
IEA Shadow Monetary Policy Committee

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IEA's Shadow Monetary Policy Committee votes by a five/four majority to hold Bank Rate in July

Following its latest gathering, the Shadow Monetary Policy Committee (SMPC) voted by a narrow margin of five votes to four that Bank Rate should be held at its current $\frac{1}{2}\%$ in July. All four SMPC hawks wanted to raise Bank Rate by $\frac{1}{2}\%$ to 1%. The lack of a '*plus* $\frac{1}{4}\%$ ' middle ground between the holds and the advocates of a $\frac{1}{2}\%$ increase reflected divergent views on a number of issues. One division concerned whether the sluggish growth of national output was a pure 'demand-side' phenomenon or whether it reflected a withdrawal of aggregate supply caused by the unprecedented peacetime increases in the burdens of UK government spending, borrowing and taxation during the 21st Century. Another divide concerned how far Britain should be regarded as a small, open economy – in which case downward movements in the exchange rate should eventually become fully reflected in domestic prices – and how far it should be regarded as a large metropolitan economy, where the output gap could be regarded as the main influence on inflation.

Other important issues on which views differed included how much reliance could be placed on the official statistics and whether the sluggishness of broad money and credit meant that there was no long-term inflation risk. Some SMPC members worried about the threat to the Bank of England's credibility caused by its non-reaction to overshoots of the inflation target. There was also concern that the British fiscal approach could lose market credibility, if public borrowing did not fall in line with the official forecasts. However, even the SMPC hawks accepted that additional quantitative easing might be needed if the Euro-zone crisis threatened UK banks.

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 31st July.



Comment by Tim Congdon

(International Monetary Research)

Vote: Hold.

Bias: To hold.

Indicators for demand and output are ambiguous

The next few months will see further disappointment on the inflation front, as electricity and gas price increases come through. However, the indicators for demand and output are ambiguous, with consumer spending likely to be flat, at best, in 2011. The recent sharp rise in employment is encouraging, but also puzzling. Broad money is stagnating, as banks continue to shed risk assets. The latest data for both mortgage approvals and 'unused sterling credit facilities' imply that the broad money supply will continue to stagnate over the summer and autumn months.

Output remains below trend and inflation should abate

Overall, it seems unlikely that output will grow at a well-above trend rate during the rest of this year and more plausible that the volume of activity will grow at a trend, or beneath-trend, rate. Since the level of output remains beneath trend – perhaps, by 2% to 3% – next year should see further weakness in underlying inflation pressures, as well as a marked abatement in the commodity and energy price cost-push inflation which has been so marked over the last year or so. My vote, therefore, is for no change in interest rates, with a bias to keeping interest rates at around their present level.



Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold.

Bias: Neutral.

Arguments in favour of a rate hike are reasonable but misguided

At its latest meeting, two members of the Bank of England's Monetary Policy Committee (MPC) voted to hike Bank Rate by $\frac{1}{4}\%$. Arguments in favour of an immediate rate hike are reasonable, albeit misguided at this particular time. If one believed that the world economy could sustain output growth of 4% to 4½% in coming years (based on purchasing power-parity-weights, rather than market exchange rates), with robust expansion in emerging economies the main driver, then a net commodity importer, like the UK, could face a sustained deterioration in its terms of trade. This could only occur if there was a marked change in the balance of world demand, away from the so-called 'borrower' economies, towards those economies which had previously run large current account surpluses. A monetary stance focussed solely on hitting a target for consumer price inflation would have to be tighter than it otherwise might be. If such a scenario for the world economy were likely, one could reasonably argue that the current setting of the UK monetary policy is inconsistent with the MPC's remit.

Chinese growth will slow, taking the fizz out of the global recovery

This is not, though, the most likely outlook for global activity in coming quarters. Four years after the global boom finished, the structural imbalances in world demand do not appear to have diminished much. One need only look at the considerable gains in market share that Chinese exporters have made since the crisis erupted to get some sense of this. The Quantitative Easing (QE) type exercise Beijing undertook in the middle of 2009 did help to temporarily boost Chinese domestic spending. However, the monetary explosion has left China with a major inflation problem. With the authorities behind the curve, the Chinese economy looks set to slow sharply over the next year or so, taking much of the fizz out of the global recovery. Commodity prices should increasingly reflect that.

UK headline inflation should ease sharply next year

While UK inflation may even rise above 5% in the near-term, the prospective fall in commodity prices should bring headline inflation down sharply in 2012. But ultimately it is the underlying rate of inflation that monetary policy needs to focus on. In the short to medium run, it is the amount of spare capacity in the economy that drives firms' price and wage setting behaviour. In the longer term, inflation is ultimately pinned down by the rate of monetary growth and inflation expectations.

Output-gap uncertainties

There has been much debate about the size of the output gap in the UK. Business surveys have generally pointed to a much smaller degree of slack within companies than statistical estimates of the output gap might suggest. The recent strength of employment growth is also hard to square with the idea that companies have lots of underutilised workers. In the downturn, labour was hoarded on a large scale. This should have left companies with considerable scope to raise output without additional staff. (A large Bank of England

survey on this issue in January suggested that 90% of firms were able to raise output without additional workers.) Yet during the recovery, growth in labour productivity has been very limited. This could suggest a much greater degree of supply disruption than data on previous banking crises would imply. Yet, evidence for this is hard to come by. Corporate liquidations, a proxy for the amount of capital scrapping, have been remarkably limited; new company formation has been robust; and, while structural unemployment has gone up, it is hard to find evidence that it has risen very far. It is possible that labour and capital have been unable to move from declining sectors - e.g. banking, real estate - to growing ones - e.g. manufacturing. Again though, survey evidence does not support this, with labour shortages in industry, for instance, still below their long-run averages.

Big picture is clear; UK output is well below trend

Notwithstanding the puzzles in the data, the big picture is clear. Private sector output is now 15% below where it would have been had output continued growing at its pre-crisis trend since the middle of 2007. Let us assume, as a slew of evidence suggests, that the economy was operating above its potential before the crisis struck, by, say, 3% points. Let's also assume that 5% of the drop in output has already been permanently lost. To add another level of conservatism, we will factor in a 0.5% point reduction in UK potential growth over the last four years. Even with all this, private sector output would still appear to be around 5% below its underlying potential. Six quarters into a recovery, the amount of slack in the economy is larger than at the depths of the 1980s recession.

Monetary analysis also indicates limited inflation risk and...

Monetary analysis would seem to confirm the limited risks to UK inflation. Broad money growth has averaged 2% in the last three years. It has been even weaker during the recovery. Over the last year, bank lending to the private sector has declined outright. Had it not been for QE and commercial banks' gilt purchases, the money stock would almost certainly have fallen sharply in recent quarters. Given the outlook for private sector credit demand and banks' efforts to rebuild their balance sheets, lending growth will be very weak for some time. The expansion in broad money will be restrained further, as banks try to meet the new Basel rules. Other things being equal, a banking system with more capital and increased reliance on long-term wholesale debt means fewer deposits held by the private sector for any given level of bank assets.

...velocity changes are unlikely to offset weak money growth

Some have argued that strong growth in money velocity could mean that low broad money growth is consistent with risks to inflation. This is possible, if, for instance, the Bank of England were to lose control of inflation expectations, but highly unlikely in my view. Since the late 1980s, money velocity has fluctuated around a downward trend of 2% per annum. There are good reasons to expect velocity to trend higher after a banking crisis, as the cost of banking intermediation rises relative to other forms of credit. Ultra-loose monetary policy should also lower the investment demand for money by creating a large wedge between deposit rates and yields on risky assets. However, it is hard to believe that prospective monetary trends are likely to be consistent with a pace of nominal demand growth that would be undesirable as we exit a recession of this magnitude. If anything, the ongoing adjustment in the banking system still poses a downside risk to nominal spending growth and inflation.



Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold.

Bias: Hold Bank rate; expand QE if M4 or M4ex contracts further.

Standard macroeconomic analysis cannot cope with balance-sheet recessions

On the basis that the economic downturn of 2008 and 2009 was primarily a 'balance-sheet recession' caused by overleveraging in both the household and financial sectors, to understand the prospects for recovery we need: (1) to consider the progress of balance sheet repair in these two sectors; and then (2) to consider whether the balance sheet deterioration in the public sector is not so severe as to offset any improvements in the private sector. Standard macro-economic analysis which looks at the relation between (say) interest rates and nominal or real GDP growth based on past relationships will fail to explain what is currently going on. Currently, the desire to repair balance sheets before resuming normal behaviour – on the part of both consumers and financial institutions – overwhelms the normal linkages. The point is that an unspoken assumption underlying orthodox macro-economic models is that balance sheets are healthy. When they are not, typical relationships (coefficients) go awry.

De-leveraging by the household sector and...

Overleveraging by the household sector is most easily observed in the household debt-to-income ratio which peaked at 174% in the first quarter of 2008, having risen from a level below 110% in 2000-01. Eleven quarters later, in the fourth quarter of 2010 (the latest available data), this ratio had declined to 157%. The de-leveraging has come about largely as a result of increases in nominal household income, considerably less as a result of debt repayment since the amount of household debt outstanding has remained roughly static since mid-2009. Nevertheless, the decline in this gearing ratio probably has considerably further to fall. The ratio is still almost 50 percentage points higher than it was at the start of the housing bubble. Consequently, until consumers feel that they have reached an equilibrium debt-to-income ratio it seems likely that they will continue to restrain spending, maintain higher rates of saving, and certainly not add to their existing stock of debt. Irrespective of what typical coefficients from macro-economic models say about the low level of interest rates and prospective nominal or real household spending, one would bet that de-leveraging will win out over macro-models.

...the financial sector

Turning to the financial sector, the evidence suggests continued de-leveraging in this sector also. The de-risking of bank and other financial sector balance sheets can be seen in a variety of recent data. Bank lending is still declining (M4 lending contracted by 1.3% year-on-year in April), banks are adding to their holdings of gilts while running down holdings of other types of securities, and interbank lending is shrinking. The net result is that UK banks' sterling assets had declined by £375bn from £4.06 trillion in January 2010 to £3.685 trillion in April 2011. Again, balance-sheet repair is the dominant driver of bank behaviour, not some knee-jerk response to low interest rates. The hand-wringing by politicians, regulators or macro-economists who wish to see faster bank lending growth is laughably misdirected. They should be

celebrating the progress in balance-sheet repair, not moaning about the lack of credit expansion.

But government indebtedness is rising

Meanwhile, in contrast to the de-leveraging in the private sector, the leveraging up of the public sector continues. In May net debt (excluding financial interventions) reached £920.9bn or 60.6% of GDP. In the peripheral Euro-zone economies, government debt-to-GDP ratios have already reached substantially higher levels. These are such that investors are now extremely reluctant to hold the sovereign debt instruments of Greece, Ireland and Portugal, except at very high interest rates. Fortunately, the British Coalition government's plans to close the deficit by 2015 and thereby stabilise the debt-to-GDP ratio still carry some credibility so Britain is not facing a similar debt crisis. However, such forbearance by international investors cannot be taken for granted.

'Quieta non movere'

Until there are signs that the balance sheet repair process is approaching completion, the best policy for the authorities is to assist in enabling such balance-sheet adjustments to occur – for example by keeping interest rates low, providing debt and interest-rate relief to deserving families or entities, or substituting lower cost, longer-term government lending for private loans. Raising rates now would only have adverse knock-on effects on households and business. If and when firms and consumers begin to re-leverage their balance sheets, then clearly there would be a case for raising interest rates. However, the evidence shows that moment has not yet arrived.

Inflation in UK and US is not a result of current monetary policy stance

The higher rate of inflation in the UK than the US or the Euro-zone reflects two main sets of factors: (1) excess money and credit growth in the UK prior to mid-2009 (this period ended only two years ago and is well within the normal lagged effect of monetary policy on inflation), and (2) a series of transient, non-monetary factors such as the surge in commodity prices over the past year, the weakness of sterling, and the increases in the UK's indirect taxes. The latter do not constitute a valid case for raising interest rates. The fact that the emerging economies are recovering strongly – in part because their balance sheets are in good shape – and are buying large quantities of commodities and pushing up their prices implies a change in the terms of trade and a change in the composition of inflation for the UK and other developed, western economies. Insofar as such changes are transitory, the correct response is to delay rate hikes until balance sheet repair is at least mostly completed and until the effects of the current exceptionally low rates of money growth provide a better indication of the true state of the economy.



Comment by Ruth Lea

(Arbuthnot Banking Group)

Vote: Hold.

Bias: To hold.

UK economic outlook remains highly uncertain

The outlook for the domestic economy remains uncertain. The official Office of National Statistics (ONS) data suggested that the economy flat-lined between the third quarter of 2010 and the first quarter of 2011. Barely had the ink dried on the pages of the March Budget forecast from the Office for Budget Responsibility (OBR) than it was shown to be overoptimistic when the first quarter Gross Domestic Product (GDP) data were released by the ONS in April. However, this is now history.

Second quarter indicators are not encouraging

The data so far available for the second quarter are not encouraging. April's manufacturing data were disappointing and May's retail sales were weaker than expected. The Markit/Chartered Institute of Purchasing and Supply (CIPS) surveys for both services and manufacturing have also disappointed. Furthermore, the housing market continues to 'tread water' (at best) with mortgage approvals well down. The labour-market data stand out as something of an anomaly and are hard to explain.

UK GDP will rise by only 1½% this year

Recent data have however been distorted by one-off factors such as the Royal Wedding and the timing of Easter. There is therefore noise in the figures and a longer run of data will be needed to assess the underlying progress of the recovery. But given the factors bearing down on growth, GDP will probably rise by only 1½% this year.

CPI inflation will remain above target this year and into 2012

Consumer Price Index (CPI) inflation remains above target and will probably remain above target into 2012. Upward pressures on utility prices, partly reflecting our insane energy policies, will probably ensure this outcome. But, unless there is another burst in commodity prices or further significant increases in indirect taxes, CPI inflation should fall back to target next year. Earnings growth is very subdued (around 2%), most British people seem resigned to their fate of falling real incomes, and there is therefore little sign of a 'wage-price spiral' becoming embedded. The Bank of England's latest survey on inflation expectations, by which it sets such store, suggested that people's expectations were slightly weakening.

Euro-zone 'car crash'

Looming over Britain's prospects is the 'car crash' of the Euro-zone, with the risk of a 'Lehman-like' shock to the global financial system. Under these circumstances, there should be no change in interest rates, together with a bias to keeping interest rates at their present level.



Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate to 1%.

Bias: To raise Bank Rate further.

Monetary-policy impasse

The UK monetary-policy debate has reached an impasse. Since the MPC did not raise rates in March, once it was clear from the survey data that the contraction in GDP in the fourth quarter of 2010 was merely a blip, it has been unclear what could possibly induce a rate rise. In a growing economy with inflation headed to 5% versus a target of 2%, leaving rates at ½% is simply derelict. The monetary discussion now appears to have returned to the possibility of more QE. Well, there should have been more QE last year, when some SMPC members urged it, starting at least by November in combination with the broader global QE2 programme. More QE now is simply chasing the problem, and likely to be pro-cyclical as a consequence. Now, if there were serious market disruption (e.g. from a Greek default or Chinese banking sector problems), then more QE might be a temporary liquidity expedient, of course. If the economy was to degenerate seriously, and inflation fall back, then again QE might be considered. However, this is not the situation at the moment. Currently, we have a growing economy and inflation heading towards 5%.

Real-economy equilibria cannot be improved by high inflation

Do we have any idea what might induce action against inflation? What about if the yearly CPI increase goes to 6%, 7% or even 10%? Might we see a couple of quarter-point rises then? We seem to have abandoned entirely the idea that real-economy equilibria cannot be improved by having high inflation but can only be made worse. We should not be hoping to keep interest rates as low as possible for as long as possible. The MPC should be seeking every opportunity, every excuse available, to return interest rates back to their natural level. Now perhaps the sustainable growth rate of the UK economy has dropped in recent years, so that the natural rate is not the 5%, or so, we previously thought. Certainly, the message from bond-market data was that the risk-free rate - which theory suggests is a fairly close proxy for the equilibrium sustainable growth rate of the economy - started falling in the early 2000s, from levels around 2.5% to 3% down to below 2%. Indeed, some recent estimates go as low as 1%. That would, of course, be unsurprising given the damage to potential growth done by the combination of very high public spending, financial market problems, and excessive regulation in response. We should not rule out altogether the possibility that the UK's sustainable growth rate is now only a little above 1% per annum, implying a nominal interest rate of only around 3.5% in a natural equilibrium situation.

Interest rates need to return to their 'natural' level

However, if the natural rate really has fallen as far as this, then the output gap is much smaller than the Bank estimates - indeed, the output gap could even be negative. So the idea that the natural equilibrium interest rate has fallen would not support keeping interest rates low. Rather, it would be an additional argument for raising them! We should be seeking every opportunity to return interest rates to their natural level. We may not know what that level is very

well at the moment - whether 3½% or 5%. However, we know it's a lot higher than the current ½%.



Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate to 1%.

Bias: To raise Bank Rate again, and for QE to be held with a bias towards reversal.

Growth figures have been weak but labour market has proved surprisingly solid

The recent news for UK growth and employment has been mixed. The growth figures have been weak, with manufacturing slowing and the ONS GDP figures downbeat. However, employment growth has been solid and unemployment falling; while public sector jobs have been cut, private sector jobs have more than made up for such losses. Falling real wages must be contributing to this, via a rise in the labour-output ratio. It is also likely that the GDP figures will be revised upwards.

MPC's failure to raise rates makes inflation expectations more persistent

The inflation outlook has worsened, with expectations now that the CPI measure will go over 5% in the second half of this year. Real interest rates are now negative, even on much private sector debt inclusive of risk premia (such as tracker mortgages). It is reckless for the Bank to forecast that inflation will come down even though it is now being rumoured that MPC intentions are not to raise rates for another year. Inflation tends to persist when there is no commitment to reduce it. Since the Bank's reason for taking no action is 'weak growth' there seems to be no reason to expect the Bank to raise interest rates sine die: our forecasts, like almost all others, now project weak growth as far as the eye can see.

The Bank's credibility is at risk

This situation is dangerous to the Bank's credibility. It was 'endowed' with this in 1997 by the long battle against inflation in the 1980s and 1990s. Up to 2010 and this year, it had seemed to be reasonably reliable as the holder of this endowment, which can be thought of as a piece of 'social capital'. The Bank is supposed to have as its only objective the hitting of the inflation target 'in the medium term'; so far it has tended to overshoot it on average but at least inflation has tended to return to around 2%.

The weak exchange rate is not an 'Act of God' but a result of UK monetary laxity

The Bank retorts that it can keep rates at zero for as long as wage increases are muted and so real wages falling. However, it is forgetting its own role in setting the exchange rate. Essentially in an open economy the main transmission channel for inflation is through the exchange rate. This is how a floating currency enables a country to run a different interest rate and inflation rate from elsewhere. The Bank has chosen to run a more expansionary monetary policy than the Euro-zone for example; this has reduced the sterling/euro rate. No doubt this was appropriate during the financial crisis in 2008 and 2009. However, it has ceased to be appropriate when inflation is threatening to move well above its target. The risk is that the Bank will lose control of sterling first and soon after lose control of domestic wage costs. If that were to happen, credibility would be lost; regaining it could be a painful process. For this reason I continue to suggest an immediate rise of ½% in rates, with a bias to raise further. QE should cease indefinitely.



The banking system is being re-capitalised at the expense of depositors

Private activity has recovered faster than GDP, explaining employment increase

Weaknesses in official data

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Raise Bank Rate to 1%.

Bias: To 'normalise' Bank Rate in small steps until it reaches 2½% but be prepared to re-launch QE if Greek crisis threatens UK bank defaults.

Britain's monetary policy makers face an unusually high degree of uncertainty at present in a situation where the world economic recovery has apparently lost momentum, a Greek default threatens the integrity not just of Continental banks but also their UK counterparties, and the ONS labour-market data appear to be telling a significantly more buoyant story than the official GDP numbers. The MPC will need to be either brilliantly clever - or brilliantly lucky - to correctly read the runes of these potential influences while trying to bring inflation back into its target zone quickly enough to hang onto some reasonable level of credibility following the inflation overshoots of recent months. Fortunately, small changes in Bank Rate have only a limited impact on the domestic economy and a 'mistake' of ½% or 1% in setting Bank Rate would probably not be fateful. However, this is especially true at present when the 'pass through' from Bank Rate to the lending rates that directly affect households and smaller businesses is unusually attenuated – large companies have little need to borrow from the banks because they appear to be flush with cash. The Bank's low-interest rate policy seems to partly represent an unannounced strategy to boost the commercial banks' monopoly profits, through widening the spread between lending and deposit rates, in order to build up their capital and reserves. This re-capitalisation is at the expense of depositors who are currently facing a covert inflation tax of, perhaps, 3½% to 4½% of the value of their interest-bearing deposits each year. The negative real return on bank deposits is probably inducing a downwards shift in the demand for money – whose effect would be symmetrical to an increase in the supply of money in a naive monetarist model – and means that the weakness of the M4^{ex} broad money definition may not have its normal recessionary implications.

Some of the divergence between the relatively satisfactory rise in private employment of 520,000 (2.3%) in the year to March, and the weakness of the GDP figures, probably reflects the fact that, having falling far more sharply than GDP in the recession, the non-socialised component of real expenditure has bounced back more rapidly than the total since its 2009 Q4 low point. With the government and the private sectors of GDP of roughly equal size, total GDP is not a meaningful measure of private activity in an era when the public sector's demand for resources is being deliberately, and necessarily, reined back. This distinction is crucial for monetary policy because monetary instruments only operate on the non-socialised sector.

Unfortunately, it is difficult to separate out the public and private sectors with adequate precision using the ONS statistics. Another statistical issue is that Britain's national accounts will shortly be rebased yet again. When this has happened in the past, the economy has often turned out to be in a different position to that which was previously believed. There can be a surprisingly poor fit between GDP and its main components measured on one base year

Exaggerated fears of economic soft patches

and another one. Indeed, one would frequently have to reject the hypothesis of a useful predictive relationship between the new base year figures and their predecessors using normal statistical criteria (*Editorial Note: The Power Point presentation *Uncle David's Chamber of Data Horrors*, available from xxxbeaconxxx@btinternet.com provides the evidence for this statement).*

Poor growth prospects reflect supply withdrawal not deficient demand

This does not mean that the UK economy is not suffering from genuinely poor growth prospects. However, it does mean that it is important to separate out the extent to which poor growth reflects inadequate demand and how far it reflects a permanent supply withdrawal caused by the spend, borrow and tax policies of the Brown years and Mr Osborne's misguided decision to raise VAT to 20% and implement Labour's damaging 'jobs tax' increase and 50% income tax rate. The more 'gung-ho' advocates of monetary expansion appear to be assuming that the entire weakness of UK activity is down to pure demand factors. However, there is widespread evidence from international growth studies that increasing the share of government consumption in GDP crowds out private capital formation almost on a one-for-one basis and leads to a deceleration in the growth rate of real GDP per head. On reasonable assumptions, the 8.4 percentage points rise in the ratio of British government spending to GDP between 1996-2000 and 2006-2010, a comparison that smoothes out the current recession, might be expected to slow growth by some 1¼ percentage points, say, from 2¾% per annum to 1½%. This is a supply side problem that cannot be cured by monetary policy.

Recent research on fiscal multipliers and crowding out

It is also arguable that there has been too much concern about the impact of the, actually pretty paltry, forthcoming public spending cuts on wider UK economic activity. The explosion of fiscal indebtedness in many leading economies has led to much new international research into the extent to which increased government expenditure stimulates national output. Recent examples include: *How Big (Small?) are Fiscal Multipliers?*, by Ilzetki, Mendoza and Vegh, International Monetary Fund working Paper WP/11/52, March 2011; *Keynesian Government Spending Multipliers in the Euro Area*, by Cwik, and Wieland, European Central Bank Working Paper 1267, November 2010; and *The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation for the Euro Area*, by Checherita and Rother, European Central Bank Working Paper 1237, August 2010.

Public spending cuts might well prove expansionary

This research suggests that the extent to which extra government spending boosts or contracts GDP (which includes government spending by definition) depends on a range of factors. However, there was considerable evidence that cutting government consumption frequently led to expansionary effects elsewhere in the economy and not the negative ones that might be expected on the basis of naive Keynesianism. Incidentally, Cwik and Wieland found that this finding was true of so-called 'New-Keynesian' models once these incorporated forward looking expectations. Such findings mean that this research is not just a re-run of the Monetarist versus Keynesian 'crowding-out' debates of the Thatcher years. The 'crowding in' effects of public consumption cuts were especially marked when the cuts were announced in advance and where the economy concerned was open, had a floating exchange rate, and had a gross public debt stock greater than 90% of GDP. Britain meets all these criteria for an 'expansionary fiscal contraction', however oxymoronic that might appear to people who have not studied the literature.

Financial markets have given Mr Osborne the benefit of the doubt until now

The institutional separation of fiscal and monetary policy in Britain does not mean that they cannot feedback on each other or that a loss of credibility in one area cannot cross infect the other. It is hard to avoid the conclusion that the Bank's credibility has suffered from the persistent overshooting of the inflation target over such a significant period. However, the financial markets have given the UK fiscal authorities the benefit of the doubt until now and assumed that the fiscal consolidation announced by Mr Osborne was running on track. One reason is that financial markets notoriously only concentrate on one thing at a time and bond investors have been fully occupied with the ramifications of the Greek debacle. However, the independent forecasts generated by the Beacon Economic Forecasting model suggest that, while falling, the ratio of Public Sector Net Borrowing (PSNB) to UK GDP will remain well above the highly-optimistic path set out in the official OBR forecasts (*Editorial Note*: the outlook for the public finances is discussed in more detail in Chapter 2 of the forthcoming IEA publication *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*, edited by Philip Booth, to be published on 13th July).

Britain risks losing both monetary and fiscal policy credibility

The view that Mr Osborne is unlikely to meet his borrowing forecasts is supported by the recent £3.8bn upwards revision to the PSNB deficit in 2010-11 and the disappointing figures for the first two months of fiscal 2011-12. The UK will not be in a happy position if it simultaneously loses both fiscal and monetary policy credibility in the financial markets in, say, a year or eighteen month's time. A modest upwards tweak to Bank Rate of say ½% – basically to show that the authorities care about inflation and the external value of sterling – seems an appropriate insurance against such a double-credibility loss. However, this assumes that the Greek crisis remains under control. The Bank's Plan B, in a situation where the Greek crisis does get out of hand, would almost certainly need to include a QE2, since there are no shots left in the interest rate locker.



Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate to 1%.

Bias: To raise Bank Rate again.

A slow recovery of UK money and credit is underway

A slow recovery of UK credit and monetary aggregates is underway. M4 lending growth (excluding securitisations) narrowed to **minus** 1.3% in April, with positive month-on-month growth for the fourth consecutive month. Other financial corporations expanded their balance sheets by 1.2% between March and April, whilst the household sector marginally increased its stock of mortgages. All other borrowing declined on a month-on-month basis as repayments continued to outstrip lending. M4 deposits have also strengthened, with financial institutions outstanding liabilities gaining 0.1% month-on-month, in both March and April, and the twelve month growth rate improving to **minus** 0.9%, up from **minus** 1.1% in March. The stock of retail deposits has continued to rise but there has been a slowing of pace since January, with the annual growth rate slipping to 2.7% in April. This is indicative of households reducing their propensity to save in response to a squeeze on their real disposable income. Wholesale deposits, on the other hand, remain in negative growth territory, but to a lessening degree.

Credibility of inflation targeting regime is disintegrating and...

Headline consumer prices rose by 4.5% in the year to May, breaching the official 2% target for the eighteenth consecutive month. Upward pricing pressures have become increasingly broad-based over this period, with core consumer price inflation at 3.3% in May (after reaching a record high of 3.7% in April). Supply-side inflationary pressures are permeating the economy. Some examples are: tools or equipment for the house or garden (11%), postal services (10.5%), household textiles (5.3%) and dry cleaning (4.6%). Although wage inflation remains subdued at present (total pay growth reached 2.2% in April), there are signs of growing inflation accommodation among large companies. Inflation expectations, as reported by the Bank of England's/GfK National Opinion Polls's inflation attitudes survey, remain elevated at around 4% for the near term, and above 3% for both the two-year and five-year horizons. The credibility of the Bank's inflation target regime is disintegrating and a strengthening of second-round inflationary effects should be anticipated.

...case for a Bank Rate increase remains intact

Despite the various setbacks in economic activity revealed by the data for recent months, the case for a Bank Rate increase remains intact. UK import price inflation soared to 7.3% in April. Further energy price increases are likely to induce sticker shock for headline UK inflation over the next few months. An immediate 50 basis point increase in Bank Rate is necessary to protect the UK from a scenario of further depreciation in the external value of Sterling and inflation accommodation.



Comment by Trevor Williams

(Lloyds TSB Corporate Markets)

Vote: Hold.

Bias: To hold Bank Rate and undertake further QE.

Weakness dominates but with patchiness

Recent domestic news on the UK economy has showed little change over the past month. That is to say that signs of weakness dominate, with some data weaker than others. Weaker data are related to consumer and government spending, like retail sales and the Confederation of British Industry's distributive trades' survey. Stronger data mainly relate to the export-oriented sector, with a softer bias to industrial production but still signs that orders are holding

Monetary weakness has stimulated renewed interest in QE

Somewhat worryingly though, the M4 broad money supply data show that liquidity is still an issue, with the headline rate falling by 0.9% in the year to April. Crucially, the MPC's preferred M4^{ex} measure fell by 2% on a three-month-annualised basis. It has also been exhibiting a weaker bias over recent months. Indeed, this outcome prompted a mention in the MPC June minutes that further QE might be required. This was the first such mention by someone other than Adam Posen for some time. Not surprisingly, the housing data have not improved, with the lending

However, price pressures remain, causing a policy dilemma

Meanwhile, the inflation data showed that price pressure remained, with CPI inflation staying at an annual 4.5% for May. Pipeline inflation also maintained its tight bias. None of this makes for easy decisions. However, the June MPC minutes showed little appetite for any change in policy and, arguably, showed a bias to staying on hold for longer, especially since the new member Ben Broadbent voted to leave rates on hold.

Low rates can be justified but only if inflation expectations remain anchored

None of this matters for my vote per se as much as the fact that global trends weakened in the last month, with the risk of debt default in Europe closer and the International Energy Authority releasing oil from its strategic stockpile to help drive prices lower and ease global price and growth pressures. Overall, there are too many uncertainties to do anything other than leave Bank Rate on hold. Yes, there are supply price pressures, and a threat of prices rising further, but with fiscal tightening looking ominous and a global growth pause, it might be best to wait for longer before raising rates. Hence, the appropriate vote is to hold Bank Rate with a bias to using QE if money supply falls further. It is clear that the economy cannot yet withstand a rate hike. Nevertheless, as soon as it looks like it can, a rate rise will be necessary to ensure that inflationary expectations remain anchored. For now, though, expectations of future inflation are anchored and real wages seem likely to stay low for some time. This means that low rates can be justified for a while longer, in my view.

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.

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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