IEA Shadow Monetary Policy Committee

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Institute of Economic Affairs

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Shadow Monetary Policy Committee votes six/three to raise Bank Rate in February

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 14th January, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 6th February. Four SMPC members voted for a ½% increase, two members wanted an increase of ¼%, and three wanted to leave rates unaltered. This pattern of votes would deliver an increase of ¼% on normal Bank of England voting procedures.

There were several reasons why a majority of the IEA's shadow committee wanted to raise rates now rather than wait until the recovery had gathered further momentum. The most important was the belief that starting interest rate normalisation immediately would avoid a damaging over-steer in the opposite direction at a later date. This argument was opposed by some SMPC members, however, who thought that less damage would be done by waiting than by raising rates prematurely. The other main disagreement within the IEA's shadow committee was over the margin of spare capacity that remained available. The SMPC's 'doves' believed that ample spare resources remained. The 'hawks' thought that there had been a major reduction in aggregate supply as a result of the Global Financial Crash and the 'big government' policies implemented under Labour and only partially reversed by the Coalition. Two general worries were that: firstly, irrationally onerous financial regulations would restrict banks' ability to underwrite the recovery through new money and credit creation; and, second, that the financial markets could be de-stabilised by political events such as the European elections, the Scottish referendum and the prospect of a change of British government in May 2015.

The SMPC is a group of economists who have gathered quarterly at the 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 elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members because it is impractical for every member to vote every month. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a result, the nine independent analyses should be regarded as more significant than the exact vote. The next two e-mail polls will be released on the Sundays of 2nd March and 6th April, respectively, while the next quarterly SMPC gathering will be held on Tuesday 15th April and its minutes will be published on Sunday 4th May.

Minutes of the meeting of 14th January 2014

Attendance: Philip Booth (IEA Observer), Roger Bootle, Tim Congdon, Anthony J Evans, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David B Smith (Chairman), Akos Valentinyi, Peter Warburton, Trevor Williams.

Apologies: Jamie Dannhauser, John Greenwood, Graeme Leach, David H Smith (Sunday Times observer), Mike Wickens.

Chairman's Statement

Retirement of Chairman

The Chairman announced that with his sixty-eighth birthday coming up in June, and having been a member of the SMPC for seventeen years and Chairman for eleven years – during which he had put out roughly one hundred and forty reports – that it was now time for him to retire as Chairman and make way for a younger successor. David B Smith had discussed the matter with the IEA representative, Philip Booth, ahead of that evening's meeting. They had agreed that the best way to proceed was to hold a secret e-mail ballot of SMPC members. In the meanwhile, the Chairman said he would continue to put out the SMPC reports until his successor was in place. This would include the (current) February report and possibly the March one. After that, he would remain available but suspected that he would not be needed. Tim Congdon proposed a vote of thanks for David B Smith for his long and diligent service and noted the difficulties of gathering e-mails and contributions from people in demanding roles and with frequent international travel schedules. Others noted what an excellent job David B Smith had done in keeping the committee on its toes and really driving it forward during this time. Everyone present joined in the vote of thanks to appreciate all that David had done during his time as chairman.

SMPC's debt to the production teams

David B Smith said that he wanted to place on record his thanks to the staff at Lombard Street Research who had been involved in publication of the printed minutes and e-mail polls since mid-2006, mentioning especially Pippa Courtney-Sutton and Tom Crew. He also thanked Rosa Gallo at Economic Perspectives for proof-reading the minutes every month. He added that the fact that SMPC reports had appeared monthly with near Bank of England standards of accuracy, despite the extremely tight schedules involved, represented a major achievement by the production teams concerned; especially as everything was done on an unpaid voluntary basis. He thanked the members of the SMPC for their regular submission of material for the monthly document, particularly as the work of the SMPC had not attracted the attention that it had earlier since Bank Rate had been frozen. He added that media interest was likely to revive once Bank Rate started moving again. The Chairman then invited Andrew Lilico to present his analysis of the economic situation.

Economic situation

Stronger international background

Andrew Lilico began his presentation by drawing the meeting's attention to a series of slides on the international economy. He noted the acceleration in economic growth in advanced economies combined with a mild slowing in the growth of the Chinese economy. The unemployment rate had been falling in the US and the UK; had been broadly flat in Japan and Germany but had been rising in France. The leading indicators compiled by the Organisation for Economic Co-operation and Development (OECD) were moderately positive for all major economies except China going into 2014. Using the OECD as the data source, there had been stable monetary growth in the US, and some pick up in Japan, but a worrying slowdown for the Euro area. Sovereign bond yields in the Euro-zone had been falling in the key contexts of Portugal and Ireland. They had been steady in Italy but yields in the US and France had risen.

Stronger UK growth and moderating inflation

Andrew Lilico then turned his attention to the behaviour of the UK economy. He began his comments by noting that UK economic growth had recovered strongly in 2013, exceeding the expectations that were held out by the broad consensus of commentators at the start of last year. According to the Bank of England, this stronger growth of GDP, which was of the order of 3% when expressed as an annualised rate, was expected to persist for some years. This was according to the projection based on market interest rate expectations and an unchanged level of asset purchases of £375bn. Confidence had increased markedly where both businesses and consumers in the UK were concerned with the point of inflection being around May or June of last year. There had been a pleasing fall in the rate of consumer price (CPI) inflation, which had dropped back to its target rate of 2% in December 2013. The Bank of England's November Inflation Report expected inflation to remain close to this central point of 2% for the next two years with a slight bias towards higher inflation rather than lower inflation.

Faster broad money growth

In the UK, there had been some pickup in broad money growth. M4 lending growth remained in negative growth territory, which had been the case for the last three years. However, the pace of decline in the total M4 broad money stock had reduced close to the zero line. During the past few months, there had been a pickup in the benchmark government bond yield in the UK of around 100 basis points (i.e., 1%). Sterling had gained ground since the spring of the year, more than recovering its early year losses.

Strong UK business surveys and labour market data

The UK Purchasing Managers' Indices (PMIs) for services, manufacturing and construction had all shown similarly strong trajectories through the second half of last year but with some faltering in the manufacturing index at the end of the 2013. However, taken together the UK PMIs were at their highest recorded level since the surveys began. The UK unemployment rate on the Labour Force Survey (LFS) measure had fallen to 7.4%; this was relatively close to the 7% threshold which had been instituted by the

Bank of England Monetary Policy Committee (MPC) in August as part of the new framework of Forward Guidance.

Not raising Bank Rate now poses major risks for the future

Andrew then raised the question of who faced the burden of proof on UK interest rate normalisation. He noted that there was strong resistance in the media to the thought that UK Bank Rate should be raised. The Resolution Foundation had argued that two million families might struggle if Bank Rate was raised. Andrew posed the question regarding UK rates: "if not now, when?" In other words, if the conditions for beginning the process of normalising interest rates were not yet in place, what would need to change to bring that about? He reiterated his own position that the medium term risks of not raising rates were greater than the short term risks of raising them. His observation was that the output gap in the UK was closing rapidly and the failure to respond to the strongly growing output of the economy would be to risk a sharp rise in interest rates at a later date.

Discussion

Output gap a 'false friend' and the regulatory fiasco

The Chairman thanked Andrew for his excellent presentation. David B Smith then started the discussion rolling by observing that, in his experience of using output gap models to forecast inflation over the past few decades, the output gap approach was what translators called a 'false friend'. In other words, it was easy to fit output gap models to historic data. However, these tended to give unstable results when used for forecasting purposes. In particular, output-gap models were unduly vulnerable to data revisions and even small changes in the estimated level of output could have major implications for the projected inflationary outlook. Patrick Minford stated that emergency monetary policy was clearly inappropriate in the light of the strengthening economy and abating inflation in the past year. He quoted a comment by a prominent supporter of regulation that "there has been a regulatory fiasco" because the response of banks to fears of escalating regulations were not factored into regulative calculations. Increasing bank regulation had been responsible for the disabling of bank asset growth and the stalemate in UK monetary policy. Patrick Minford advised a detox of regulation as a remedy. He was worried that regulation had been used to justify the persistence of very low interest rates and questioned whether it would be feasible to raise interest rate in the election year of 2015. Trevor Williams disagreed, saying that delaying the first rate rise till 2015 would not present a problem in terms of the election taking place in the summer of that year, because it could be presented as a sign of a recovering economy for which the government should take credit.

Costs and benefits of raising Bank Rate too early compared with doing so too late

Roger Bootle responded to Andrew Lilico's "if not now, when" challenge. His response was "quite simply: later". Roger Bootle posed the question, to which he admitted that he was not able to find a good answer, of how serious were the losses associated with making a monetary policy mistake and having to raise monetary rates later? What might we learn from keeping interest rates low now? Roger Bootle believed that we would not see evidence of inflationary pressures reviving and was worried that, if rates were raised, this would result in a strong appreciation of Sterling which he considered an unhelpful development. Ideally, it would have been better for Sterling to be below its current level.

The ½% Bank Rate taboo

David B Smith pointed out that it was not inevitable that Sterling would end up stronger in the event of a rise in Bank Rate provided the public relations aspects were handled competently by the Bank of England and the Chancellor. He added that there was a risk that distortions would continue to build up in the economic system for as long as Bank Rate was being squished down. Peter Warburton believed that the ½% Bank Rate which had persisted for almost five years had acquired the status of a taboo which was a very unhealthy state of affairs for UK monetary policy. He added that to break the taboo, to have a Bank Rate rise and see that it did not have devastating effects on the economy, would be a very healthy development. At the moment, some media commentators

were building up the consequences of even the smallest Bank Rate rise as being implausibly large.

Defence of the output gap and dangers of regulatory overkill

Tim Congdon defended the output gap as an indicator of capacity but advocated using survey data to calibrate the most recent values of the output gap, rather than the admittedly dubious Office for National Statistics (ONS) data. He conceded that the surveys were suggesting that there was not a lot of spare capacity in the economy. However, he observed that if interest rates were too low, then surely there would be a rapid expansion of credit which he failed to see. So his willingness to wait and see on the path of the economy was guided in part by the lack of response of private sector credit growth. Regarding the stronger growth of broad money than bank credit, Tim Congdon noted the powerful impact of Quantitative Easing (QE) on the broad money aggregates. In the absence of QE, he wondered whether broad money growth would fall back. He believed that banks had been unduly kicked around by regulators. In his view, banks remained under severe pressure with the latest impositions of the leverage ratio implying a disproportionately tight regulatory stance that went beyond that required by Basel III, the international standard. The growth in banks' risk assets was very low. Tim Congdon saw no great risk of prospective inflation and thought that it would be sensible to wait for another six months and watch the growth of broad money before taking action.

Long run damage caused by unduly low rates

David B Smith discussed the supply side consequences of very low interest rates. He argued that the prevalence of very low interest rates was associated in time with a misallocation of capital that ultimately meant that the potential growth of the economy would be damaged. Current policies represented an undue state-backed comfort blanket for speculators – such as buy to let investors – and were teaching an entire generation that only mugs made long-term investments to provide for their future needs. Tim Congdon disagreed, arguing that, on his estimation, companies were now requiring higher target rates of return to undertake projects rather than lower.

Euro-zone sovereign risk crisis remains a lurking danger

Trevor Williams raised the issue of risk posed by the Euro-zone sovereign and banking crises. He did not believe that the crises had passed or that the convergence of peripheral European bond yields was a good indicator of resolution. He observed the situation where aggressive purchases of domestic sovereign debt by some Euro-zone banks had left their balance sheets in a more vulnerable condition than before. Philip Booth reminded the committee that 2% inflation was a target, not a floor; that the target has been hit for the first time in four years; that the UK retained one of the highest inflation rates in Europe. There was a risk in not beginning to return interest rates to normal under the current circumstances.

Where is the productivity growth?

Kent Matthews posed the question: how will low interest rates solve the growth problem? He asked, "where is the productivity growth?" He said that the improvement in the economy had come about with zero growth in productivity. He was concerned that the increase in the size of the government sector, alongside the existence of so called 'zombie' firms, meant that the economy was unable to respond even in a very low interest rate environment. Firms that should be growing were unable to obtain credit and those that could only survive with cheap credit should be folding. The combination of these factors was worrying for the outlook for UK productivity. His judgment was that a small rise in interest rates would not do the damage that had been suggested by Roger Bootle.

Nominal rigidities but where are the distortions?

Andrew Lilico raised the issue of nominal rigidities in the economy. At the moment, lower inflation was compatible with higher real GDP growth. However, if nominal rigidity persisted, then a return of inflation to higher ground would necessarily detract from the growth outlook. He expressed the view that there was a need for real wages to grow, having been held down for the past four years. Roger Bootle asked where the massive distortions that others had suggested existed were. He asked for concrete examples of distortions. He observed that consumer confidence was still depressed and that the balance sheets of many consumers and businesses were shot to pieces. He was concerned that a raise in interest rates would deliver a hammer blow to private sector confidence. Even if such an increase was reversed, the damage would have been done; there would not be a positive response to a reversal of higher interest rates.

Undue complacency about possible consequences of the Euro elections

Roger Bootle commented about the likelihood of recurrence of a Euro-zone crisis describing the attitude to the upcoming European elections as rather odd. He noted that in the UK, in France and in the Netherlands there were expectations of protest parties gaining ground – e.g., UKIP in the UK and the Nationalist movement of Marine Le Pen in France. Philip Booth countered that regardless of whether interest rates were raised and then had to be lowered again, or whether they were held at levels that were too low for too long and then had to be raised rapidly, there would be costs. It was true that raising rates prematurely had costs. However, so would the rapid rise in rates that would follow later on if they were artificially suppressed for too long. Philip Booth next asked why Lloyds Bank and other UK banks did not place their Euro-zone loans into subsidiaries in order to insulate their balance sheets from the potential impact of a recurrence of a Euro-zone crisis. Trevor Williams responded that UK banks had extricated themselves from Euro-zone exposure to a large extent and that this would not serve any useful purpose, in his opinion.

Need for a communications strategy

Anthony Evans joined the discussion arguing that there was a difficulty, he felt, in offering a view on interest rates without being able to accompany that with a communication strategy. His point was that to read that the SMPC supported a rise in interest rates, to read that in isolation (and in conjunction with the communication strategy of the MPC) may be thought to have a jarring impact on the economy. Nevertheless, SMPC members who wished to vote for a rise should not be constrained by the communication strategy of the MPC, and if the basis of this decision had been made over a period of time then this would not be a shock.

'Natural' rate of UK unemployment more likely 5.5% to 6% than BoE's 7%

Trevor Williams expressed the opinion that the UK 'natural' rate of unemployment (NAIRU) was not 7% on the Labour Force Survey (LFS) measure but quite a bit lower, possibly 5.5% to 6%. Therefore, he did not see a risk from continuing with the policy of ½% Bank Rate because unemployment had scope to fall further before being associated with an inflationary condition. Akos Valentinyi talked about the unusual nature of the recession and the difficulty in assessing the risks on both sides of the decision. He felt there were three reasons still to raise rates: first of all that asset prices were elevated and that there was a risk of instability if interest rates were kept too low; secondly, there was an expectations argument and he spoke about the impact of US tapering on rates in the UK; thirdly, he thought another reason to raise rates was the absence of 'credit cleansing' so far, which was one possible reason for depressed productivity growth.

Triggers for raising Bank Rate

Tim Congdon countered that he did not regard the existence of so called zombie companies to be a valid argument for raising interest rates. In his view, bygones were bygones and that these companies should be allowed to live, provided that the variable costs of production were being covered. Trevor Williams agreed that, in many cases, insolvent or nearly insolvent companies could be nursed back to health with the help of the specialist restructuring teams operated by the banks. Andrew Lilico said that he felt the burden of proof was still with those who did not want to raise rates to state what would be the conditions that caused them to change their minds. Tim Congdon's response was he would like to see six months of ½% per month increases in broad money. Roger Bootle said he would like to see evidence of a pickup of wage inflation above that of price inflation.

Low interest rates have encouraged excessive corporate gearing

Peter Warburton offered, as an example of the distortion that Roger Bootle had been seeking, that the concentration of corporate balance sheets towards debt had been an unwelcome development and one that was potentially damaging to the stability of companies in the future. He argued that the low interest rates available to larger companies in the capital markets had induced them to take on more debt which had been used primarily to retire equity rather than to finance capital spending or other aspects of business growth. Andrew Lilico argued that there was an opportunity cost to allowing zombie companies to continue in operation; that if their assets were liquidated then they could be redeployed in more profitable uses. Roger Bootle maintained that the instances of distortions were weak and vague. He added that Alfred Marshall had claimed that an argument was not convincing if we could not give examples of a phenomenon. Roger Bootle argued that distortions arose from the crisis as well as from the policies. He averred that the outlook for inflation was still to fall with weak pipeline pressures on producer prices, subdued intentions of producers to raise prices.

Private investment has been far weaker since late 2008 than historic relationships would have suggested

David B Smith raised the issue of the apparent discontinuity in UK private fixed capital formation. He said that he had recently completely re-estimated his Beacon Economic Forecasting (BEF) macroeconomic forecasting model using the new 2010 based national accounts data (the latest manual describing the BEF model is available on request from xxxbeaconxxx@btinternet.com). As part of this process, he had used a post 2008 Q4 'dummy variable' to try and quantify the effects of the Global Financial Crash – there were now enough post-crash observations for this to be statistically reasonable. He added that in many cases, including the relationships for the volume of household consumption, real exports and stock building there had been no indication of a structural break. However, there appeared to have been a negative post-crash break of around 28.5% in the equations for the determination of aggregate UK private investment, after allowing for all the obvious other factors at work, such as activity, real interest rates, taxes etc. He had no clear explanation for this phenomenon; but increased political risk, the need to top up company pension schemes and increased risk aversion were all possible factors. However, a sustained reduction in private capital formation would be associated with a marked slowdown in technical progress and, hence, productivity growth in a post-neoclassical endogenous growth model, and so might help explain Britain's poor productivity performance and unexpectedly strong demand for labour in recent years.

Favourable international supply shocks reduced inflation

Peter Warburton disagreed with Roger Bootle on both the UK and global inflation outlook arguing that favourable supply side factors had greatly influenced the evolution of inflation in the past two years, notably in energy prices and food prices; and that these positive influences could not be relied upon to continue.

Call for votes and comment by Kent Matthews

The Chairman then moved to request that votes were taken of the meeting. He added that the IEA observer Philip Booth would not be co-opted on this occasion because ten full SMPC members had been present. Kent Matthews had been obliged to leave the meeting early, to catch a flight to Hong Kong, and had generously volunteered to abstain from the poll. If had been able to vote, Kent Matthews would have advocated a rise of ¼% in Bank Rate and had a bias to raise Bank Rate further in a series of short steps. It was his view that the Bank of England still had QE in its armoury and that this weapon could always be deployed independently of Bank Rate if the Euro-zone crisis flared up again. Kent Matthews had added that monetary policy was only a short-term measure which could not be expected to solve the low productivity of the British economy. That would require more fundamental changes involving the size of the state sector, taxation and the reallocation of credit. For this process to begin, real interest rates needed to get back to a normal level. In accordance with normal SMPC practice, the votes taken into consideration are listed alphabetically below.

Comment by Roger Bootle

(Capital Economics Ltd)
Vote: Hold Bank Rate.
Bias: Neutral.

Weak inflation pressures justify wait and see

Roger Bootle stated that his preference – in view of what he perceived to be weak inflation pressures – was to wait and see where Bank Rate was concerned and to accept the risk that interest rates might have to rise faster later on.

Comment by Tim Congdon

(International Monetary Research Ltd)
Vote: Hold Bank Rate.
Bias: Neutral.

Nominal national income determined by quantity of money

Tim Congdon commenced his remarks by stating that, as ever, his comment was motivated by the guiding principle that the equilibrium values of national income (in nominal terms) was a function of the quantity of money. By the latter, he meant a measure that embraced all money balances and was dominated by bank deposits. In more down-to-earth terms, the rate of change in the UK's nominal GDP, and hence in its inflation rate, was closely related over the medium term to the rate of change in the M4ex money aggregate.

But money supply is being largely sustained by QE and credit growth is weak

In the three months to November, the annualised rate of increase in M4ex was 4.9%; in the year to November M4ex rose by 4.4%. In the context of virtually zero short-term interest rates and moderating inflation, these rates of money growth had been consistent with strong asset price advances and a healthy recovery in demand in recent quarters. However, continuing QE operations until September 2013 had been vital to maintaining money growth at a 4% to 5% annual rate. The MPC had not changed its policy on QE since late 2012, but QE operations to boost the quantity of money had remained in force until quite recently. Banks in the UK were still not growing risk assets. Talk of 'a credit boom due to low interest rates' was bunkum. Thus, in the three months to November, the M4exL total – i.e., lending to the private sector, excluding intermediate other financial corporations, by UK banks and building societies – barely changed, with the three-month annualised rate of increase a mere 0.5%. Within this, lending to households, on the same definition, had a three-month annualised rate of increase of 1.7%.

BoE Governor wrong to believe that UK has ample spare capacity

He added that he did not agree with Mark Carney that the UK had abundant unused spare capacity at present. Tim Congdon even feared that – because of such interventions as auto-enrolment and yet more labour market regulations from the European Union – the natural rate of unemployment was above 7%. However, for the moment his main worry was that money growth would fade, because the banks remain very much under the cosh of ever-tightening regulation. This judgement might prove a mistake and he would readily admit that was the case – if we saw M4ex rising by ½% or so a month in 2014 without the crutch of the QE operations. However, for now, he would like Bank Rate to be kept at ½% and he was far from persuaded that the UK recovery had a self-sustaining momentum.

Comment by Anthony J Evans

(ESCP Europe)
Vote: Raise Bank Rate by ½%.
Bias: Neutral.

Need for a clearer communications strategy

Anthony Evans said that he wanted to accompany his vote for a ½% increase in Bank Rate by emphasising the need for a clearer communications strategy on the part of the Bank of England that expressed a clearer understanding of the circumstances in which the official REPO rate would be raised.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no change to QE.
Bias: Raise Bank Rate further.

Now time to raise Bank Rate

Andrew Lilico said that he could only repeat the views set out in his economic background presentation that the medium-term risks of not raising rates were greater than the short-term risks of raising them. Despite all the practical measurement problems involved, the output gap in the UK appeared to be closing rapidly. The failure to respond to the strongly growing output of the economy would be to risk a sharp rise in interest rates at a later date, in Andrew Lilico's view, particularly as the preliminary ONS data frequently tended to understate the strength of activity in the recovery phase.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate.

Raise rates and continue normalisation

Patrick Minford voted for a ½% increase in Bank Rate but added that there was scope for the Bank of England to add to its stock of purchases of assets as a means of bolstering the growth of the money supply. Patrick Minford had a bias to raise rates further and continue the process of normalisation.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)
Vote: Raise Bank Rate by ¼%; QE to be run off gradually as debt matures.
Bias: Bank Rate to be cautiously raised to 2% before pausing

Forward Guidance a rod for MPC's back

David B Smith expressed the view that Forward Guidance had turned out to be a rod for the MPC's own back in the sense that Forward Guidance had made it more difficult to raise interest rates in response to changing circumstances. However, we were where we were and the 'false consciousness' created by forward guidance – i.e., that Bank Rate would not be raised for a long period of time – made it difficult to tighten monetary policy without delivering a severe psychological shock to the borrowing classes. As a consequence, he wanted to proceed carefully in tightening, possibly with pre-announced steps of ¼% increases every second month or so until a level of 2% Bank Rate was reached. He reiterated that it was wrong to regard a strong currency as an unambiguously negative factor for growth. The evidence suggested that any detriment to net exports would be more than offset by the increased living standards associated with the lower price level, in his view.

Political risks to the UK recovery

David B Smith expected CPI inflation to ease further in 2014 – probably to 1½% to 1¾% by the fourth quarter – but to pick up again moderately in 2015. He believed that the UK patient was gradually coming round from the cranial trauma caused by the Global Financial Crash – and the second sandbagging caused by Mr Osborne's perverse 2010 tax hikes – but that there was an urgent need for supply side measures to consolidate the recovery. The fiscal background was not as healthy as it appeared, and there were looming political risks that could de-stabilise business confidence, sterling and the gilt-edged market. Not only was there the EU election, referred to by Roger Bootle, but also the Scottish Referendum in September. Furthermore, he suspected that the financial markets would begin to discount the 2015 UK general election at least a year in advance (i.e., within a very few months).

Labour's anti-market rhetoric may be making businesses reluctant to invest

He was apprehensive that the Labour leader's Hugo Chavez-style rhetoric meant that business people were already becoming reluctant to invest – because of the future political and regulatory risks associated with a change of government – and that neither the foreign exchange markets nor bond investors would welcome the prospect of a Labour government (or a potentially fiscally improvident Lib-Lab coalition) being formed after May 2015. The political parallels seemed closer to the period 1974 to 1976, ahead of the December 1976 International Monetary Fund (IMF) loan, than they did to the arrival of the ostentatiously, albeit only ostensibly, moderate New Labour government in 1997.

Comment by Akos Valentinyi

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

Holding Bank Rate the greater risk

Akos Valentinyi believed that there should be a slow return to more normal levels of interest rates. He also believed that keeping Bank Rate too low for too long carried the greater risk than sitting on Bank Rate for the indefinite future.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate.

Rates should have been raised already

Peter Warburton argued that it was already the case that interest rates should have been raised and that now a more urgent pace of increase was appropriate in view of the recovery of the mortgage credit market, the strong growth of employment and indications that wage inflation was at last responding to improved economic circumstances. While the strength of Sterling was currently acting as a break on domestic inflationary pressures, this could not be relied upon to continue.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking and University of Derby)
Vote: Hold Bank Rate.
Bias: Neutral on Bank Rate; leave the amount of QE at current level.

Plenty of time to raise Bank Rate without a risk to inflation

Trevor Williams supported a policy of gradually depleting the level of QE through redemptions. He believed the growth of money supply was still too weak to be confident about the recovery and particularly that the pace of bank lending growth was insufficient. He argued that the high level of repayment of corporate debt was due to a lack of productivity. He did not see signs of inflation pressure in the near term. He remained concerned about deflationary risks emanating from the Euro-zone. In conclusion, he believed there was plenty of time to raise UK interest rates without taking a risk with inflation. It was better to ensure that the recovery was firmly grounded first, before contemplating a rate hike.

Policy response

1. On a vote of six to three, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in February. The other three members wished to hold.

2. There was some modest disagreement amongst the rate hikers as to the precise extent to which rates should rise. Four voted for an immediate rise of ½% but two members wanted a more modest rate rise of ¼%.

3. Four of those who voted to raise rates expressed a bias to raise rates further, while five shadow committee members had a neutral bias where the months beyond February were concerned.

Date of next meeting

Tuesday 15th April 2014.

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 (Beacon Economic Forecasting and University of Derby). 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 Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), 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 Commercial Banking and University of Derby). 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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