



Shadow Monetary Policy Committee

September 2012

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IEA's Shadow Monetary Policy Committee votes by six to three to hold Bank Rate in September

In its most recent monthly e-mail poll, completed on 28th August, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Britain's Bank Rate should be held at ½% when the official rate setters meet on Thursday 6th September. Two dissenters wanted to raise Bank Rate by ½%, while another desired an increase of ¼%. There was a further divergence with respect to the desirability of further quantitative easing (QE). Most SMPC members were content to complete the existing programme – except for one who wanted an immediate phased programme of withdrawal – but there was no consensus whether QE should then be held or a further tranche introduced later on this year. However, there was widespread agreement that QE would have to be used aggressively if the Bank of England again found itself in a lender of last resort situation, perhaps as a result of events in the Eurozone.

In addition, there was a consensus on the SMPC that the UK economy was broadly flat lining, but that the official growth figures were so dubious that it was impossible to be more precise. Several SMPC members noted the contrast between the weak output figures and the stronger picture painted by the labour market statistics. A substantial body of opinion also thought that output was supply constrained – perhaps as a result of the massive increase in the socialisation of the economy in the first decade of the 21st Century – and that bold supply-side reforms were a necessary condition to get the economy motoring again. Without these, any further monetary stimulus would be dissipated in higher inflation.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts exactly nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses correspondingly should be regarded as more significant than the precise vote. The next SMPC gathering will be held on Tuesday 16th October with its minutes published on Sunday 4th November. The next two SMPC e-mail polls will be released on the Sundays of 30th September and 2nd December, respectively.

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Comment by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate.

Bias: To hold for the time being.

Surveys a better guide than ONS national accounts

The UK's national accounts have often given a bad guidance to monetary policy decisions in the past. More reliable aids to understanding current conditions are business surveys and labour market data. These suggest that, for most of 2012, the British economy has been growing and indeed growing at least in line with a miserably low trend figure. Some slowdown seems to have taken place in the last month or two, in the backwash from the Eurozone crisis. However, this deceleration may prove transient. The international background ought, on the whole, to be improving. Monetary policy is being eased in China, while money growth appears to be reviving in the USA.

Rates may have to rise next year but not now

My recommendation is to leave policy unchanged, with Bank Rate held at ½% and QE maintained at the present level. It is possible that it will be appropriate to favour a rise in interest rates at some point in 2013. However, my bias is for the moment is best described as being for 'no change'.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate; continue with agreed asset purchase programme.

Bias: Additional monetary stimulus.

Draghi statements have calmed market nerves in the short term

Following Mario Draghi's remarks in London at the end of July, and his subsequent comments at the early August European Central Bank (ECB) monthly press conference, there has been a sizeable rally in global equities, an upswing in commodity markets and a generalised decline in credit spreads. These trends largely reflect declining risk premia rather than a re-assessment of global growth prospects. Although August is generally a quiet month in bank funding markets, there have been signs of improvement of late. European banks' Credit Default Swaps premia have fallen by around 40 basis points on average since late July, most notably for troubled institutions in the periphery. Evidence from foreign exchange swap markets suggests access to short-term dollar funding markets has also improved of late.

But long run Eurozone problems have not been solved

Whether this hardening of financial market sentiment can be sustained through the autumn is debatable. For the moment, Mario Draghi's pledge to do "*whatever it takes to preserve the euro*" is simply that – a pledge. He may believe that "*it will be enough*", but he has to convince sceptical investors of that fact with concrete action. It is clear we will get some kind of ECB-led bond-buying programme; but to be successful in reversing the self-fulfilling loss of market confidence in Spain, Italy etc. it has to be both unlimited and unconditional. We know it will not be the latter – Draghi made clear that no bond purchases will take place until a country has formally applied for European Financial Stability Fund (EFSF)/European Stability Mechanism (ESM) support, i.e., there will be no reactivation of the Securities Market Programme (SMP) which bought sovereign paper without explicit conditionality. Moreover, the pledge to do 'whatever it takes' is unlikely to mean unlimited bond purchases across the yield curve. We are told that the ECB is only going to buy short-dated paper – since most of the sellers at this part of the curve are likely to be banks, the direct boost to broad

money will be limited. It is even suggested that the ECB will confine itself to the treasury bills of those countries affected. Targeting the spread over bunds at the short-end of the curve is only one of many mooted options. In short, the plan is not shaping up to be either unconditional or unlimited. There is room for market disappointment when the plan is formally revealed.

Buffeted by political gyrations

Markets may also be buffeted by political gyrations this month. The German constitutional court will decide on the legality of the ESM. While it is highly unlikely to be struck down, there are concerns about the constraints the court may place on the Bundestag in providing future financial support to troubled Eurozone economies. On the same day as the ruling, Dutch voters go to the polls. On the basis of recent polling, there is scope for a major upset, with the main pro-euro parties in danger of losing their effective majority in parliament. There is also the continuing debacle in Greece. The next tranche of official financial aid is not yet assured. Antonis Samaras, the new Greek prime minister, has gone to Berlin and Paris with his begging bowl, hoping to be rewarded with additional time in which to meet the deficit reduction targets. He will no doubt receive some superficial hand-outs from the Germans; but it is clear that there will be no meaningful change in the fiscal adjustment expected in Greece. How robust the Greek coalition government will prove when this becomes obvious is anybody's guess. It is an added dimension of uncertainty in a highly uncertain environment.

The UK funding for lending scheme (FLS)

With another round of gilt purchases underway and the 'funding for lending scheme' (FLS) still in its infancy, there is merit in the monetary policy stance being left unchanged this month, despite the balance of risks to both growth and inflation being on the downside. There is a small chance that the Draghi plan, which is now due to be announced at the 6th September ECB meeting, has a meaningful, long-lasting impact on investors' risk appetite and bank funding conditions. A credible bond-buying programme could alter the balance of risks to inflation in the medium-term. There is an argument in holding fire until we have more information from the ECB.

Pros and cons of the FLS

There is also considerable uncertainty surrounding the magnitude of the monetary stimulus that the FLS will provide. While the scheme is little more than a collateral swap facility, allowing banks to receive treasury bills in exchange for illiquid securities and loans, its cost and size is directly linked to the amount of net lending to the 'real economy' that banks undertake. At its least effective, the scheme will simply provide a (large) funding subsidy for lenders, which they will use to boost profits and capital. This should lower the cost of funding that banks have to pay in the markets, making them more likely to lend over the longer-term. At its most effective, the FLS will actively encourage banks to increase/reduce their lending more/less than they otherwise might have done, and make credit available to borrowers who otherwise could not get a loan. While it should reduce the effective cost of credit to existing borrowers, it may also alleviate some of the quantity rationing that banks are currently imposing. Relative to the counterfactual, the expansion of private credit and broad money could be substantial. There is a good case for waiting to see how banks respond to the FLS in the weeks ahead, even though any conclusions will be tentative.

Additional UK monetary stimulus may be needed in late 2012

The likelihood is that additional monetary stimulus will be warranted later in the year, however. Notwithstanding the difficulties in looking through the highly volatile GDP data, the economy appears close to stagnation. Business surveys suggest output was expanding very slowly in the first half of this year. Recent reports suggest the pace of growth has moderated, and in the case of manufacturing they show an outright drop in

activity. After four months of falling new orders, the July Purchasing Managers Index (PMI) survey pointed to the biggest fall in industrial production since March 2009. Meanwhile, service sector activity also appears to have faltered, leading to a decline in investment and hiring intentions since the spring.

Energy and food costs

The recent upward lurch in global energy and food prices suggests the central path for inflation may be somewhat higher in coming quarters than was likely a couple of months ago. Nevertheless, and to the extent that these moves primarily reflect temporary supply shocks, they are unlikely to have much information regarding medium-term inflation. If anything, global, particularly emerging world, growth forecasts have continued to fall in recent months. Domestic price pressures remain fairly limited despite what appear to be extensive effective supply failures. ‘Supply-side pessimists’ take these to be a permanent cost of the financial crisis, arguing that the apparent weakness in labour productivity should be considered a reduction in underlying productivity. In this line of thinking, the output gap is currently relatively small.

Weak demand may have depressed potential output

Potential output may have been depressed by the financial crisis, but this could have as much to do with weak demand, a collapse in ‘animal spirits’ and banking dysfunction, as factors which will permanently depress potential output. This is a vital distinction – if persistently sluggish demand growth is itself feeding the rise in risk aversion and the unwillingness of banks to lend, potential output may be significantly affected by the path of demand. Doing too little now may contribute to a permanent fall in the sustainable level of UK activity. There is a strong case for policymakers erring on the side of doing too much in this environment even if the central case had inflation at the 2% target in the medium-term.

Comment by Anthony J Evans

(ESCAP Europe)

Vote: Raise Bank Rate by ¼ %.

Bias: No additional QE but Bank should be on standby with other monetary tools.

Tumbling pillars

The two main pillars of the Bank of England’s inflation targeting regime are: 1) hitting a Consumer Price Index (CPI) target of 2%; and 2) communicating its decisions and justifications in a transparent way. It is currently failing at both. Most economists accept that they have adopted a *de facto* Nominal Gross Domestic Product (NGDP) target of sorts, but its failure to confront this issue is dramatically undermining its credibility.

Bank of England needs to signal that inflation takes priority

Although there are reasons to suggest that CPI remains above target because of temporary or external factors, the inflation target should reflect them all. The Bank’s job is not to deliver 2% inflation on the domestically determined components of CPI alone. Ascertaining the breakdown is only helpful in as much as it allows people to make forecasts about the future path of CPI – on this point, the US Federal Reserve Bank of Atlanta has an index of ‘sticky prices’ which would be interesting to replicate for the UK. However, we have overshot the target for over two years by now, and inflation is creeping up once more, from 2.4% in June to 2.6% in July. If the Bank intends to retain the inflation-targeting regime, they need to signal that inflation remains a priority. If they are willing to tolerate above target inflation to temporarily

hold up NGDP, they should communicate this. Until then, they've tied their own hands and should remain true to that.

Monetary Ritalin

Richard Fisher, President of the Federal Reserve Bank of Dallas, has recently talked about the threat of over prescribing 'monetary Ritalin' and it is important that the risks of low interest rates are investigated further. Low yields increase pension deficits and this has the potential to divert corporate money from much needed business expansion to cover the shortfall. In addition, it is no bad thing to permit moderate wealth transfers from people with tracker mortgages to those with tracker savings accounts. The main problem in the economy is not insufficient liquidity provisions by central banks, but a breakdown in effective intermediation – which is partly due to capital requirements and other regulatory shocks – and supply side problems.

Supply side factors constraining output, not demand

As more time passes since the 2008 crisis, it becomes clearer that it is supply side factors hindering the recovery rather than inadequate aggregate demand. Fiscal and monetary policies have both been accommodating, but stimulating aggregate demand cannot capture lost output if the long-term growth rate has changed in the meantime. The official GDP forecasts from the Office for Budget Responsibility (OBR) have been shown to be hopelessly optimistic. Even so, this does not necessarily mean that the output gap is widening. In terms of a basic aggregate demand/aggregate supply model, policymakers are attempting to get back to a long run aggregate supply curve that has shifted. Doing so will increasingly deliver inflation rather than output growth. In addition, permanent 'crisis' rates of interest will make the economy more vulnerable to future shocks, and generate capital misallocations.

Bank should minimise distortions caused by ultra-low interest rates

The Bank of England should concentrate on minimising the distortions caused by ultra-low interest rates, and recognise the limits of what they can do. Although future events may make emergency liquidity provisions necessary, that should not prevent attempts to return interest rates to their natural rate now.

Comment by Ruth Lea

(Arbuthnot Banking Group)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate; complete the latest £50bn QE stimulus.

UK labour market data are weaker than they appear on the surface

The Office for National Statistics (ONS) have revised their estimate of GDP in 2012 Q2, as expected, from a fall of 0.7% to a fall of 0.5%, reflecting less negative estimates for production and construction. After allowing for the extra bank holiday for the Queen's Jubilee, underlying GDP was probably flat in the second quarter. Nevertheless, there has been much speculation that the ONS is underestimating GDP, even after this upward revision, because of the seeming buoyancy of the labour market figures. However, a fairly quick inspection of the employment data suggests that not all is positive. In the second quarter, the number of full-time employees was down compared with a year earlier whilst part-time employees and the self-employed, who may or may not be fully occupied, increased. In addition, the number of part-time employees who worked part-time because they could not get full-time jobs has increased. Furthermore, a recent survey from the Chartered Institute of Personnel and Development (CIPD) suggested that one in three firms were holding onto more labour than they needed in order to retain skills but that, ominously, there would be redundancies if the economy did not pick up.

Business surveys suggest renewed weakness

Surveys of business activity have also been quoted in support of the 'ONS is underestimating GDP' school and, indeed, many surveys until fairly recently had been modestly upbeat. However, the latest Markit Purchasing Managers Index (PMI) surveys for July were discouraging. They suggested that manufacturing was indeed declining whilst there was very little growth in services and construction. The ONS may revise GDP data, indeed they are almost certain to revise the GDP data, but their picture of a stagnant economy, at best, looks credible.

BoE will maintain accommodative monetary stance

Under these circumstances the Bank of England looks set to maintain its very accommodative monetary policy for months, if not years, to come. This remains the broadly correct policy, notwithstanding the unexpected pick-up in July's inflation figures. However, they are unlikely to make any further moves before November for at least two reasons. Firstly, the current £50bn of QE stimulus will not be completed until end-October and, secondly, the Bank appears to be prepared to wait a few months before assessing the impact on borrowing costs and lending of the Funding for Lending Scheme (FLS). The Bank seems, albeit cautiously, to have high hopes for the FLS. Indeed in the August Monetary Policy Committee (MPC) Minutes they wrote of the FLS that "*in response a number of banks had already announced reductions in the rates on certain mortgages and small-business loans.*" On balance, the Bank's 'wait and see' mode seems eminently sensible. The MPC does however seem to be hostile to any further Bank Rate cut. The June Minutes claimed "*a reduction of Bank Rate below 0.5% might squeeze some lenders' interest margins to such an extent that they became even less able to extend new credit.*"

50:50 chance of Greek Eurozone exit before the year end

Suffice it to say that the Eurozone crisis rumbles on. However, and despite the blood-curdling and apocalyptic warnings about the economic effects of a 'Grexit' and accompanying 'contagion', the probability of a Greek exit rises by the week. It is impossible to say if and/or when Greece will leave the currency union but surely there is at least a 50:50 chance that the country will have departed from the Eurozone by the end of the year. Overall, I continue to support very accommodative monetary policy. However, the time to consider a further tranche of QE is November at the earliest. Bank Rate should be left at its present ½%; there is little point in cutting it further.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate; no more QE but no withdrawal of QE.

Inflation outlook justifies a Bank Rate hike

Inflation has long since ceased to be an important determinant of monetary policy. However, and if it were, the outlook would recommend a rise in rates. The rate of price increase continues to be well above target and, although there has been some recent reduction, the outlook for energy and food prices suggests that annual increases in CPI above 3%, again, may not be far away.

But authorities are concentrating on growth

In truth, though, inflation is now almost irrelevant. The key factor is growth. The UK double dip recession goes on. The Eurozone crisis continues its wayward and extended course. Either Greece or Finland may leave as soon as October. A Greek departure could herald a turning point, with a rapid transition to a Single European State, ongoing year-on-year fiscal transfers, and the eschewing of debt pooling. A Finnish departure could herald a wider breakup from the wealthier members and the

disastrous consequences that would entail. The UK government estimates that a disorderly collapse of the Euro could mean a further 7% contraction in UK GDP and there may be a 35% subjective probability of such a disastrous contraction. It is no surprise that UK corporates are not investing their cash in such an environment.

Monetary policy cannot help

Monetary policy cannot help here, any more. All that macroeconomic policymakers can usefully do is to return policy settings to neutral and thereby facilitate the maximum medium term growth rate. We must not forget that medium term growth is not maximised with interest rates of zero. Only six years ago, anyone proposing that this would be how to maximise growth would have been laughed out of office. The truth has not changed; only the willingness of policymakers to hear it.

Supply-side measures are required

It is supply-side policy that can make the difference here. Government consumption spending should be cut. The efficiency of government spending (i.e., public sector productivity) should be raised. There should be reforms to areas such as planning regulation. Beyond that, all that macroeconomic policy can do is not to impede. Government debt should not be excessive. Interest rates should be raised back towards the natural rate.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks.

Plan A or not Plan A?

The latest statistics on GDP, employment and unemployment, business surveys and most recently public sector borrowing have created an unending debate between supporters of 'Plan A' and those who want to see Plan A abandoned in favour of extra spending on infrastructure. Yet, there is no real controversy here. The truth is that worthwhile infrastructure projects with a good long-term return are always welcome. Traditionally, they were entered in the public accounts 'below the line' so recognising that they are: 1) temporary, and 2) to some degree self-financing in the context of the inter-temporal government budget constraint.

Disagreements within the Coalition constrain infrastructure investment

What 'Plan A' rules out is permanent extra spending and capital expenditure with no proper return. It therefore cannot be a 'general stimulus', which often seems to mean in practice that extra money is printed via QE whenever left-wing politicians demand it. The trouble is that such infrastructure spending would probably be going on anyway under existing plans. The main difficulty with infrastructure spending at present is that the coalition cannot agree on what is necessary. Witness the disputes over the HS2 rail link – which is clearly about to be dropped as the white elephant that it is – and the third runway at Heathrow.

UK economy is growing weakly and there has been no 'double dip'

The economy itself is growing weakly and the GDP figures are likely to be revised up to reflect this. There has been no 'double-dip' recession. This weak growth comes three years after the end of the recession proper and it is astonishing that people are still calling for continuously loose monetary policy. Macroeconomic theory and the models we have that fit the facts suggest that monetary policy moves lose their effects on output once they are well-anticipated and of long standing. Instead, if they affect anything, they affect prices.

QE has been offset by rise in bankers' balances

In the present context, it seems that they are not affecting anything since as fast as QE money is printed it winds up in the Bank of England as bankers' balances. Banks

are unwilling to make extra loans except to non-risky borrowers (i.e., some large companies) who have no demand for it, enjoying surplus cash and with low investment plans. When it comes to small- and medium-sized enterprises (SMEs) the new capital regulations force large costs on banks if they lend.

But QE has reduced returns to savers

However, while QE has not affected bank lending and therefore has failed to increase the money supply, and by implication has not reduced the cost of credit, it has succeeded in reducing the returns to savers. This has happened two ways. First, QE has added massively to demand for gilts, taking by now nearly 40% of available gilts, even after the large increase in public issue to meet its borrowing; this demand from the Bank must have driven down the yield to persuade institutions that would normally require gilts for their balance sheet ratios to part company with them. Secondly, QE has driven down the banks' cost of funds and hence its offers of returns to savers.

This distortion made worse by ultra-low Bank Rate

This distortion of the savings market is further encouraged by the very low Bank Rate. Commercial banks can obtain funds from the Bank of England at this rate, and their bankers' balances also attract a rate related to this. Thus, this is the rate at which the massive QE is available to the banks as a funding source. Yet, the banks will not lend it to extra (i.e., SME) borrowers because of other regulatory costs. Hence what this QE and low Bank Rate do is to depress what they offer to savers, and build up bank profit margins on existing business.

UK suffering financial repression

So we now have a monetary policy that is not boosting output via increased lending and lower lending rates, but is depressing returns to savers, and with it the cost of funds to the government. As I have noted in previous SMPC comments, this is essentially what 'financial repression' does in developing countries via controls designed to force savings resources cheaply to government. Here the repression is occurring through the new controls on banking, combined with the massive printing of government-backed money.

Treasury is aware of the issue hence the new incentives for lending scheme

The has begun to realise that its new banking regulations are causing these effects and its latest gambit has been the new incentives for lending scheme, under which 'extra lending' is rewarded by the government/Bank with a subsidy to the cost of bank funds. There is no reason to believe this bureaucratic scheme will work to expand lending, as opposed to expanding 'extra lending' as lending that would have occurred anyway will be diverted into the scheme.

Reverse regulatory overkill and break up the state dependent clearing banks

Unfortunately, the only way to reverse the malign effects of the new bank regulations is to reverse the regulations themselves. Furthermore, to force the banks to compete and not to continue as an effective cartel, with only a few players, the government should force the break-up of RBS and Lloyds into several competing units; it should not hang on to its stakes in their present form and build up their profits for a share sale. It would be better to have less capital return and a growing economy with a healthy credit supply. Alas, in the present political climate both in and outside the coalition, these actions are not likely. So the economy is stuck with a distorted savings market; a controlled credit supply, and an impotent monetary policy.

Raise Bank Rate and reverse QE

My recommendations for monetary policy are, first, for bank regulations to be greatly eased and for the banks to be broken up. However, and second, whether this is done or not (as seems more likely), interest rates should be raised and QE reversed to remove the distortion from the savings market. So the recommendation is for a rise in

Bank Rate to 1% with a bias to raise rates further. In addition, QE should be reversed by £25 billion per month until liquidated.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Hold Bank Rate; no immediate increase in QE.

Bias: To raise Bank Rate; avoid regulatory shocks; maintain QE on standby.

UK economy becalmed

Perhaps the best analogy for the current British economy can be found in Samuel Taylor Coleridge's 'Rime of the Ancient Mariner, published in 1798:

*"Day after day, day after day
We stuck, nor breath nor motion;
As idle as a painted ship
Upon a painted ocean".*

Certainly, there has been nothing in the UK economic releases of the past month to change one's view as to the appropriate conduct of UK monetary policy, even if there remain the well-established inconsistencies between the weakness of the ONS GDP statistics and the stronger trend shown by the labour market data. The ONS has published a paper dealing with this issue, *The Productivity Conundrum, Interpreting the Recent Behaviour of the Economy*, by Joe Grice, which was released alongside the GDP figures published on 24th August, albeit with somewhat inconclusive results. We are also promised an ONS conference on the subject this autumn. A long-shot suggestion is that there might be glitches in the new software introduced when the ONS switched from its ancient Heath-Robinson methods of calculating the national accounts to its new fully automated system last year. The possibility of a programming error would certainly be consistent with the unfortunate recent experiences of financial institutions such as Knight Capital Group and the Royal Bank of Scotland.

July inflation uptick

Meanwhile, the uptick in CPI inflation from 2.4% in June to 2.6% in July and the rise in 'double-core' retail price inflation – which excludes mortgage rates and housing depreciation and is the most historically consistent inflation measure – from 3% to 3.3% must be regarded as a disappointment, especially as US inflation eased from 1.7% to 1.4% between the same two months, Chinese inflation fell from 2.2% to 1.8% between June and July, and Eurozone inflation was unaltered at 2.4%. Recent trade figures, and the most recent public sector finances release also suggest that the two key financial balances of the current account balance of payments and the budget deficit are deteriorating, rather than improving.

Modest reasons to be cheerful

On a more positive note, the growth of M4^{ex} broad money seems to have recently stabilised in the 3% to 3½% range – it was 3.5% in the year to June – and annual UK house price inflation was positive at 2.3% in the years to both May and June according to the ONS index. The national growth rate was held back by the 11.9% drop in Northern Irish house prices, however, which probably had more to do with the property collapse in the Republic of Ireland than mainland UK conditions. English house prices increased by 2.8% in the year to June, Welsh prices were unchanged, and Scottish prices eased by 1%. The reduction in producer output price inflation from 2% in June to 1.7% in July, the drop in core producer inflation (excluding food, beverages, tobacco and petroleum products) from 1.7% to 1.3%, and the 2.4% decline in producer input costs since July 2011 also suggest that the upwards blip in CPI inflation in July is likely to be reversed. The double whammy of the Royal Jubilee and

the Olympics has complicated the interpretation of some recent figures. However, the Jubilee-affected manufacturing output figures in June, which were down 2.9% on the month and dropped 4.3% on the year, were not as weak as the financial markets had feared, while the 2.8% increase in the volume of retail sales in the year to July, when the value increased by 3.1%, was also stronger than anticipated.

UK growth may pick up in Q3, but international outlook is poor

The Bank of England has estimated that the Jubilee shaved some 0.5 percentage points off national output in the second quarter, suggesting that the underlying figure was flat. Some of this undershooting is likely to be clawed back in the third quarter: Bank officials have also suggested that any Olympics effects in the third quarter are likely to be small. Unfortunately, while the UK growth rate may enjoy a 'dead cat bounce' in 2012 Q3, the survey evidence from overseas is less positive. The Munich based CES Ifo world economic climate indicator, published on 16th August, fell in the third quarter, after two successive increases. The decline was due to both unfavourable assessments of the current economic situation and a less positive six-month economic outlook. The Ifo survey results were particularly downbeat for Western Europe and North America. In Asia, confidence was held back by the poor current situation, but there was also some optimism that matters would improve over the next six months.

The recent oil price rise

One factor that has not helped either business confidence or the real economy has been the recent rise in the price of a barrel of Brent crude oil from a temporary low point of US\$89.2 on 21st June to US\$112.6 on 28th August. This development has partly resulted from the increasingly effective sanctions on Iran, but there have also been output losses in South Sudan, Syria and Yemen while North Sea production has been cut by heavy maintenance schedules and a strike in Norway. This has offset a marked increase in Saudi Arabian production and strong production growth in the US and Canada. The increased oil price should, correspondingly, be regarded as a genuine supply shock, rather than a wider indicator of global economic activity. Nevertheless, dearer energy costs will act as a drag on global recovery, regardless of their cause.

Slow growth is a supply-side problem that reflects excessive socialisation of the British and US economies

For at least three decades time series statisticians have been using statistical techniques in an attempt to distinguish between demand-side shocks, and supply-side ones. The essential distinction is that demand side shocks are considered to be 'transitory' in their effects, while supply side effects are considered to be 'permanent'. There is also quite compelling evidence for a wide range of developed economies that supply-side shocks were at least as common and powerful as demand side ones before the 'Great Recession'. This makes it all the more surprising that the current period of weak output, which has now persisted for roughly four years, is widely treated as being purely a demand-side problem and one that would respond to naïve 1960s style Keynesian remedies. Furthermore, it is perverse to treat the current difficulties as a failure of capitalism when one of the most obvious features of the 21st century has been the huge increase in the socialisation ratios of most of the worst-hit leading economies, and the noticeably better performance of countries such as Germany, Canada, Australia and Switzerland where this did not happen. The latest figures from the Organisation for Economic Co-operation and Development (OECD) show that the ratio of general government outlays to the market-price measure of GDP rose from 38.8% in 2000 to 43.2% in 2011 in the OECD area as a whole, but increased from 36.5% to 49.1% in Britain and 33.9% to 41.7% in the US. There is long-standing evidence that increases in the government spending ratio induce a

slowdown in the rate of increase in GDP per capita. Moreover, there is some statistical evidence for the OECD in aggregate that, once the government spending ratio exceeds around 38%, or so, all further increases in the government spending are reflected one-for-one in the ratio of the budget deficit to GDP.

The September Bank Rate decision

As far as the September Bank Rate decision is concerned, the continuing uncertainties in Continental Europe – which represents a gross failure of the Continent’s political class and not of capitalism – warrant a tactical hold. However, the medium-term aim should be to get Bank Rate into the 2% to 3% range at which point it may re-engage with the money market rates that determine borrowing costs, while desisting from ill-considered financial regulatory initiatives that unduly hamper the credit- and money-creation processes. Once the current tranche is completed, additional QE should be kept on standby in case there is a renewed threat of a banking meltdown caused by events in Continental Europe. However, QE should be reserved for lender of last resort purposes and not employed as an instrument of day to day monetary policy. Pace the Bank’s recent discussion paper on the subject – *The Distributional Effects of Asset Purchases*, 12th July 2012 – QE has created huge and morally totally unjustifiable windfall losses and gains for individual savers and borrowers even if the aggregate effects for a theoretical large and diversified national portfolio might cancel out. It also seems rather strange, from a political-economy perspective, that Bank of England officials are just about the last group in the country to still enjoy retail price index linked pensions. If any group should have their pensions unconditionally valorised at the CPI inflation target of 2%, surely it ought to be the people whose actions largely determine inflation in the first place?

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Hold Bank Rate; diversify existing QE into non-gilt assets.

Bias: To raise Bank Rate.

Bank has lost control of borrowing costs

It is becoming increasingly obvious that the Bank of England has lost control of UK retail borrowing costs. During the three years-plus that Bank Rate has been set at ½%, the average interest rate paid on banks’ and building societies’ notice deposit accounts has risen from a low of 0.17% in February 2009 to 1.83% in July 2012. Admittedly, the quoted monthly rates have bounced around, but the average for 2012 is 1.41%. This is a measure of the average cost of retail funds to the banking sector; the marginal cost is closer to 3%. On the other side of the balance sheet, Santander UK has recently announced a 50 basis point increase in its standard variable mortgage rate, to 4.74% from October. Clearly, the level of Bank Rate has played no role in the evolution of market rates for the past three years. The MPC’s consideration of a cut in Bank Rate is perverse and farcical in this context. As and when the UK economic news flow permits, Bank Rate should be raised in order to reconnect it to the structure of market rates. However, with UK activity indicators currently erratic and weak, now is not a good time to do this.

Mounting inflationary risks

It is important not to lose sight of the beneficial purpose of raising Bank Rate, at least to approximate a zero real rate, and preferably a modestly positive one. The UK is subject to mounting inflationary risks. Some of these risks are visible and obvious; others are as yet latent. Unconventional monetary policy is associated with a much wider range of inflation outcomes than conventional monetary policy because unconventional interventions tend to be poorly calibrated. As the official Bank of

England and Debt Management Office holdings of conventional government bonds approach 50% of the total in issue, it is time to wonder where the tipping point for inflationary expectations lies. The willingness of overseas investors to piggy-back on the Bank's Asset Purchase Programme will one day evaporate and be replaced by a fearful rush for the exits because of Sterling depreciation risk. The loss of the sovereign's coveted AAA-rated status cannot be far away now and this too could be a catalyst for overseas selling of UK government bonds.

Nightmare scenario

Regardless of how soon this nightmare scenario arrives, there is plenty of inflationary concern that is already visible. Over the past five years, the UK has demonstrated a greater vulnerability to global inflation than other large European countries. Retail price inflation averaged 5.2% in 2011 and CPI inflation 4.5%. Inflation exceeded the year-ahead forecasts made by the Bank of England for the third year in succession. Factors influencing the pass-through of foreign pricing to domestic pricing include the lack of indigenous competition to imports; an oligopolistic distribution system, especially in food retailing and domestic electricity and gas provision; and a dramatic upward revision to clothing and footwear price inflation. Sterling has been fairly stable in terms of its trade-weighted index over the past three years, but economic weakness poses a renewed threat to the 'safe haven' status of its fixed interest market. The flexibility of Sterling to depreciate means that global pricing pressures have the potential for magnification, given that the UK is an effective price-taker in many sectors. Long after the Sterling depreciation of 2008, import price inflation of 5% or so has persisted.

Debate over medium term growth

The sluggishness of the UK economic recovery has reopened the debate regarding the potential medium-term growth rate. The Bank of England and the OBR routinely assume that the medium-term growth rate of the economy lies in the region of 2% to 2.5% per year, but in a credit-constrained world, these growth rates may be no longer attainable. The shocking manner in which the economic recovery has petered out since the summer of 2010 underlines the centrality of the role of credit, in its broadest sense, in healthy economic development. To the extent that cheap credit fostered the creation of excess capacity in the distributive and financial services sectors, for example, not only was their growth rate unsustainable but their peak level of activity was also artificial. Post-slump, the viable economic size of these industries may remain below their prior peaks for an indefinite period. This may already be reflected in stagnant productivity and rising unit labour cost inflation. After examining the behaviour of forty-four economic sub-categories, our conclusion is that the prevailing rate of sustainable economic growth may be as low as 1%. In these circumstances, economic stimulus whether monetary or fiscal, is liable to deliver an adverse mix of inflation and real activity.

Global inflationary pressures have increased

The view of the Bank of England, reflected in the economic consensus (e.g., Barclays) is that an abatement of energy and commodity price inflation will allow the UK CPI to return to its target rate of 2% per annum and possibly fall beneath it during 2013. However, this has been the official view consistently and incorrectly for the past three years or so, regardless of the external realities. As ex-MPC member Andrew Sentance has pointed out, global inflationary pressures have strengthened since 2008 and 2009 and the UK is susceptible to them. Global goods deflation has been replaced by moderate inflation. The improvement in the non-food and energy inflation rate in 2011 and 2012 has been associated with a particularly weak sequence of economic outturns. Supposing that there is some recovery reflex, aided by the various policy

stimulus initiatives, the Bank of England cannot rely on a stagnant economy to deliver its inflation objective, any more than it can rely on a sequence of good harvests to deliver low food price inflation. For some years now, domestically generated private sector inflation has departed from its stable low trend during 1993 to 2008, and there is evidence of a return to an inflationary mentality, reflected in term inflation expectations of the general public.

Now, too late

If the Bank of England was taking its inflation mandate seriously, it would have raised Bank Rate to 2% or more during the past three years. It has not and it now cannot.

Comment by Trevor Williams

(Lloyds Bank Wholesale Markets)

Vote: Hold Bank Rate; maintain.

Bias: To ease further via QE, with wider range of collateral.

Stronger retail sales

It always seemed likely that the much-publicised very weak provisional GDP figures for the second quarter, which were published on 25th July and registered a fall of 0.7% on the first quarter, would be revised higher. The figures published subsequently, for retail sales but especially for employment, suggested that an upward revision was inevitable. In the event, the revised data published on 24th August showed a revision to a decline of 0.5%, a 0.2% better outcome though still a fall.

Dichotomy between output and employment

One of the most puzzling aspects of the performance of the UK economy in recent years has been the dichotomy between output and employment growth. While the level of UK output has reportedly contracted by around 4.5% since the onset of the downturn in mid-2008, despite rising public sector job losses, total employment is back to where it was prior to the onset of the 2008 recession. The divergence between output and employment has been particularly stark in recent quarters: while the level of GDP has contracted by a cumulative 1.4% since the third quarter of last year, the total number of employed has risen by 1.4% – its strongest three quarter gain since the third quarter of 1997. Although less pronounced, there is a similar divergence between the level of GDP and hours worked.

Lloyds Bank surveys suggest economy still growing

We estimate that, using employment trends alone, the underlying economy expanded by 0.2% in the second quarter; a similar expansion may take place in 2012 Q3, though the headline numbers might be flattering for the pick-up. Our survey data, from the monthly Lloyds Bank Economic Bulletin, also suggests that there is still underlying growth in the economy, albeit low. Trade data are implying that the rebalancing that had shown promising signs might be faltering.

Bank's easy monetary policy is the right one

Despite distortions, the Bank of England is right in my view to have eased policy via QE and other credit easing measures. Given continuing market volatility it is likely to remain vigilant, mindful of headwinds from Europe. I would therefore keep policy on hold, with Bank Rate at ½% and QE at its current rate.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly 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 (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), 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 Bank Wholesale 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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