IEA Shadow Monetary Policy Committee

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IEA's Shadow Monetary Policy Committee votes by eight to one to hold Bank Rate in March

In its most recent poll, the Shadow Monetary Policy Committee (SMPC) decided by eight votes to one that UK Bank Rate should be held at ½% when the official rate setters meet on Thursday 8th March. The sole dissenter on the shadow committee wanted to raise Bank Rate by ¼%. This was mainly to provide a clear signal about the future anti-inflationary resolve of the monetary authority. The predominant reason why most SMPC members voted to hold the official interest rate in March was their continuing concern about the uncertainties arising from the situation in the euro-zone together with the view that there remained ample spare resources in the British economy, despite some tentative and welcome signs that the first green shoots of recovery were starting to emerge.

Two things that the SMPC agreed on were that a Greek default was largely discounted in the financial markets and that there was a serious inconsistency in British monetary policy between hard-line financial regulation and the need to shore up the supplies of money and credit to sustain activity and the tax base. The SMPC does not normally discuss fiscal issues, unless they have monetary consequences. However, the general view was that the November 2011 projections for public borrowing in 2011-12 would be achieved, but that there would still only be cosmetic tax cuts in the 21st March Budget. This was despite the view of some SMPC members that many specific taxes were on the wrong side of their 'micro-Laffer' curves, so that well-designed tax cuts would reduce public borrowing if Mr. Osborne were bold enough to try them.

The SMPC itself is a group of independent economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it is the longest established such body in Britain and meets physically to discuss the issues involved distinguishes the SMPC from the similar exercises carried out by several publications. The next SMPC minutes will be published on Sunday 1st April.

Comment by Roger Bootle

(Capital Economics)
Vote: Hold Bank Rate.
Bias: Increase Quantitative Easing and carry on increasing it as necessary.

Some signs of life but UK economy still in a dire state

Recent economic indicators on both sides of the Atlantic have shown some welcome signs of life. Nevertheless, the economy remains in a dire state. It is important not to bank on signs of recovery which may easily prove to be misleading. The euro-zone crisis may yet deal a devastating blow to confidence and the state of the banking system. Meanwhile, the size of the drop in output registered over the last few years is such that even a vigorous recovery could take place for a couple of years without stoking unacceptable inflationary pressure.

Inflation should fall

Inflation should continue to fall throughout this year, with the headline rate falling below the 2% target by the autumn, and continuing to fall thereafter. With unemployment set to rise, there is no foreseeable reason for pay inflation to pick up. It may even fall. Unless commodity prices undergo another sharp spike – which is possible, although I am not expecting it – then come next year inflation could be below 1%, with deflation a realistic fear.

Keep on adding QE

In these circumstances, the Monetary Policy Committee (MPC) should keep Bank Rate at the current level, or even lower it a bit, in line with what the US Fed has done – and keep up its programme of bond purchases. Once it has completed its current programme of £50bn of quantitative easing (QE), it should embark on another £50bn and another after that. If the economy still looks weak thereafter, then the Bank should continue repeating the dose.

Comment by Tim Congdon

(International Monetary Research)
Vote: Hold Bank Rate.
Bias: To hold for the time being.

Great Recession caused by excessive regulatory pressure being placed on banks

The cause of the Great Recession was official pressure on the banks – particularly in the UK, but across the industrial world – to 'deleverage' and shrink the risk assets on their balance sheets, and to hold more capital relative to such assets. This pressure was most forceful in late 2008 and early 2009, following the closure of the international inter-bank market in mid-2007. Because inter-bank lines were no longer available to the same extent, many banks then had difficulty in funding their assets and persuading financial markets that they remained solvent. The result of bank deleveraging was a dramatic fall in the rate of growth of the quantity of money, broadly-defined, which was common to all the main monetary jurisdictions of today (i.e., the USA, the euro-zone, Japan and the UK). Despite slashing the short-term money markets rates to zero, central banks could not offset the deflationary forces set in train by the regulatory changes which they had created to a significant extent.

Resulting slump in money growth has had the predictable adverse consequences

The slump in money growth had the predictable effect of motivating falls in asset prices, demand, output and employment. One says 'predictable', as some economists have insisted on the validity of the monetary theory of national income determination even in the last few years, when that theory has been unfashionable. Nevertheless, very few economists – if any – actually predicted the catastrophic slide in economic activity in early 2009, because no sensible observer could reasonably have anticipated the idiocy of official actions in late 2008. The major central banks gave every sign of not having any understanding whatsoever of the debacle for which they were largely responsible.

Mistaken theories that ignore money

A variety of mistaken theories – that national income is a function of bank lending (the credit channel version of 'creditism') or the monetary base ('base-ism', New Classical Economics) or the budget deficit (Keynesianism) or 'financial frictions' (the asymmetric information version of 'creditism') – were propounded by academic economists and received attention, far too much attention, in central bank research departments. The correct theory, that national income and wealth in nominal terms are a function of the quantity of money (i.e., of the quantity of bank deposits, more or less), had been developed decades earlier by such figures as Wicksell, Irving Fisher, Keynes and Friedman. The correct theory was staring the economics profession in the face in the Great Recession, just as it was staring it in the face in the Great Depression eighty years earlier. Nevertheless, most economists did not recognise it.

Regulatory induced downsizing by RBS alone would have a major adverse impact on broad money

The point of this harangue is that – at least in the UK – the official attack on the banks is still not over. Royal Bank of Scotland (RBS) group is widely reported as being expected to shed about £120bn of non-core assets, in order to comply with the Vickers Report. Now, £120bn is equal to roughly 8% of the M4ex quantity of money. If RBS complies with the Vickers' demand by selling the assets to non-banks, the non-banks will pay the banks by reducing their bank deposits. In other words, M4ex will fall by 8% because of transactions being conducted by only one bank. In practice, RBS will no doubt sell the assets partly to other banks (when M4ex would be unaffected) and partly to foreign buyers (when the monetary effects are complex), and the sales will be phased over time. Nevertheless, it beggars belief that officialdom appears to be indifferent to – and indeed even ignorant of – the monetary results of its regulatory decisions.

Excessive regulation has undone gains from QE

This analysis is important in appreciating the disappointing response of UK money, broadly-defined, to the latest round of QE. This round was of £75bn, about 5% of M4ex, and compressed into a mere three-month period (i.e., the three months from early October, more or less) and ought to have meant an extremely fast money growth rate in that period. In fact, M4ex fell slightly in the last three months of 2011. The discrepancy can surely be explained, mostly, by UK banks' continuing measures to comply with official demands that they reduce their risk assets.

Not everything is doom and gloom

All is not gloom and doom. First, in the USA banks seem now to have gone a long way to meet the new regulatory standards. In general, banks are maintaining capital/asset ratios about 50% higher than was normal during the years of the 'Great Moderation' (i.e., the period of over twenty years from 1984 in which macro outcomes were much more stable than before). The American banking system appears to be expanding again, leading to low but positive rates of money growth. Secondly, in the euro-zone the European Central Bank (ECB) has embarked on extraordinary measures (i.e., the 'long-term refinancing operation', with three-year facilities at 1%) to ensure that banks can fund their assets and so to prevent the monetary contraction that might otherwise ensue.

Central objective of monetary policy should be to ensure steady moderate growth in broad money

It remains my view that the central objective of monetary management should be to ensure steady growth – at a low, non-inflationary, rate – in the quantity of money (i.e., to repeat, of bank deposits). One cannot judge the exact severity of the balance-sheet shrinkage facing UK banks post-Vickers but it is reasonable to assume some further shrinkage is needed to comply with the Vickers' prescription. For the time being, a ½% Bank Rate should continue to be favoured together with receptiveness to yet another round of money creation by the state. It would be preferable if this money creation occurred through the government/Debt Management Office concentrating its financing of the budget deficit at the short end from the banks, rather than by the complex and awkward operation of QE, but let this pass. If officialdom does not see the rationale of stable money growth, it is unlikely to understand the technicalities of operations which would facilitate that goal.

More benign global outlook in 2012

Overall, this year should see a relatively benign global outlook, with the USA leading the upturn phase of the business cycle. The euro-zone is a mess. Nevertheless, the main message from the first few months of the Draghi presidency of the ECB argues that any deterioration in macroeconomic conditions is likely to be met by large and aggressive monetary stimulus.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: To expand QE if euro deteriorates once again.

UK economy faces a difficult future

The UK economy has a difficult future ahead of it. Although the most immediate downside risks have diminished, the British economy is not yet out of the woods. Recent evidence does not suggest the economy is in recession, but it could still be some time before the recovery regains the kind of momentum that would be desirable given the scale of the 2008/09 downturn. In addition, there is still a risk that the euro crisis may worsen, causing the British economy real difficulty.

Increased QE a reasonable pre-emptive measure

The recent increase in planned Bank of England gilt purchases – by another £50bn – may not have been justified based on the most likely path for CPI inflation; but it seems a perfectly reasonable pre-emptive step given the balance of risks to UK inflation and the wider threats to the stability of the UK's financial system. Looking ahead, additional QE may well be needed, most obviously if the euro-zone situation deteriorates once again, but also if emerging world growth is more sluggish than currently expected. The outlook is also clouded by the possibility of increasing tensions, if not outright war, in the Middle East and the upward pressure this would place on oil prices.

But little evidence of a return to recession

Despite the usual media hysteria, there has been little evidence over the last few months that the UK was going back into recession. The 0.2% contraction reported by the Office for National Statistics (ONS) in 2011 Q4 is not supported by recent survey evidence. The monthly Purchasing Managers Index (PMI) reports, for instance, did point to a marked slowdown in growth at the end of last year, but did not suggest that private sector activity was falling. The average composite PMI of 51.9 in the fourth quarter has been consistent with private output growth of 0.2%, historically. In fact, over the last couple of months there has been a marked rebound in the PMI indices. The January reports for manufacturing, private services and construction suggest new business grew at its historical average. Giving support to the latest survey evidence, retail spending and car sales were surprisingly robust at the start of this year.

UK economy remains under the weather

However, there is a danger in setting monetary policy on the basis of the recent data flow. Looking through the short-term volatility in measures of output and demand, it is clear that the economy remains under the weather. Nominal private sector domestic demand has grown by only 1.6% over the last year. Even if one looks at private final demand (i.e. including net trade), nominal spending growth has only been 2.9%.

Domestic inflation pressures are limited

It is also evident that underlying inflationary pressures remain limited. In the last two years, CPI inflation has run on average at 4%. However, if one looks at the gross value added deflator – a measure of whole-economy inflation excluding the effects of indirect taxes – inflation has been running at 1.9% over the same period. For the private sector only, the figure is a mere 0.3%. These last two data points would chime with evidence from the labour market that domestically-generated inflation is still very low, consistent with a large amount of spare capacity in the economy.

Easy monetary stance is justified but just how easy?

A considerable shortfall in nominal spending and widespread slack, especially in the labour market, would seem to justify a very easy monetary stance. The question is how easy it should be. There are upside risks to CPI inflation, e.g., from oil prices, a faster-than-expected recovery in emerging world growth or ongoing effective supply constraints because of the dysfunctional banking system; but these are offset, possibly more than offset, by factors that could bear down on inflation over the medium term. Although the large fall in the real exchange rate has started the process of demand rebalancing in the UK, it is threatened by the ongoing euro crisis. The ability of Britain to export its way out of its debt overhang is hampered by the ever-worsening growth outlook on the continent. Domestic spending, particularly business investment, may recover less quickly than hoped because of further disruption to the banking sector. In connection with this, broad money and credit growth remain extremely limited – neither have returned to levels consistent with the kind of above-trend nominal demand growth one would like to see.

Balance of risks, particularly overseas, suggests that more QE may be needed

Broadly speaking, the balance of policy in the UK is correct, even if one can criticise the government for putting too little emphasis on the supply-side, particularly tax reform. The overhang of private and public debt means low interest rates are necessary for forestalling wider financial instability. UK banks' balance sheets are still stuffed full of assets that would sour quickly in the event of rapidly rising market interest rates. Low policy interest rates and a tight fiscal stance are both desirable at this stage. To encourage the shift in demand towards net trade, a cheap currency (in real terms) is also critical. The monetary policy stance does not need to be altered this month; but the balance of risks to growth and inflation suggests more QE may become necessary later in the year. In the event of a Greek exit from European Monetary Union (EMU), or the failure of a large European financial institution, the Bank and/or government must stand ready to expand the QE programme dramatically, including purchasing debt from UK banks.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate; no more QE immediately; no bias regarding future QE.

GDP figures reveal output slippage but no public spending cuts

GDP slipped by 0.2% in the final quarter of 2011, according to the ONS. Even though household consumption chalked up its first quarterly rise in the year and General Government consumption rose by 1%, contrary to the centre-left's rhetoric of 'deep spending cuts', the increase in inventories was well down on the third quarter's increase and gross fixed capital formation fell by nearly 3%. On a brighter note, there was a healthy contribution to GDP from net exports after two very disappointing quarters, so this aspect of 'rebalancing of the economy' could be gaining momentum, despite the continuing travails of the euro-zone.

Lighter mood in euro-zone

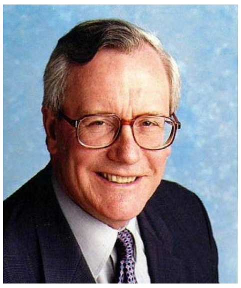
However, the mood has lightened even in the euro-zone since the closing months of last year, courtesy of ECB President Mario Draghi's generous liquidity boost last December - and there is more to come. Greece's second bailout package was eventually agreed, though whether the Greek people are prepared to endure more austerity is questionable. GDP has been falling since 2008 and fell about 7% last year. Unemployment is rising fast and is now over 20%. The latest European Commission forecasts suggest a mild recession for the euro-zone this year, projecting a fall in GDP of 0.3%. However, there is expected to be a glaring dichotomy in performance within this most dysfunctional of currency unions. Germany (0.6%) and France (0.4%) are expected to grow modestly, whilst falls in GDP are projected for Greece (4.4%), Spain (1.0%), Portugal (3.3%) and Italy (1.3%). Incidentally, the Commission expects Britain to grow by 0.6%.

More encouraging signs from Britain, but high oil price a threat

The mood has also lightened in the UK with the latest Markit/CIPS PMI surveys for manufacturing and services picking up significantly. The expected fall in January's CPI inflation, reflecting the dropping out of last year's VAT increase from the twelve-monthly comparison, should herald further decreases in inflation throughout the year. CPI inflation should be down to about 2½% in the second half of this year, reducing the squeeze on real incomes and therefore supporting the growth of personal consumption and, hence, GDP. Such projections assume that there will not be another explosion in oil prices reflecting the tension in the Middle East. However, Brent Crude has already reached record levels in sterling terms.

Public borrowing outlook has improved

January's Public Sector Net Borrowing (PSNB) data were better than expected and the PSNB for fiscal year 2011-12 may be £115bn to £120bn compared with the £127bn forecast by the OBR in November 2011. (However, note that the OBR forecast £116bn in June 2010.) Given these numbers, there will probably be some tax cuts in the Budget to be held on 21st March but the Government will almost certainly resist a major fiscal stimulus as proposed by the Opposition. The recent warning from Moody's, downgrading Britain's outlook from stable to negative, was timely on this issue. However, the Government seems to be relying on the Bank to provide much of the economic stimulus, given the absence of effective supply-side policies. The MPC has obliged by sanctioning very accommodative monetary policy. It should continue to do so. There is no need for any change in policy at the moment.



Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼ %.
Bias: Neutral.

QE has not led to stronger credit growth, particularly where SMEs are concerned

Superficially, it may seem as if the Bank of England is getting away with its policy of allowing inflation to breach the target so badly for two years in a row. Inflation is falling, so far down to 3.6%. Most forecasts expect it to fall at least close to 2% over the next year or so. So what is not to like? One concern is that the Bank has now undertaken to do £325bn of QE. This means that nearly three years' budget deficits' worth of finance will have been provided by printing money. This represents about a third of outstanding public debt. Its objective is to stimulate growth by stimulating credit. However, there is no growth in credit and this may now be a key factor in holding back growth in output, since small business credit is in steep decline, as is Small and Medium Enterprise (SME) credit to a slightly lesser extent. The SME sector, which accounts for around one half of GDP, is the key source of the innovation and competition which spur productivity growth, in turn. Productivity growth has stalled.

'Revenge of the regulators' is damaging the economy

The reason for this failure to achieve credit growth lies in the regulative onslaught on the UK banks. This will not achieve its objective of stopping future crises but it is preventing the banking sector from doing its job of lubricating the capitalist engine. The bureaucracy, having failed to prevent the crisis, is now taking its revenge on the supposed authors of the crisis, the banks. Yet they seem, on our analysis of the data through the lens of a model with banking processes in it, to be more the victims of crisis than its authors.

Need for bank bail-outs reflected slackness of regulators before the crisis

The fact that some banks needed bail-outs reflects on the slackness of regulators in the run-up to the crisis; these regulators failed to apply the 'speed limits' suggested in Basel II, speed limits that some foreign regulators (e.g. in Spain and Australia) fortunately did apply. The problem with our UK regulators' revenge is that it is damaging the UK economy. Together with QE, it is causing a form of 'financial repression' under which the nation's savings are directed at the lowest possible interest cost into the government's coffers.

Monetary stimulus has been neutralised by regulatory overkill

Now, consider the dangers the Bank of England is running into. It will meet its inflation targets if growth continues to fail to recover – because monetary stimulus is neutralised by regulative overkill. Thus, it will succeed if it fails. Now, suppose the economy does recover and credit somehow takes off with it. The banks will have a massive amount of liquidity to make loans with – around one fifth of GDP in the form of reserves held at the Bank of England. How quickly will the Bank be able to retake control and liquidate its bond holdings?

Dangers of a renewed commodity price spike

Suppose, finally, that the economy does not recover but that there is a renewed spike in oil and commodity prices as world growth picks up in 2012. The private sector, feeling more buoyant, notices and bids up wages, finally to compensate for huge real wage cuts; the inflation target is regarded as lost. Credit demands rise to pay for these target-busting wage demands. How easy will it be for the Bank to cut its bond holdings when so doing will reduce aggregate demand and return the economy to stagnation?

Warnings from Weimar

In the early stages of the Weimar Republic, politicians congratulated themselves on their sagacity in printing money to meet their bills. Unfortunately, they lost control of expectations and of prices and of the money printing process in one big descent into chaos. It is now time for the Bank to become more traditionally cautious – about QE and its balance sheet and about the breaching of the inflation target. It is vulnerable to the shocks already described and needs to become less vulnerable. The euro-zone crisis is in remission and can no longer be used as an excuse for a permanent loosening of policy. Clearly, it will stay with us for months, even years, but it is now becoming part of the normal background.

Bank Rate should be raised at earliest opportunity

So, my policy conclusion is that interest rates should be raised at the earliest opportunity. The latest indicators are more positive; a signal needs to be given about monetary intentions. Bank Rate should be raised by ¼%; actual rates are in fact above 0.75% already, so little would change in the market. However, the signal would be understood. The extra £50bn of QE should also be abandoned; merely keep it in reserve and announce that every opportunity will now be taken to run down QE. On the macro-prudential side, it is time the Bank takes a stand on behalf of the banks in the regulative mess that is now emerging; it must stop overkill - defer Vickers *sine die*, stop the bonus populism (explain that banks are the closest we have to John Lewis) and encourage new bank entry and competition.

The case for a negative interest rate penalty on money with the Central Bank

Finally, what can be done to kick-start lending? We see the Treasury struggling with a scheme of 'credit easing', which is already bogged down with problems to do with it being illegal state aid under EU rules. A simpler route would be to levy a tax (in the form of a negative interest rate, payable to Her Majesty's Revenue and Customs, HMRC) on banks' income from balances at the Bank and also on bank holdings of government debt. This could be offset by a reduction in the 'bank levy' or by a simple lump sum transfer to all banks. The measure would therefore be revenue-neutral for both banks as a whole and HM Treasury.

Negative rates on bankers' balances would incentivise individual banks to lend more

The consequence, however, would be that – by extra lending to the private sector – each bank individually would seek to avoid the tax by switching its Central Bank balances into lending. Of course, we know that at the aggregate level of all banks there would be no change in bankers' balances since the extra credit to the private sector must be matched by extra deposits, which in turn will be re-deposited in the banks and thence into bankers' balances. However, this is not the point; each bank will still wish to switch, making such an expansion of credit take place and with it an expansion in bank deposits. Within the banks, those banks that lend most aggressively could succeed in offloading their bankers' balances onto other banks, hence obtaining a net reward from their switching at the expense of others that do less. Until banks can be forced into greater competition and the regulations can be eased off, this negative interest rate measure (which has also been used in the context of foreign depositors in Switzerland for example) can be used to encourage banks into lending.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate, until the euro-zone situation clarifies, but then to raise; keep more QE on standby but only for lender of last resort purposes.

Fiscal policy decides the 'nastiness' of the output/ inflation trade off facing the central bank

The most important UK economic event this month will be the 21st March Budget, given that the scope for further policy initiatives from the Bank of England is probably exhausted – apart from yet more rounds of QE whose effectiveness has probably now hit serious diminishing returns. There is still a tendency to treat fiscal and monetary policy as belonging in separate boxes and to ignore the links between the two. However, fiscal and regulatory policy can make a major difference to the severity of the output/inflation trade-off facing the central bank. Furthermore, monetary attempts at demand stimulus can only operate on the private sector so monetary policy becomes increasingly irrelevant as the socialised sector expands. With roughly half of UK GDP now accounted for by general government expenditure – and some two-thirds in the North Eastern region, just over 70% in Wales and almost three-quarters in Northern Ireland – the reach of monetary policy instruments is now very limited in geographical as well as macroeconomic terms.

PSNB in 2011-12 likely to come in at £117bn to £120bn

The data for the first ten months of fiscal 2011-12 suggest that Public Sector Net Borrowing (PSNB) is likely to come in at around £117bn to £120bn in fiscal year 2011-12. This is a poor figure by historic standards but it is probably good enough to restrain Mr Osborne from raising taxes any further. There may be trivial tax cuts on 21st March but these will almost certainly be politically motivated and cosmetic. There is now a strong probability that the UK is on the wrong side of the aggregate Laffer curve, as well as being on the far side of the numerous micro-Laffer curves that apply to individual taxes. At the micro level, rates are already too high in many cases even to maximise revenue, let alone the performance of the wider economy or social welfare.

Provided Mr Osborne does not raise taxes, UK growth could be better than the consensus expects in 2012

One reason for expecting a slightly stronger growth performance from the UK economy from now on is that Mr Osborne is unlikely to do anything as damaging as his earlier decisions to hike VAT and employers' NICs – presumably in an attempt to build up a war chest to fund pre-election giveaways – which probably cost more than a quarter of a million jobs, reduced national output by some 1¼% and actually made public borrowing worse rather than better according to simulations on the Beacon Economic Forecasting model that were published shortly afterwards (see: Chapter 2 in the 2011 IEA publication *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*, Edited by Philip Booth, for further details). A 'do-nothing' Budget on 21st March would, at least, create no harm and would probably allow the economy to grow by around 1¼% this year rather than the not quite ½% which seems to be the present consensus.

UK national accounts remain a mess and tax receipts suggest activity may be understated

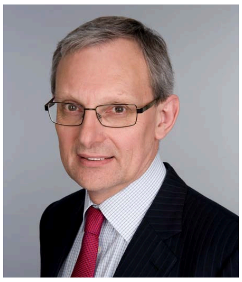
Unfortunately, the ONS national accounts have not yet recovered from the trauma of the botched and belated introduction of the new ESA 2010 methodology last year. In particular, long-back runs of many important series are still not available before the later 1990s making any attempt at 'scientific' model-based forecasting virtually impossible. The relative strength of tax receipts so far in 2011-12 may indicate that the private sector is slightly stronger than the fourth quarter national accounts, published on 24th February, suggest. Nevertheless, the only safe conclusion is that any attempt to project the future course of the UK economy is lost in a statistical fog. Incidentally, the latest ONS figures reveal that the volume of general government current expenditure was 0.7% higher in 2011 Q4 than it had been at the time of the election in 2010 Q2, implying that there have been no real 'cuts' so far. The value of general government consumption rose by 3.2% over the same period.

Bank of England research on impact of QE

The Bank of England has recently released a number of discussion papers attempting to quantify the wider macroeconomic benefits from QE. Having published a quantitative study in the June 2010 IEA Economic Affairs, one can only express some surprise at the power of the effects found by some of the Bank's economists. However, nobody has denied that there are very large margins of uncertainty attached to all such estimates. A particularly interesting recent Bank of England Working Paper is no 442, *The Impact of QE on the UK Economy – Some Supporting Monetarist Arithmetic*, by Jonathan Bridges and Ryland Thomas. The paper employed a money demand and supply framework to estimate the impact of QE on asset prices and nominal spending and then tried to establish the impact of QE on M4ex broad money. The central case estimate was that QE had boosted the broad money supply by £122 billion or 8%. The estimated impact of QE on the money supply was then applied to a set of 'monetarist' econometric models, which articulated the extent to which asset prices and spending needed to adjust to make the demand for money consistent with the increased broad money supply associated with QE. The Bank authors' central case estimate was that an 8% increase in money holdings may have pushed down yields by around 150 basis points in 2010 and increased asset values by approximately 20%. This, in turn, would have had a peak impact on output of 2% by the start of 2011, with an impact on inflation of 1 percentage point around a year later.

Bank of England research allows estimates to be made of adverse economic effects of regulatory shocks

The interesting and highly important point about this paper is that, because it quantifies the impact of exogenous shocks to M4ex broad money on the wider economy, it can also be used to estimate the impact of regulatory shocks to the money-creation process about which SMPC members have consistently expressed grave concern. As Tim Congdon has pointed out in his contribution to this report, the proposals in the Vickers report imply that the Royal Bank of Scotland group alone might need to contract its balance sheet by the equivalent of 8% of M4ex, which is coincidentally the same figure as appears in the Bridges and Thomas paper. If one then assumes that the RBS group accounts for roughly one quarter of UK deposits, and that other major banks would be affected in a similar manner, then the Bank of England's study implies that there could be a loss of 8% of real GDP, followed a year or so later by 4% off the price level. The strong conclusion is that worrying about 25 basis points on or off Bank Rate, or the impact of an extra £50bn of QE, is no more than an irrelevant distraction when compared with the massive damage that could be done from misguided financial regulatory interventions.



Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Hold Bank Rate; no extension of QE; reinstate Special Liquidity Scheme if the European banking crisis deepens.
Bias: Raise Bank Rate.

Colossal exposure of Continental banks to Greek debt

As a preface to this discussion concerning the appropriate stance of UK monetary policy, it may be helpful to repeat the comment made in January: *"The disintegration of the euro remains a highly improbable outcome until the mechanisms and protocols for orderly departure from the euro area have been devised and formally approved. Disorderly exit of Greece, or of any other country, would carry grave consequences for French and German banks through their colossal exposures to interest rate swap contracts. It is a reasonable assumption that the euro area nations will not embark on a path of mutually assured destruction."*

But ECB actions have reduced the risk

Thus far, the assumption holds: the approval of the second rescue package and debt-swap for Greece and the ongoing three-year Long Term Refinancing Operations (LTROs) have reduced significantly the tail risks for European banks and sovereigns. While hardly anything has been resolved in a structural sense, the criticality of the European financial situation has been alleviated. How then, should the Bank of England conduct policy?

Pre-commitment to an ultra low Bank Rate is a mistake

It is important to distinguish contingency plans from medium-term objectives. Hopefully, the interim Financial Policy Committee will assume ultimate responsibility for the systemic liquidity, capital and collateral issues that underpin the financial stability of the economy, leaving the MPC free to plot a course for the normalisation of monetary conditions. Central to this normalisation process is the restoration of Bank Rate to the region of 2% to 3%, within the context of a nominal GDP expansion of around 5% to 6% per annum. Pre-commitment to sustaining Bank Rate at a very low level is a misguided policy that is more likely to perpetuate economic stagnation than to relieve it. In particular, the revival of the interbank and securitisation markets, through which monetary policy formerly operated, is vitiated by near-zero interest rates.

Some hopeful signs for UK economy

Meanwhile, the UK economy has responded well to the ending of the Bank of England's aggressive credit tightening, implied by the repayment of the Special Liquidity Scheme. The resumption of the asset purchase programme has also eased financial conditions and stimulated UK equity prices. In the real economy, the intensity of households' real income squeeze has dwindled and this has contributed to an ongoing improvement in the contribution of net exports to UK growth, through the lessening of demand for imports. The New Build Indemnity Scheme, announced last November, is being taken up by UK house-builders and perhaps 25,000 to 30,000 additional homes will be built this year, with 95% loan-to-value mortgage finance guaranteed. Alongside the painful reductions in public sector part-time employment there is a remarkable growth in full-time self-employment and new business formation.

Consistent performance of service sector

At the core of the resiliency argument for the UK economy is the consistent, if dull, growth performance of the dominant service sectors. Service sector output growth was 1.6% in 2011, as against 1.4% in 2010. While distribution, hotels, restaurants, transport, storage and communication sectors suffered deceleration in 2011, business services, finance, government and other services showed an improvement. Remarkably, the productivity of public sector services increased throughout 2011.

Recent survey data is also encouraging

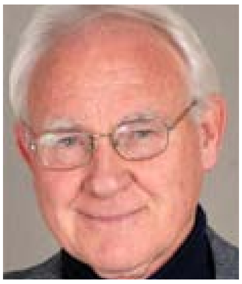
Recent data releases contain some more hopeful readings for the UK economy. The Markit/CIPS survey showed business confidence rising by its highest in the index's history (on a month to month basis) from 64 to just above 70. The survey also indicated that the business activity index had increased to a ten-month high of 56 compared to 54 in December – the third consecutive rise in the index, boding well for 2012.

Payrolls are expanding and retail sales have been stronger than feared

Furthermore, a rise in new work had encouraged companies to add to their payroll, resulting in the strongest increase in employment since March 2008. Growth in volumes of retail sales also surprised on the upside between December and January, rising 0.9% in contrast with economist predictions of a 0.3% fall. On a quarterly basis, retail sales also increased by 1.3%, reflecting the strongest growth seen since the summer of 2009.

QE is suffering from diminishing returns and should not be extended

Sluggish private sector loan demand and poor transmission of negative real interest rates to the real economy remain key impediments to a more vigorous UK recovery. Hence, this is not the moment to raise Bank Rate. However, the reconnection of Bank Rate with the market interest rate structure cannot be postponed indefinitely and a token Bank Rate increase should be pencilled in for later in the year. The Bank's programme of gilt purchases appears to be suffering from the law of diminishing returns and should not be extended in its current form.



Comment by Mike Wickens

(Cardiff Business School, Cardiff University)
Vote: Hold Bank Rate.
Bias: To raise interest rates.

Broad – but misguided – monetary consensus

There appears to be a broad consensus - which now seems to include members of the SMPC - that UK monetary policy should remain very loose with Bank Rate being maintained at ½% for the foreseeable future, and more QE being desirable. The basis of this seems to be that although inflation is still over twice its target level, it is falling, implying that inflation is no longer a threat; output is still flat and so unlikely to cause inflation to increase; and QE is the only monetary tool available to raise output that has proved effective. Such views might provide a good prediction of future MPC decisions, but do they provide a satisfactory basis for monetary policy?

Inconsistent official accounts of how QE is meant to work

Ultimately, the aim of QE is to stimulate private expenditures, especially investment, the component of demand that has contributed most to the poor output performance in recent years. The Bank does not have an agreed story on how QE works. One view is that it increases the liquid funds available to investors and better enables them to finance expenditures, especially if they are facing credit constraints. Alternatively, investors may use the cash to buy other financial assets such as equity or corporate bonds, thereby reducing borrowing cost for companies. Another explanation is that the cash is used by companies to repurchase their debt and so again reduce their financing costs.

Bank may have overstated the effectiveness of QE

In their most detailed study of QE, the Bank conducted a counterfactual experiment, asking what would have happened if there had been no QE. The study assumed that the first £200bn had reduced the ten-year spread by 100 basis points and then estimated the effects of this on GDP. They came up with a number of estimates ranging from raising GDP growth by 8 percentage points at the top end down to only 2 percentage points, their preferred – and published – estimate. Since the higher estimate used the most sophisticated methodology, its implausibly high value casts doubt on the whole exercise. If we add to this that spreads increased over the period, that lending fell dramatically, that corporate spreads hardly moved and that accumulated new government borrowing has been nearly as large as the level of QE, it is difficult to have much confidence in the effectiveness of QE. More recent QE has been accompanied by very small reductions in yields. However, this has been a period dominated by a marked loosening of ECB monetary policy.

Main effect of QE has been to depreciate sterling with inflationary consequences

The evidence in support of QE is therefore very weak and, so low are yields already, further QE seems very unlikely to reduce them significantly. The aim of QE is to boost output rather than bring inflation back on target as the Bank's remit requires. In effect, QE is simply a way of monetising government borrowing which so far has had little influence on banking lending or private sector investment. Its main effect is probably to depreciate sterling which adds to inflation.

Output is flat because expectations are poor

Output is flat because expectations are so poor. It is not encouraging that inventories (previously over-estimated demand?) and government expenditures are the only significant contributors to positive demand growth in the latest GDP data for 2011 Q4, and that investment and consumption are flat. Exports and imports have fluctuated over time. As both have either risen or fallen together it seems unlikely that changes in competitiveness are the main driver; fluctuations in world economic activity seem more likely.

Inflation fall reflects VAT and oil price

Inflation seems to have fallen mainly due to the elimination of VAT effects and a fall in oil prices (which have recently risen again). Neither is the result of monetary policy actions. The MPC may be correct in their forecast that the danger is that inflation may fall below target. Nevertheless, their forecasting record over the past few years has been so poor that it is tempting to conclude on the basis of their persistent forecast errors that inflation will be much higher than these forecasts.

UK monetary policy is now just a matter of appearance

All of this suggests that there is little that UK monetary policy can achieve in the near future. Although interest rates obviously need to increase at some time in order to better reflect the cost of saving, an immediate increase would open the MPC to much criticism. Additional QE would almost certainly be ineffective but, as in the past, would give the appearance that the MPC is doing something rather than nothing. In other words, at present, monetary policy is just a matter of appearance. All the action lies with fiscal policy.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold Bank Rate.
Bias: To hold; keep a further £75bn QE in reserve.

UK has avoided a technical recession

It looks as if the UK economy will avoid a technical recession (two consecutive quarters of negative growth) in 2012 Q1. After a fall in GDP of 0.2% in the final quarter of last year, the signs so far are that it will rebound by about the same magnitude in the first quarter of this year. The latest data showing the breakdown of GDP showed that, in line with the modest recovery in retail sales, consumer spending rose by 0.5% in 2011 Q4. This was the strongest quarterly increase since the second quarter of 2010. The improvement was driven by aggressive discounting and unusually mild weather conditions. Although retail sales in January also posted a sharp increase, it is doubtful whether this pace of improvement can be sustained – given the tightness of credit conditions, the fragility of the labour market and the ongoing contraction of household real incomes. Government spending was also surprisingly firm, rising by 1% on the third quarter. Again, it is questionable how long this can last against the backdrop of increasing government cutbacks, the bulk of which have yet to take place.

Improved net exports but companies remain reluctant to invest

More encouragingly, net exports posted a sharp improvement in end quarter of last year, driven higher by a 2.3% rise in exports – its strongest quarterly increase since 2011 Q1. That exports managed to post such a firm bounce-back amid the turmoil in the euro area – the UK's largest trading region – is clearly encouraging. It provides further, albeit still tentative, support for the view that the UK is undergoing a rebalancing of sorts. Offsetting this, however, business investment fell by 5.6% in the quarter. The decline occurred despite the fact that companies are sitting on record financial surpluses. On the face of it, the continued scaling back in spending on plant and capital equipment does not bode well for future jobs or productivity growth. One should be cautious, however, against reading too much into this. On closer inspection, much of the decline appears to have been driven by the utility sub-sector and therefore may be idiosyncratic rather than cyclical. Manufacturing output has also staged something of a recovery in recent months and looks as if it is returning to growth rates seen in the first half of 2011, before the tsunami, earthquake and nuclear meltdown in Japan. Exports are up and order books look healthy.

And money supply growth is weak and falling

However, and before getting carried away, we have to look at the monetary and fiscal background facing the UK economy. Money supply growth is weak and falling, driven by de-leveraging by households and business. Hence, the pressure on balance sheets remains a real issue for the pace of the recovery. Furthermore, growth in our key Continental European export market remains weak. UK economic growth this year will be only just positive, in a likely range of around the ½% to 1% level through this year. Fiscal policy will remain on its tightening path, despite some better than expected numbers in the last two months. With this in mind Bank Rate should be kept on hold and QE maintained at £325billion, with a further £75bn held back to counter the effects of any future downward pressure on the money supply.

Notes 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 poll, conducted by the SMPC in conjunction with the *Sunday Times* newspaper.

Current 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 members of the Committee include: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Gordon Pepper (Lombard Street Research and Cass Business School), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) 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 exactly nine votes are always cast.

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