

The Shadow Monetary Policy Committee

Editorial Note

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to monitor the Bank of England's interest rate decisions and to make rate recommendations of its own. 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 almost every quarter since.

The Secretary of the SMPC is Professor Kent Matthews of Cardiff Business School, Cardiff University, and its present Acting Chairman is David B Smith of Williams de Broë Plc. Other current members of the Committee include: Professor Patrick Minford (Cardiff Business School, Cardiff University), Professor Tim Congdon (Founder, Lombard Street Research), Professor Gordon Pepper (Lombard Street Research and CASS Business School), Professor Anne Sibert (Birkbeck College), Dr Peter Warburton (Economic Perspectives Ltd), Professor Roger Bootle (Deloitte and Capital Economics Ltd), John Greenwood (AMVESCAP), Professor Peter Spencer (University of York), Dr Andrew Lilico (Europe Economics), and Dr Ruth Lea (Director, Centre for Policy Studies), who has recently joined the Committee. Professor Philip Booth (Cass Business School and IEA), who also attends SMPC meetings, is technically a non-voting IEA observer. However, he is awarded a vote on occasion to ensure that exactly nine votes are cast.

The document that follows reproduces the IEA Press Release (page 1) and the Minutes of the SMPC meeting held on Tuesday 25 October (page 3). This material appears with the permission of the original authors. It has not been significantly edited by Williams de Broë, apart from the addition of margin notes and some minor amendments to achieve consistency with our 'house style'. The opinions expressed are, correspondingly, the views of the individuals concerned. We are disseminating the SMPC material as a contribution to the UK monetary debate. The next physical SMPC meeting will be held on Tuesday 17 January 2006. The SMPC's regular monthly e-mail polls will continue to appear in the interim.

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Shadow Monetary Policy Committee Votes to Hold Interest Rates

For Immediate Release

At its 25 October meeting, the IEA's Shadow Monetary Policy Committee, a group of leading monetary economists that monitors developments in monetary policy, voted against changing interest rates by seven votes to two.

Members of the SMPC were concerned about short-term inflationary pressures arising from rising oil prices, but most members felt that now would be the wrong time to raise interest rates. A number of participants expressed concern about the medium-term outlook for inflation, particularly as the main money supply measures had been growing rapidly for some time. However, the majority of the members who took that view felt that the slowdown in the real economy would be sufficient to offset inflationary pressures. A rise in global saving and the likelihood of households reacting to their very high debt levels by reducing spending were also given as reasons for leaving rates on hold.

Two members, Peter Warburton (Director, Economic Perspectives) and Prof. Patrick Minford (Cardiff Business School) expressed fears of a potential economic slowdown and both wanted to cut interest rates. Peter Warburton said, "High levels of debt repayments and potential defaults on this debt mean that the economy is unlikely to be revived by modest cuts in the REPO rate." Other members put the slowdown in the real economy down to 'supply side factors' such as higher oil prices, business regulation, higher taxes and increases in public sector employment, and believed that the Committee should concentrate on the inflation outlook, which did not merit a cut in rates. David B Smith (Chief Economist, Williams de Broë) summarised this view: "the output gap is narrowing from the supply side, regardless of what is happening to demand but, overall, there is no need to do anything aggressive at the current time."

Note to Editors

The minutes of the meeting are attached below. Minutes of all recent Shadow Monetary Policy Committee meetings are available from the [Articles Section](#) of the IEA website at www.iea.org.uk.

The Shadow Monetary Policy Committee, which has shadowed the MPC since its creation, meets quarterly but also conducts a regular e-mail monthly survey of members' views on monetary policy. It normally publishes this, together with a poll on the committee's view on interest rates, on the Sunday before the meeting of the Bank of England's Monetary Policy Committee.

Shadow Monetary Policy Committee

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Minutes of the Meeting of 25 October 2005

Attendance: Professor Philip Booth (IEA Observer), John Greenwood, Dr Ruth Lea, Dr Andrew Lilico, Professor Kent Matthews (Secretary), Professor Patrick Minford, Professor Gordon Pepper, David B Smith (Chair), Dr Peter Warburton.

Apologies: Prof. Tim Congdon, Professor Anne Sibert, Dr Roger Bootle, Prof. Peter Spencer.

Chairman's Comments

Chairman's Comments

David Smith began the meeting by describing recent press coverage, mainly as provided by the *Sunday Times* and *The Business*. He welcomed Dr Ruth Lea, Director of the Centre for Policy Studies, as a new member of the SMPC.

New SMPC member

The Economic Situation

David Smith next invited Andrew Lilico to present his analysis of the world and domestic economy.

World Economy - Robust Despite Negative Effects of Oil Prices and Katrina

Andrew Lilico referred to his circulated notes (appendix). Inflation pressures are mounting as a result of the cumulative effects of oil prices - particularly in the USA. Although oil prices have fallen back recently, they still remain at nearly double their 2004 value. However, the US economy continues to grow at a robust rate despite the negative impacts of oil prices and hurricanes. Growth is still forecast to be 3-3.5%. The Fed has raised rates to 3.75% up from 1% in June 2003, but rates are expected to increase even further and peak at 4.5 - 4.75% in the coming year.

US inflation and growth

Euro-zone growth is still sluggish but inflation reached 2.5% in September, probably largely as a result of the high oil price. Japan shows signs of revival with industrial output in August up 1.2% and unemployment falling to 4.2% from 4.4% in July. The Bank of Japan has suggested that interest rates may rise in the New Year from their current near-zero level.

Euro-zone and Japan

China continues to expand robustly despite some belated efforts by the government to slow the economy down by introducing limited revaluation of the Yuan and by raising interest rates.

China

The most significant policy development may turn out to be the appointment of Ben Bernanke as Chairman of the Federal Reserve. Bernanke is a leading advocate of inflation targeting. It seems likely that the US will institute some type of inflation target but there is uncertainty as to what will be the exact measure.

Ben Bernanke

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UK Economy - Money Supply Growth Back Up After a Small Dip in August

The September growth in broad money has reversed on its dip in August. The twelve-month figure for August was 10% but September saw it rise back up to 11.2%, in line with what it was in July. Latest figures for secured lending show a continued downward trend although loans for house purchase were higher in August than in July. While consumer credit in August was slightly higher than in July, the trend is firmly on a downward path. Other indicators point to a continued real economy downturn, however, the retail sales figures may be overstating the slowdown.

Money and credit

Andrew Lilico said that the perception has been built up that the MPC will cut rates at the first sign of a slowdown and that there has been some suggestion that rises in inflation driven by oil prices should be ignored. But this is not the remit of the MPC. The MPC's role is to target CPI inflation, not inflation excluding oil prices.

MPC's remit

Discussion and Policy Responses

World Economy - Dangers in Switching Inflation Measures

David Smith said that core consumer deflator inflation in the US was 2%, but CPI inflation was 4.7% in September, so the precise choice of the inflation measure to be targeted was not a trivial issue. The US could learn from the UK's experience when adopting a preferred inflation measure. In the UK, the shift to targeting the CPI was probably a mistake because most wage bargainers still monitor the RPI, which is also used to up rate welfare benefits and bureaucrats' pensions. It can lead to all sorts of problems for the credibility of the monetary authority if the populace follows an inflation measure that is running well above the official target one.

Divergent inflation measures in US

Domestic Economy - Interest Rates Too Low by the Standards of the Last 30 Years

David Smith said the ONS figures for the growth of Britain's real GDP might be running too low, a point also made in the October MPC Minutes. In particular, the labour market seems stronger than the ONS output figures suggest, with both the Labour Force Survey and Workforce measures of employment showing rises over the past year. The large and growing share of GDP in the government sector also makes the whole concept of GDP problematic. He suggested that GDP is not a useful measure upon which to base monetary policy, because altering the rate of interest has no effect on government spending. David Smith then speculated that the new 'Market Sector Gross Value Added' series from the ONS - as described in the October 2005 ONS *Economic Trends* - might increasingly displace GDP for monetary policy purposes.

Measurement problems with GDP

Gordon Pepper reminded the Committee that the Bank of England used to have inconsistent objectives, namely, inflation,

Microeconomic problems

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unemployment and the balance of payments, which had led to unaccountability, and that Lord George had deliberately chosen to have inflation as a single objective. Further, Nigel Lawson had explained that macroeconomic policy should be used to control inflation while microeconomic policy - for example, supply side measures - should be used to stimulate real economic growth. Microeconomic measures explained the current slowdown. The Committee should concentrate on the outlook for inflation rather on what is happening to the real economy.

Patrick Minford agreed that supply-side factors have worsened but claimed that underlying growth of the economy is still in the region of 2.5% and the underlying trend in productivity growth is around 2%. He said that we should not try to select the bits of GDP that we do not like. Inflation is barely flickering with forecasts all uniformly around 2%. In this environment, where policy is strongly credible, the MPC should take into account the complete economic environment. The Bank has considerable flexibility and freedom to operate monetary policy in a situation where the inflation targets give credibility to policy.

UK supply still growing at around 2.5%

Philip Booth said that CPI inflation has risen from an annual rate of 1.1% to 2.5% and that the market predicts that with such a rise, interest rates would increase. Ruth Lea said that we would expect inflation expectations to feed into wage growth but there is no sign of this, which is the key factor that distinguishes the present situation from the 1970s. Patrick Minford agreed and said that any signs of a loss of credibility would be shown up in expectations-sensitive variables, such as bond rates or wages. Instead, what we know is that there is a serious weakening of the economy.

Wage bargainers' inflationary expectations remain subdued

Individual Votes

The individual votes cast at the meeting are listed below in alphabetical order, as is customary.

Comment by Professor Philip Booth (Cass Business School and Institute for Economic Affairs)

Vote: No Change

Philip Booth said that he did not understand Patrick Minford's position that raising interest rates is activism but lowering them is not. Whether the Bank targets money GDP or inflation, the growth of broad money is still too strong. He voted to hold rates.

Rapid monetary growth precludes rate cuts

Comment by John Greenwood (Chief Economist, AMVESCAP)

Vote: No Change

John Greenwood said that the global surplus of savings relative to investment explains the low long-term real interest rates of 1.5% implied by long bonds and indexed-linked securities. The economy

Global savings surplus

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is a little bit weaker but the house price deceleration is unlikely to create a slowdown in consumer spending. He said that he considered that current short-term interest rates are about right and voted to hold interest rates at the current position.

Comment by Dr Ruth Lea (Director, Centre for Policy Studies)

Vote: No Change

Ruth Lea said that she was optimistic that inflation was not going to rise. There is no evidence that the output gap is increasing; indeed substantial parts of the economy are growing well and in many areas of the country the labour market is very tight. She voted to hold interest rates at their current position.

Low inflation, and high capacity, indicates a 'hold'

Comment by Dr Andrew Lilico (Europe Economics)

Vote: No Change

Andrew Lilico said the stability of wage demands and inflation expectations in the bond market was a symptom of the credibility of the MPC, and hence embedded expectations of appropriate policy responses (including the belief that the Bank would act to raise interest rates if needed). It did not imply that money growth and inflation would ease by themselves, so that rates could be cut safely. To wait for inflation expectations to rise before raising rates would be to surrender the credibility of the policy framework. However, as matters stand, although monetary growth is still too high, the slowdown in the real economy may be enough to offset inflationary pressures for the moment and may eventually drive down broader monetary aggregates for a time. He voted to hold the REPO rate at its current position.

Factors balanced on REPO rate

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

Vote: No Change

Kent Matthews said that declining consumer spending is consistent with an expected fall in output which, in turn, is supply driven. Ricardian equivalence issues suggest that consumer spending should fall faster than the rise in government spending. He also thought that the economy was doing better than the picture painted by official statistics. He voted to keep interest rates on hold.

Slower growth has supply-side causes and does not justify lower rates

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

Vote: Cut Rates by ¼%

Patrick Minford said that since there is not a flicker of inflationary activity in the labour market, the Bank has considerable freedom to stabilise growth. He added that following a Friedman money rule

Low inflation and slow growth warrant a cut

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would imply much greater volatility in interest rates that would be set by the market. In a downturn, such as the current situation, the market would lower interest rates. He voted to cut rates by $\frac{1}{4}\%$.

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

Vote: No Change

Gordon Pepper stated that, given the continued double-digit growth of the money supply, interest rates should be raised at the first opportunity. He voted to hold interest rates at the present with a bias to raise.

Hold with a bias to raise

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

Vote: No Change

David Smith said that there was no pressing reason to raise rates because of the strength of sterling and the fact that Britain's inflation remained reasonably stable in September, unlike the situation in the US where it rose from 3.6% to 4.7%, or Germany, where annual inflation accelerated by 0.6 percentage points between August and September. Private domestic spending is weak, if one believes the ONS figures, but the reversal of the Thatcher reforms means that supply growth is slowing, so the output gap is narrowing from the supply side independently of what is happening to aggregate demand. Overall, there was no need to do anything aggressive in monetary policy. He voted to hold interest rates at their current level.

Strong pound and moderate inflation suggest current REPO rate is correct

Comment by Peter J Warburton (Director, Economic Perspectives Ltd)

Vote: Cut Rates by $\frac{1}{4}\%$

Peter Warburton referred to his written submission (available by enquiry to economic.perspectives@ntlworld.com). With the increase in household debt, there is more to the consumer slowdown than first appears. Default rates of vulnerable groups are set to rise. High levels of debt repayments and potential default mean that consumer spending is unlikely to be revived by modest cuts in the REPO rate. The government is set to continue its excessive pace of borrowing, putting pressure on long-term rates to ensure take-up of debt from foreigners. Private sector inflation is only 1.3%, and real rates are in excess of 3%. The sharp rise in mortgage possession orders is symptomatic of the general economic environment, which is one of a serious deceleration in growth. Peter Warburton voted for an immediate cut in the REPO rate of $\frac{1}{4}\%$.

Rising debt distress suggests rates should be reduced

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Policy Response

- 1) On a vote of 7 to 2 the SMPC agreed that interest rates should remain on hold for the time being.
- 2) Two members voted for a $\frac{1}{4}\%$ cut in rates.
- 3) One member voted to hold rates at the current position with a bias to increase as soon as the opportunity arose.

Date of Next Meeting

Tuesday 17 January 2006 at 6:00pm.

Appendix

The Economic Situation - by Andrew Lilico

1) The International Economy

International oil prices had fallen somewhat recently, with Brent Crude down to around \$57 per barrel on Monday morning, having fallen late last week after a US government report showed rising stocks of both crude and petrol, down from over \$68 per barrel in late August in the immediate aftermath of Hurricane Katrina (though a considerable proportion of this fall has been offset by currency movements). Nonetheless, oil remains at nearly double its level of early 2004. Presumably partly as a consequence of the impact of cumulative increases in the oil price over the past year, inflation pressures appeared to be mounting in some countries, notably the United States, where retail prices were up 1.2% in September alone (including a 12% rise in energy prices - the biggest in 48 years) and annual inflation is now 4.7%. However, excluding food and fuel, September inflation was only 0.1% (annual, 2.0%). The producer price index was up 1.9% in September, while core producer prices actually fell 0.3%.

Oil and US inflation

At its September meeting, the Federal Reserve raised rates for the eleventh consecutive time, now to 3.75%, up from 1% in June 2003, and analysts are suggesting that rates will almost certainly rise to 4.25% by the turn of the year, and are likely to peak at around 4.5%-4.75%. Rising interest rates appear to be having some impact on the housing market, with rises in inventories of unsold properties and a slowing volume of transactions matched with a shift in the balance of mortgage applications away from short-term variable rates and towards longer-term fixed rates.

US monetary policy

Spikes in prices on the scale mentioned above might be expected to have a significant impact on GDP growth - for example, the US Treasury Secretary John Snow forecast that up to 0.5% might be knocked off annual GDP growth. However, the October Federal Reserve Beige Book survey suggests that the US economy has kept growing despite the negative effects of the hurricanes and surging oil prices, and economic growth this year is still forecast to be 3% to 3.5%. Nonetheless, oil price rises have had an impact, even before the hurricanes - the trade deficit grew 1.8% to \$59bn in August, representing the third highest monthly figure ever, including a record \$17.2bn spent buying crude oil supplies and a rise of 4.6% in the politically-sensitive deficit with China to \$18.5bn.

Katrina and US trade

The US budget deficit shrank to \$319bn in the 2005 fiscal year, down from \$412bn in fiscal year 2004, and well below the \$427bn initially forecast, although it should be noted that Congress has allocated a staggering \$62bn to post-hurricane Katrina emergency aid and reconstruction, of which only \$4bn fell into fiscal 2005. Looking forward, the University of Michigan preliminary index of consumer

Federal Budget deficit and US consumer confidence

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sentiment for October was 75.4, down from 76.9 in September. Ben Bernanke has been announced as the new Federal Reserve chairman, with Alan Greenspan retiring in January.

Euro-zone growth dipped to 0.3% in the three months to the end of June, from 0.4% in the first quarter, but the European Commission forecasts that growth will have accelerated to 0.4% in 2005 Q3 and reach 0.6% in Q4. Euro-zone HICP inflation reached 2.5% in September, with ECB President Jean-Claude Trichet attributing this, for the moment, to the temporary effects of oil price rises, but saying that “strong vigilance” was needed to ensure that this did not translate into ongoing higher inflationary pressures.

Euro-zone

In Japan, 2005 Q2 GDP growth was revised up 0.5 percentage points to 0.8%, and Q3 signs were positive: in August, industrial output rose 1.2%, the unemployment rate fell to 4.2% (from 4.4%), and spending by households headed by salaried workers rose by 3.2%. Looking forward, the Bank of Japan's Tankan survey of sentiment among big manufacturers showed a positive balance of 19 for the three months to the end of September (though this was slightly down on expectations), and Toshihiko Fukui, the governor of the Bank of Japan, has suggested that early next year the bank may shift its policy of keeping interest rates close to zero per cent.

Japan

China continues to expand robustly, up 9.4% annually in 2005 Q3 (the ninth straight quarter in which growth has been 9% or more) despite some apparent efforts by the government to achieve some slowdown in the economy by putting interest rates up, revaluing the Yuan, restricting credit levels, and also trying to limit investment in industries such as steel, cement and aluminium.

China

II) Comment

Potentially the most significant recent development is the appointment of Ben Bernanke as Federal Reserve chairman. Bernanke has been a leading advocate of (i) inflation targeting, a policy opposed by Greenspan, and a policy potentially difficult to reconcile with the swings in US inflation over the past few years; and (ii) the ‘asymmetric dangers’ view, according to which the dangers of having a little deflation are sufficiently materially greater than those of having a little inflation to justify a policy bias as inflation falls towards zero.

Ben Bernanke

Focusing on inflation targeting, it now seems very likely that some form of inflation target will be instituted for the US. But (a) What will be the measure - will it be core inflation, or something else? Might there be multiple measures? and (b) What will the rate be? Presumably around a 2.5% figure, as Bernanke appears to prefer in his writings. Might an inflation target be used even as part of getting inflation down from its current level? Or will it be instituted in a period of more stability? In his writings Bernanke appears to believe

Possible US inflation targets

that inflation targets are useful transitional devices, as well as devices for locking in gains made through other methods.

III) UK Money, Credit, GDP, Prices and Employment

Monetary and Credit Growth, and Exchange Rates

Provisional figures for September indicate that M4 rose by £17.1bn, seasonally adjusted; above the average rise for the previous six months of £9.7bn. The twelve-month growth rate rose to 11.2% from 10.0% in August, while the downward spike in three-monthly M4 growth, upon which some members commented at the time of the September e-mail poll, appears to have been reversed in September, and short-term M4 growth is still solidly above 10%. M4 lending increased by £15.6bn or 0.1%, seasonally adjusted, in September. The twelve-month growth rate rose to 9.9% from 9.7% in August.

M4 broad money

For August, the trend in growth in lending secured on dwellings continued downwards. The increase in net lending secured on dwellings, of £7.6bn, was stronger than the increase in July and stronger than the previous six-month average, though the twelve-month growth rate fell to 10.3%, from 10.4% in July. The number of loans approved for house purchase was 8,000 higher than in July, and those for remortgaging and those for other purposes were also higher.

Lending

The increase in consumer credit (£1.3bn) was slightly higher than July's outturn. Within this, net credit card lending was stronger than in July but in line with the previous six-month average, while net other loans and advances were weaker than July's outturn and the previous six-month average. Nonetheless, the three-month trend is firmly down.

Consumer credit

Weekly narrow money figures for September and October appear in Table 1 (below). The table suggests that, potentially, there might be some slight easing in M0 visible, but nothing dramatic.

Base money

At October 24, £1 = US\$1.769 (the 2005 range being US\$1.931 at 8 March to US\$1.730 at 20 July) and £1 = €1.476 (2005 range: €1.417 at 4 Jan to €1.510 at 23 June). The Sterling effective exchange rate index was 100.3 on October 24 (Jan 2005 = 100), having traded in the range 98.0 to 102.8 through the year. (Recent peak: 104.1, 17 June 04).

Sterling

GDP and its Components

GDP rose by 0.4% in the third quarter of 2005, down from 0.5% in the previous quarter. Industrial production fell by 0.6%, with a 0.4% increase in manufacturing being more-than-offset by a 6.8% fall in mining and quarrying (mainly driven by reduction in oil output, apparently associated with maintenance work), and a 1.8% fall in electricity, gas and water supply. Services rose by 0.6%, maintaining

Recent growth figures

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similar growth to the previous two quarters. Government and other services rose by 0.7%. Construction rose by 0.5% in the third quarter.

Table 1: Narrow Money: Weekly Data – Levels for September & October 2005

	Notes & Coins		M0	
	Not Seasonally Adjusted (£m)	Year on Year Growth Rate (%)	Not Seasonally Adjusted (£m)	Year on Year Growth Rate (%)
07 Sep	43,364	4.5	44,078	6.1
14 Sep	43,231	4.3	44,071	6.2
21 Sep	43,138	4.1	43,828	5.6
28 Sep	43,227	3.8	43,899	5.3
05 Oct	43,261	3.9	43,952	5.4
12 Oct	43,122	3.7	43,849	5.3
19 Oct (P)	43,073	3.4	43,889	5.2

The volume of retail sales in the three months July to September 2005 was 0.4% higher than in the previous three months. This follows growth of 0.9% in the three months to August and compares with growth of 0.9% at the same time in 2004. As has been widely discussed in the press, compared with the same period a year ago, sales in the three months to September 2005 were up just 1.0%, the lowest annual growth since January 1996. The unadjusted value of retail sales was a mere 0.2% higher than in the same period a year earlier, lower than June's record of 0.3%, and the lowest growth since comparable records began. Average weekly sales in September were £4.6bn 0.1% lower than a year ago.

Retail sales

It is plausible, as suggested in the latest minutes of the Bank of England, that a focus on retail sales growth may exaggerate the weakness in overall consumer spending. This is because household demand for petrol and utilities may be fairly insensitive to price rises in the short term, with the consequence that higher oil prices could be expected to increase the share of expenditure on these items, to the detriment of retail sales. Official figures also appear to have some difficulty in dealing with retailing via the Internet, and growth in this area may lead to exaggeration in measured retail slowdown.

High petrol prices may have crowded out spending in shops

Whole-economy investment growth was 1.5% in 2005 Q2, the same as business investment growth. More contemporaneously, the September CIPS/RBS seasonally adjusted Purchasing Managers' Index was 51.5, indicating a modest expansion in manufacturing - the highest level recorded since March. There also appears to be stronger growth of incoming new orders. However, a survey by Ernst & Young, out on Monday, suggests that in 2005 Q3 there were 39% more profit warnings issued by LSE firms than in 2004 Q3.

Investment and business surveys

Net trade made a 0.6 percentage point contribution to Q2 GDP growth. The turnaround in the net trade contribution in the first half of the year appears to have been largely driven by weakening import

International trade

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growth, consistent with subdued growth in consumer spending, particularly on durables. However, the deficit on trade in goods and services widened to £5.3bn in August, compared with £3.9bn in July. It is noteworthy that this figure includes a downward adjustment to services data of £1.4bn to account for the estimated payment of claims by Lloyd's of London arising from the effects of Hurricane Katrina.

Prices

CPI annual inflation rose to 2.5% in September, the highest rate since the start of the official series in January 1997. The largest upward effect came from transport, particularly driven by petrol prices. RPI inflation had a large downward component from the levelling off of house prices eliminating housing depreciation rises, but RPIX inflation still rose to 2.5% from 2.3%.

Consumer and retail prices

Output price inflation for manufactured products was 3.3% in the year to September, up from an annual 3.0% in August. In contrast, input price inflation fell to 10.3% in the year to September from 12.9% in the year to August.

Producer prices

The Average Earnings Index rose by 4.0% in the year to August, unchanged from July, or 4.2% including bonuses. Including bonus payments, private sector growth stood at 4.1% compared with 4.3% for the public sector.

Earnings

Employment

The employment rate for people of working age was 74.8% for the three months to August, up from 74.7% in the previous three months. The number of people in employment increased by 103,000 over that period, and by 345,000 over the year, to reach 28.8m. Total hours worked per week increased 14.5m over the year to August, to reach 921m.

Employment is up

The official unemployment rate was 4.7% in August, unchanged both over the quarter and over the year. The claimant count was 875,500 in September, up 8,200 on the previous month. The claimant count has increased for eight consecutive months and it is 61,700 higher than the recent low point in January 2005.

Unemployment

The average number of job vacancies for the three months to September 2005 was 625,100. This was down 15,800 on the previous quarter and 18,100 over the year. The redundancy rate for the three months to August 2005 was 6.1 per 1,000 employees, up 0.9 on the previous quarter.

Vacancies and redundancies

IV) Comment

If we were to approach the current situation 'cold', without the benefit of the debates of the past six months about when interest rates would be cut and how far, I suggest that the current policy

The monetary debate

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debate would concern whether interest rates should go up straight away, or whether we should wait to see if the slightly negative real economy factors already in play would bear down on inflation without the need for policy to change. Indeed, the current decision for this month seems very straightforward. I will vote to hold.

However, looked at from a perspective of the recent history of the MPC, and its success in maintaining steady growth for so long, aspirations for what the MPC should be able to achieve are very high. Growth of 1½% or so seems like the sort of slowdown that we would expect the MPC to respond to by cutting interest rates. The problem in the current situation is that above-target and rising inflation reduces the MPC's scope for such rate cuts - precisely the scenario some of us were warning about when we called for higher rates at the end of last year.

The deteriorating
output/inflation mix

It is of interest to consider how we might characterise the current real economy slowdown. I offer a few potential hypotheses:

The first is that oil price rises have raised production costs and the costs of retail forms of energy and, as a consequence, prices are rising at the same time as output is slowing. Some commentators suggest that if current inflation is high because of oil prices, we should ignore it. But the inflation target is 2.0% CPI inflation, not some 'CPI excluding oil' measure. And rising oil prices are hardly a 'shock' - they have been rising aggressively for several years, and particularly since late 2002. A 'two-year-ahead' perspective does not seem to have led to policy being tightened *early* in response to rising oil prices, so why should it now absolve the MPC from maintaining a tighter policy *late*?

Higher oil prices
have caused
stagflation

The second hypothesis is that the housing market has slowed, and consumption growth has slowed with it. I note that even if house prices do not fall further, the removal of mortgage equity withdrawal support for consumption could have had a material impact. The SMPC knows my own views about the housing market. I will not bore you by repeating again my reasons for thinking that house prices are too high. But I will offer the following set of alternatives to my view, for you to consider:

Housing slowdown
has reduced
consumption

- 1) The '**standard view**': Analysis can show us that house prices are overvalued, but the way that equilibrium will be restored is by house prices stagnating for many years, and the difference being inflated away. *Translation: "There is a medium-run Phillips curve", or "Keynes was right". I will take some convincing.*
- 2) The '**real asset view**': Housing is a real asset market about which fundamental analysis cannot tell us anything - if you think housing is overvalued, then betting exchanges will offer you the opportunity to place money on your view. Be our guest. *Translation: Monetary policy cannot be used for demand management purposes. Half the MPC's mandate is misguided.*

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- 3) The '**financial asset view**': (Roughly) Excess supply of money finds an outlet in assets, including in housing, but this will eventually result in inflation and a policy response, at which point house prices may need to fall (depending on the detail of available other asset returns at the time), but are not over-valued until the policy response arises. *Translation: Agents do not have rational expectations. So the key insight in macroeconomics in the past 25 years is just wrong.*
- 4) Fundamental analysis can identify errors, and markets are self-equilibrating, but the fundamental analysis has missed something. My current favourite is that expectations of working lives changed much more dramatically in the late 1990s than anybody expected, and that this is also associated with low pensions saving. But I'm not very convinced, yet, that it could have changed so fast or so much.
- 5) The OECD, the IMF, PWC, Roger Bootle and I were right in our fundamental analysis - prices are overvalued - and prices can fall, but it hasn't yet happened.

A third hypothesis that might explain the current slowdown in the real economy is that consumers are now curtailing their taking-on of new debt, having reached their preferred new equilibrium level, causing a very temporary soft patch prior to a new steady growth path. In that case, there may be nothing for the MPC to do on the real side. As the BBC's Economics Editor, Evan Davis, put it recently, "Stuff happens".

Consumers now have sated their desire for debt

A fourth possibility is that fear of future tax rises is causing consumers to re-assess their spending plans. There has been much discussion of 'black holes' and how Gordon Brown will be 'forced' to raise taxes in order to meet his fiscal rules. As I have discussed before, in my view taxes will rise, but not because of anything directly to do with the fiscal rules. The fiscal rules will change dramatically, probably starting from this coming year. I predict that when they are modified there will be four important changes:

Ricardian equivalence effect

- ◆ There will be a tolerance band around a central target.
- ◆ There will be symmetry - spending below target will be just as 'bad' as spending above target.
- ◆ They will be forward-looking. They will look at a forecast over the cycle ahead to reach the same stage of the cycle as today, instead of backwards looking as now.
- ◆ There will be an 'objective' assessment of important inputs, such as the forecast of the economic cycle or the definition of categories of investment/expenditure, done by a QUANGO.

A fifth, and final, hypothesis is that the private sector is being squeezed out by the public sector. Whether 500,000 or 600,000, the number of extra public sector workers since 1997 is a large figure.

Private sector is being crowded out

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However, I suspect that changing the public/private balance in the economy tends to squeeze a couple of tenths of a percent off the long-term growth rate, rather than causing half-point falls in growth in particular years.

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