetary growth will not fall back without a rise in interest rates. With output being above trend and M4 growth at about 10%, inflation will rise above the target. If M4 growth remains at around 10%, inflation will eventually rise to 5% a year.

Discussion and Policy Responses

World Economy: Weaker than Expected

Uncertain prospects for world activity

David Smith said that, as regards the world economy, oil prices are a matter of concern, and there may be a sluggish first half but there should be a pick-up in the second half of this year. Roger Bootle said that the world economy is likely to be softer than expected. The Euro-zone remains very weak and the recent retreat in the stock market indicates a much weaker world economy.

Domestic Economy: Interest Rates Too Low By the Standards of the Last 30 Years

What happens if UK monetary growth does not slow down

David Smith said that simulations with the Williams de Broë economic model suggest that, if M4 growth remains at 9½% per year indefinitely, things looked quite attractive for several years before CPI inflation picks up to just over 4½%. He added that net exports seem more sensitive to excess money creation than consumer prices, as long as overseas capital inflows are funding the balance of payments deficit.

Weak retail sales may indicate a wider slowdown

Roger Bootle said that Tim Congdon had pushed aside the evidence of retail sales as only representing 20% of GDP. Information about broader consumption trends is unknown and, if the retail sector slowdown is symptomatic of a wider slowdown in consumption, then more than 60% of GDP is affected. Kent Matthews asked what the impact on M4 growth would be from a weakening in expenditure. Andrew Lilico asked how much of the monetary tightening would occur naturally from international forces. David Smith said that, since M4 is endogenous in his model, it was not a simple matter to deconstruct the different forces that act on it. He said that a rise in real interest rates would deflate private demand by increasing the demand for M4 broad money, because it makes the interest-bearing component of M4 a more attractive asset compared with real goods and services.

UK money and nominal GDP should cointegrate, but data problems could make it hard to test

Tim Congdon said that a rise in the rate of interest slows down the growth in bank credit, and money supply growth will decelerate. Over the long period, nominal GDP and M4 grow at roughly the same rate. Kent Matthews asked if there was any empirical evidence that M4 and nominal GDP are cointegrated. David Smith said that the data were so bad that the new 2005 based Bank of England sterling index did not appear to cointegrate with the former 1990 price measure, using quarterly data from the early 1980s onwards, for example. This meant that he was not too hopeful about the usefulness of such investigations, since even different generations of official statistics for the same variable did not seem to pass Dickey-Fuller tests. However, it would be an interesting issue to investigate.

Different views on rates

Roger Bootle and Philip Booth had to leave the meeting early. Roger Bootle indicated that he would vote to keep interest rates on hold and Philip Booth indicated that he would like to see a ¼ percentage point rise. The meeting decided to follow its usual practice and invite written submissions from non-attendees to make up a quorum of nine votes.

Individual Votes, Including Votes *In Absentia*

The rate recommendations of the five SMPC members who attended the 19 April meeting, together with four votes cast by other SMPC members *in absentia*, are listed in alphabetical order below. All of the individuals concerned speak in a personal capacity.

Comment by Roger Bootle
(Economic Adviser to Deloitte)

Vote: No Change

Mixed economic picture suggests that rates should be left on hold for now

Recent news has suggested that inflationary pressures may be building in the UK. Meanwhile, news on the work economy has been soft. But the main issue at the moment is what is happening to consumer spending here in the UK. Recent data on retail sales has been flaccid. If this continues, then even though the inflation numbers themselves have been poor, the MPC should be looking to cut interest rates. I believe that, on balance, this is exactly what will happen.

Comment by Professor Tim Congdon
(Lombard Street Research)

Vote: Raise Rates by ¼%

Conflict between real and monetary data

Real-side pointers to economic activity and monetary data are in open conflict at present. The real-side pointers argue for stable rates or even a cut, but money growth is in double digits. I still favour a rate rise of ¼%, but I would feel happier if more of the real-side data were on my side.

Comment by Professor Gordon Pepper (Lombard Street Research and Cass Business School)

Vote: Raise Rates by ¼%

Excess supply of money relative to demand

The monetary aggregates continue to indicate that the economy will be more buoyant than the consensus forecast. The supply of money continues to be in excess of the demand for money. Although there are some signs that the factors contributing to recent monetary growth are on the wane, in past cycles others have taken over.

US monetary indicators suggest downside risks to growth

Monetary indicators in the US are suggesting the opposite to the UK. They are indicating that economic growth is likely to be more sluggish than the consensus forecast, and that the stock market will fall. If this happens, lower rates of interest may well be appropriate in the UK. In the meantime, however, UK policy should be determined by domestic factors and not by what might, or might not, happen elsewhere.

Comment by Dr Andrew Lilico (Europe Economics)

Vote: Raise Rates by ¼%

The MPC should aim for neutral REPO rate in 5¼-5¾% range

With inflation at 1.9%, only just below target, GDP growth steady, and little evidence of an output gap, in the absence of other factors we should be aiming for at least a neutral level of interest rates - which in the UK's case is probably somewhere in the 5.25-5.75% range. In fact, given that monetary growth has been very rapid in recent years, and that this has probably generated a backlog of inflationary pressure, it would be natural to expect rates to peak in the upper end of this range. This case is further strengthened by the rapid growth (and sustained high levels) of commodity prices, especially oil, and the likelihood of further monetary tightening in the US.

Housing market concerns

Against this, the one overwhelming factor is the housing market. The Bank of England has been reluctant to tighten rates rapidly for fear of disrupting a clearly heavily overvalued housing market. There is a strong case that it is not the job of monetary policy makers to target prices of a particular asset, and it is far from clear, in any event, that it would even be possible for monetary policy-makers to prevent house prices from falling (even were preventing that desirable, which it is not). On the contrary, as house prices fall it will be desirable to be able to cut rates rapidly to counter any deflationary or growth-dampening impact.

Raise rates until house prices deflate

Unless and until significant house price deflation becomes clear and established, interest rates should rise to dampen excess monetary growth.

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

Vote: No Change

Monetary growth is a worry, but rates should be held

Broad money growth is worrying and, if sustained at current rates of growth, interest rates would have to rise. However, M4 growth is endogenous and a slowing of consumer spending and mortgage lending in combination with international forces could see M4 growth dip back down to 8%. Until the mixed signals from the real side of the economy indicate which way the economy is going, he voted to keep interest rates on hold.

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

Vote: Cut Rates by ¼%

The case for a cut remains, but not as strongly as before

The latest data have included a rise in inflation to just below the target rate and a drop in growth in the first quarter to an annualised 2.4%. Wages are growing at 4.7%, which is roughly consistent with unit costs rising at the inflation target rate. Monetary base growth is fairly subdued at around 5% and M4 growth around 10%. Hence the figures are somewhat more mixed than the fairly clear slowing that I had expected. However, looking ahead to a likely rise in taxes after the election (or equivalent cuts in spending), the likely outlook remains one of a slowdown in demand. This still inclines me (though less strongly than before) to favour a small cut in interest rates in May.

Comment by Professor Anne Sibert
(Birkbeck College)

Vote: No Change

Bad March CPI probably reflects transitory factors

Much has been made of the recent increase in CPI inflation from 1.6% (year on year) in February to 1.9% in March. However, since 1997 there have been ten monthly increases of at least this size; it is an increase to take note of, but not to overreact to. CPI inflation is still below target. A large part of the recent increase reflects rises in the sterling prices of oil and other commodities. If these increases are temporary, then the resulting cost-push blip in inflation should not be of concern to the MPC. If the increases are permanent, then it is unclear whether the effect on supply is larger than the effect on demand; hence, there is no clear-cut case for raising UK interest rates.

Raising rates would suggest that MPC was behaving asymmetrically

Real GDP growth is likely to be about 2.5 percent in 2005 - in line with most estimates of potential growth; hence, there is no strong evidence of an output gap. House price inflation has fallen and UK short-term interest rates are high relative to those in the rest of the industrialised world. If the MPC were to raise interest rates now, it would strengthen the already widespread belief that the MPC is pursuing an asymmetric inflation target, rather than the official symmetric inflation target.

Comment by Professor Peter Spencer
(University of York)

Vote: No Change

Hold rates for now, but raise later

Interest rates are below the natural rate and the wide monetary aggregates are expanding at a rate that is faster than is consistent with the inflation target. I believe that interest rates will need to go up later in the year, but that it would be premature to raise them now. The High Street and the housing market still look fragile. The growth in exports and investment is disappointing, especially when seen against the background of the strength of world trade and company cash flows. The recent rise in the CPI is a concern, but this largely reflects the effect of high oil prices, which will tend to deflate economic activity. It is not clear what the eventual effect on inflation will be.

Comment by David B Smith
(Chief Economist, Williams de Broë plc)

Vote: No Change

UK is developing a stagflationary bias, making monetary policy more difficult and politically controversial

Historically, episodes of stagflation appear to have had three proximate causes. One was the pursuit of irresponsible tax-and-spend fiscal policies, which slowed the sustainable rate of growth and raised structural unemployment, a syndrome only too apparent in Continental Europe. Second was oil price shocks, which pushed up headline inflation while reducing the spending power of business and consumers. The third was the re-entry problem observed after a period of unduly rapid money and credit growth. This latter was because the slower money and credit growth required to avoid inflation locking onto an unacceptably high path, tended to undermine asset prices and real activity, until expectations had adjusted to the more rigorous monetary regime. These factors suggest that Britain is now on the verge of a mildly stagflationary epoch. However, it is unlikely to be anything near as bad as the one in the 1970s.

Limited options for central banks confronted with stagflation

The issue is what the central bank should do in these circumstances, particularly as monetary policy becomes more difficult, and more politically controversial, as the output/inflation trade-off facing the economy deteriorates. A rate hike before the election might have encouraged a less irresponsible spending debate on the part of all the parties. However, it is now too late for such political economy considerations to be relevant. There appear to be sufficient uncertainties around for a policy of 'wait-and-see' to be justified for the next month or two. The longer-term outlook for UK interest rates is likely to depend on international developments as much as the home economy. It is difficult for the UK to avoid importing overseas real interest rates, in practice, because of the effects on sterling of having real interest rates out of line with other countries.

Policy Response

The uncertainties affecting both the international and domestic economies, which were partly a reflection of the stubbornly high price of oil, meant that the nine members of the SMPC who voted on this occasion split three ways. Three members voted to raise rates on 9 May, one voted for a reduction, and five voted to leave rates unchanged at their current 4¾% for another month.

Date of Next Meeting

Tuesday 19 July 2005 at 6:00pm.

Williams de Broë Plc

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P.O. BOX 515, 6 BROADGATE, LONDON EC2M 2RP. TELEPHONE: +44 (0)20 7588 7511 FACSIMILE: +44 (0)20 7588 1702

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