
IEA Shadow Monetary Policy Committee

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Institute of
Economic Affairs

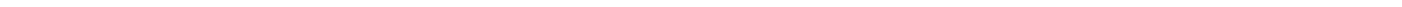
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Shadow Monetary Policy Committee votes seven/two to raise Bank Rate by ½% in March

In its most recent e-mail poll, finalised on 26th February, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) decided by seven votes to two that Bank Rate should be raised on Thursday 6th March. In particular, five SMPC members voted for an increase of ½%, two members voted for a rise of ¼%, and two wanted to leave rates unaltered. This pattern of votes would give rise to an unambiguous increase of ½% on the usual Bank of England voting procedures.

The IEA shadow committee's rate recommendation contrasts with the view taken by Mr Carney at his 12th February *Inflation Report* press conference. Individual SMPC members had a variety of reasons for not being persuaded by the Bank's analysis. However, there was a general suspicion that the concept of 'slack' used to justify freezing Bank Rate was so immeasurable in practice that it was incapable of operational implementation. It was also suggested that the Bank's underlying theoretical model, which justified the emphasis on slack, was itself inadequate as a description of a small, open, trade-dependent economy, with a large socialised sector, and where financial regulation was delivering constant regulatory shocks to the supplies of money and credit. However, some SMPC members felt that it would be desirable to pause and reconsider the process of rate normalisation once the nominal interest rate was in the 2% to 2½% range. There was also a view that the, possibly unrealistic, expectations of Bank Rate stasis created by Forward Guidance meant that any rate increases had to be delivered in a series of small phased doses in order to minimise possible adverse shocks to business confidence.

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 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. As a result, the nine independent analyses should be regarded as more significant than the exact vote. The next quarterly SMPC gathering will be held on Tuesday 15th April and its minutes will be published on Sunday 4th May. The next two SMPC e-mail polls will be released on the Sundays of 6th April and 1st June, respectively.

Comment by Phillip Booth

(Institute of Economic Affairs and Cass Business School)

Vote: Raise Bank Rate by $\frac{1}{2}\%$ and hold QE.

Bias: Increase Bank Rate; QE to depend on behaviour of broad money.

Is 2% CPI inflation intended as a target or as a floor by the Bank?

Although there has been a fall in inflation to just below the 2% target in January, it is the first time that this has been achieved for four years and it makes one wonder whether the 2% target is being treated as a symmetrical target or a floor. Going forward, a rise in confidence and a more generalised return to normal economic conditions suggest that the equilibrium (or natural) rate of interest should return towards more normal levels – perhaps sooner rather than later. There may be dangers in raising rates too quickly. However, there are bigger dangers in keeping rates depressed for too long. Given the shifting nature of forward guidance which is making monetary policy more opaque, keeping interest rates at current levels might signal (indeed, perhaps it is intended to signal) that they will remain very low for many years to come whatever the impact on inflation.

Bigger danger is leaving rates too low for too long

If economic conditions do improve dramatically and a steep rise in rates is needed, the dangers for businesses and households could be considerable. On balance, the dangers of inflation undershooting 1% (i.e., 1 percentage point below target) as a result of modest increases in interest rates in the near future are less than the dangers of leaving rates too low for too long. This is both in relation to hitting the inflation target and also in relation to more general concerns about the economy.

Comment by Anthony J Evans

(ESCP Europe Business School)

Vote: Raise Bank Rate by $\frac{1}{2}\%$.

Bias: Further rises in Bank Rate.

Valid reasons for a rate increase

Throughout the low and slow recovery there have been two different reasons for advocating the normalisation of interest rates. One is that the emergency monetary measures introduced by the Bank of England are somehow akin to tinder that will start to catch fire, and possibly get out of control, once economic activity returns to normal. Therefore, it is safer to start raising rates too soon, rather than too late. Another perspective is that the foundations of the recovery are somewhat weak, and subject to even more negative growth shocks. Keeping rates low during a period of relative calm is not only a de facto commitment to permanently low rates, but also reduces the scope for conventional monetary easing if and when required. Both the 'escape velocity' and 'eye of the storm' scenarios demonstrate that there are valid reasons to consider raising rates. The Bank of England's commitment to forward guidance has been an attempt to avoid this conversation.

Bank's opaque definition of spare capacity obfuscates rather than clarifies

The main problem is that it has been used as a *justification* for the policy stance, rather than as a means to understand what is driving the thought process governing the decision. Markets and commentators want to understand when rates will rise. 'Later' is not a good enough answer.

The utilisation of a 7% unemployment threshold was intended to show that monetary policy would stay looser for longer than markets had previously thought. In fact, it has shown that the necessity for loose monetary policy is lower than the Monetary Policy Committee (MPC) had thought. Instead of confronting this surprise, however, Forward Guidance II has not so much shifted the goal posts but obfuscated them. At least, the unemployment measure was something that we all understood. The Bank's definition of 'spare capacity' is less obvious. MPC member Martin Weale recently attempted to provide his own (loose) forward guidance by stating that rates would begin to rise in spring 2015, and then rise at a gradual rate. The Bank of England has told us not to expect a return to a pre-crisis 'norm' of around 5%. However, this overstates the control that they have. There is a conflation of: 1) what the Bank expects to happen to market interest rates; and 2) what the Bank intends to do with the Bank rate. The problem is that they have little credibility over their ability to forecast the former, and an attribution bias around the latter. Ultimately the greater the amount of control that a central bank has over a monetary indicator, the less important that indicator is to economic activity. This is especially dangerous if the public take present rates as a reliable indicator of future rates and build low rates into their expectations and economic calculation.

Should QE start being withdrawn before or after the first Rate rise?

An interesting issue is whether interest rates should start to rise before QE is unwound. Logically, one might expect the extraordinary monetary policy to be undone before returning to the standard tool. However two reasons suggest that QE should be left alone. Firstly, raising rates would send an important signal to firms and households about the necessity to factor higher rates into their forward planning. If a moderate rate rise would cause problems now, after five years of emergency monetary policy, then it should be confronted as soon as possible. Secondly, one of the biggest problems with the implementation of QE is that it was used in an ad hoc manner. Instead of being tied to clear policy targets – preferably nominal GDP growth, but even unemployment might have been better than nothing – it has been a tool of discretion. Undoing it in a discretionary way may be especially damaging.

Consensus forecasts for 2014 and 2015 are perilously close to the overheating zone

Recent news about the Consumer Price Index (CPI) has certainly reduced the argument for rate rises now. However, it has not by much. Price deflation would be a concern, or a dramatic reduction in inflation expectations would be a concern. However, the rate of inflation slowing to the target level (or moderately below, at 1.9% in January) should be no cause for concern in and of itself. In addition, narrow money measures are still growing above 4% on an annualised basis and, although broader measures were slightly lower in December 2013 than previous months, they are not sending any

major warning signals. Ultimately, the consensus forecasts for 2014 and 2015 are CPI inflation rates and GDP growth that go beyond a low and slow recovery (when their combined rate touches upon 5% we should be concerned of overheating). If anything, there is potential for a little scorching as we approach the 2015 general election. Raising rates risks choking the recovery, but higher rates would make whatever recovery that does result more sustainable. With the trade-offs that we currently face, that may be the best we can hope for.

Comment by Graeme Leach

(Legatum Institute)

Vote: Hold Bank Rate and QE.

Bias: Neutral.

Weakening inflation and monetary growth imply a rate hold

Weak inflationary pressure and a weakening in the Bank of England's chosen money supply measure, suggests monetary policy will remain unchanged for some time yet. The three month annualised rate of growth in broad money excluding Other Financial Institutions (OFIs) slipped to 3.7% in December from 5.1% previously. However, the 'Divisia' broad money measure remains strong, rising by 9% year on year in December. Whilst showing a slightly contrasting picture, broad money supply measures suggest UK economic performance is likely to remain firm in 2014. This is likely to be reinforced by an improvement in real earnings growth, as inflationary pressures ease and productivity driven pay awards increase. By the middle of 2014, the UK economy is going to look and feel quite 'perky'.

And recovery contains the seeds of its own destruction

Despite the optimistic outlook for this year, however, the recovery contains the seeds of its own destruction. Firstly, the faster GDP growth is this year, the greater will be the expectation of a shift towards a normalisation of monetary policy next year. Second, beyond the expectations effect, the implementation of a shift towards normalisation – however modest – in 2015 will directly slow economic activity through the withdrawal of purchasing power from debt constrained households and companies. Finally, supply side constraints – most notably, a decline in the UK's rate of potential output growth over the past decade – probably mean that, whilst any spare capacity could absorb the inflationary consequences of faster growth this year, that is unlikely to be the case next year. In other words, the CPI is likely to move back above the 2% target.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate.

Bank of England is now palpably behind the curve

The argument for raising rates has been compelling for some time. With the Bank of England forecasting 3.4% growth for 2014 – which is up a full 1% from the Office for Budget Responsibility (OBR) forecast in December – it has become overwhelming to the point that the Bank is now far behind the curve and there is a need for catch-up. Rates should already be above 1%, and it is tempting to recommend a 1% rise. However, it remains just about best to recommend only a ½% rise in March to begin with perhaps.

Indefensible official arguments for holding Bank Rate

What defence could there be of continuing to maintain rates at ½% with four continuous quarters of GDP growth and eighteen months of solid growth already behind us? The Bank claims there is some ‘slack’ in the economy, probably of 1% to 1.5%. This is apparently not equivalent to an ‘output gap’ since it will not disappear as the economy grows at 3% plus for some time. So, presumably, the output gap is believed to be larger — maybe in line with the OBR estimate of 2.2% as of 2013 Q3. Yet, Mr Carney claims that, even when the economy returns to interest rate equilibrium, the new normal will be rates of 2% to 3% not 5%. However, since the equilibrium interest rate is given, at a first iteration, by the sum of the target inflation rate plus the sustainable growth rate of the economy plus an inflation risk premium, a 2% target inflation rate implies a sustainable growth rate of below 1% even over the medium-term. If the Bank believes the sustainable growth rate is that low, given that the OBR believes the sustainable growth rate will be around 2.2% to 2.3% in the medium-term, how can the Bank believe there is currently any output gap at all? The Bank’s entire case is seen by almost all commentators as simply an excuse for keeping Bank Rate unchanged at ½% for as long as it can get away with it.

Risk of a boom-bust cycle under present policies

On OBR numbers, at 3.4% growth the output gap at the end of 2014 would be just 0.8%. Ideally, we ought to seek to reach a zero output gap at the equilibrium interest rate and the target inflation rate – so that output, inflation and interest rates are all on target at the same time. Given the OBR estimate of the medium-term sustainable growth rate rising in due course to 2.3%, which appears more credible than the Bank’s extraordinarily pessimistic implicit figure of well below 1%, the medium-term equilibrium interest rate can be expected to be close to 5%. If interest rates were still ½% at end-2014 whilst there were no output gap, that would imply a huge policy imbalance, with the economy being massively over-stimulated at equilibrium output. The only plausible consequence would be a highly damaging boom-bust cycle, with an eventual recession potentially as bad as that of the early 1980s to follow.

Bank's 'fig-leaf' cover

The Bank currently is obtaining some fig-leaf cover for its policy from inflation being below-target, despite being driven by exactly the same sort of 'one-off factors' that the Bank said it could safely ignore when they took inflation far above target for years at a time. This raises the important question of whether the inflation target is still symmetrical, as it was claimed to be for so many years. If it is okay for inflation to be driven to 5% (i.e., 3% above target) by one-off factors, why is it not okay for it to be driven to *minus* 1% (i.e., 3% below target) by special factors? Why is an inflation undershoot of 0.1 percentage points now believed to be a good reason not to raise Bank Rate when an overshoot of 3 percentage points was not considered a good reason to raise them?

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE by £25bn per month.

How durable is the recovery?

It has become a cliché of recent commentary to remark that the UK's recovery has been weak, compared with the past and with other economies. We also see that there is a 'productivity puzzle' – productivity has fallen and may still only be rising weakly. Of course the question is, why? The UK economy before the crisis had experienced strong productivity growth since around 1982. Furthermore, it had enjoyed – although that is not really the right word – gruelling supply-side reform more or less continuously since 1979. There had been some recidivism under Labour's tenure between 1997 and 2010. Nevertheless, as many have said, Blair and Brown were in many ways Thatcher's children and the reversals put in place mainly were at the margin – e.g., some slight restoration of union protections, and the establishment of a minimum wage. However, the recent evidence from the labour market has confirmed that the UK has considerable wage flexibility, both nominal and real, and that union power is weak even in the public sector. Whether minimum wages are binding on demand for lower-paid labour remains a concern; but it seems that zero hour contracts and part-time work in practice produce a lot of flexibility even at this lower stratum of the market.

Four shocks

My own view of the current situation is that it is the product of four major shocks:

- First, a massive run-up in commodity prices that battered living standards;
- Second, the North Sea, where UK policy attempted excessive and 'time-inconsistent' extraction of revenue (i.e., like Oliver they kept on coming back for more);

- Third, excessively tight bank regulation in response to the crisis; this has hit the banking sector;
- Finally, the collapse of the European market for UK manufacturing.

All these are familiar points. However, as David H Smith of the *Sunday Times* has noted, they account for the fall in productivity and also the strength of employment as due to a shift of UK output composition: the sectors hit hardest were all high-productivity sectors while the service sector which has managed to recover most has absorbed many low-productivity workers.

Accelerated run down of North Sea output and excessive bank regulation were self-inflicted wounds

The middle two factors (oil and bank regulation) were self-inflicted by the Whitehall establishment. Fortunately, there are signs that George Osborne and the Treasury have now understood and are trying to reverse the damage. We have yet another rapprochement with the North Sea industry and we have Funding for Lending and the Help to Buy scheme, which mean that credit to mortgages is starting to flow. Small and Medium Enterprises (SMEs) are still affected by the credit famine and UK broad money growth remains weak. Nevertheless, life is returning. QE seems to be having an impact via asset prices, private equity and the new fast-growing peer-to-peer lending. The biggest problem remains bank regulation; banks continue to shrink their balance sheets, effectively pulling against the monetary recovery.

Commodity prices and Euro-zone now less of a drag

Factors 1 and 4 (commodity prices and the Euro-zone) are now also reversing. Commodity prices are coming off, under the impact of monetary tightening in emerging markets like China as well as resource productivity growth due to fracking etc. The Euro-zone has also hit bottom and is recovering. The recovery is therefore looking much stronger. SMPC members like Trevor Williams and Tim Congdon have still stressed potential weakness, however, and the need for monetary ease to stimulate credit and money growth; in this they are at one with Bank Governor Carney and his determination to keep money easy and rates low for the foreseeable future. They seem to have a good point in the sense that the money supply figures support their interpretation.

Growth of secondary lending channels means broad money may be overstating financial tightness

My concern remains that the weakness of the money supply is distorted by bank regulation and is 'structural'; i.e., that there is an artificial block on credit and money creation that is spawning money and asset substitution, while also raising the costs of particular industries and firms. Some SME businessmen have said that the banks will never be trusted again by SMEs and that they are now looking to the new alternative channels of finance. At the same time, the interest rate structure is heavily distorted by both regulation and the zero bound policy; this is illustrated by the massive gap that has opened up between rates on official paper and rates on lending to private corporations, particularly SMEs. We may well be creating the conditions for an asset price boom while diverting this boom away from general credit and money. The recovery could be strong on the back of this

Attack all four constraints as fast as possible and raise Bank Rate

boom while money growth remains weak. We are not there yet but I see no reason to delay in heading off such conditions.

My policy recommendation is to attack these distortions as best we can. First, row back on bank regulation: we do not want to create a 'shadow banking sector' but we are doing so already. Second, restore a normal interest rate structure by raising Bank Rate steadily. Third, operate on the money supply via open market operations (including QE); with the current distortions of the statistics it is hard to know exactly what to do with QE but the overhang looks threatening and it should be reduced, while being willing to return to the open market as the statistics clarify. Thus, I favour continuation of the schemes to restore bank credit growth and encourage the banks back into activity; a rise in Bank Rate towards 'normality', with upward steps of $\frac{1}{4}\%$ starting now; and a reduction of QE in steps of £25 billion per quarter starting now.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)

Vote: Raise Bank Rate by $\frac{1}{4}\%$; hold QE.

Bias: Avoid negative regulatory shocks; break up state-dependent banks more aggressively; raise Bank Rate to 2% to $2\frac{1}{2}\%$, and gradually run off QE.

Recent data have been much as expected at the start of this year

Recent monthly indicators and the revised GDP estimate for the fourth quarter of 2013 released on 26th February – which showed quarterly and annual increases of 0.7% and 2.7%, respectively – have all been consistent so far with the New Year forecasts from Beacon Economic Forecasting (BEF) described in the January 2014 SMPC report. This comes as both a surprise and a relief, given all the traumas that the international and domestic economies have undergone over the past six or seven years and the often inaccurate forecasts that have resulted. However, it may also indicate a wider return to more normal economic conditions as these earlier shocks fade with time. The three main issues arising immediately are: 1) the enhanced political uncertainty likely to be experienced between May 2014 and May 2015; 2) the forthcoming 19th March Budget, and 3) the question of how to interpret the Forward Guidance II launched in the Bank of England's 12th February *Inflation Report*.

But the economic outlook is subject to major political uncertainties

The three main political concerns facing economic agents are the Scottish independence referendum and the European Elections this year, and the UK general election next year. There seems to be least concern about the European Union elections, to be held between 22nd and 25th May – presumably, because many people do not take the European Parliament seriously, despite its propensity to introduce damaging anti-market legislation. The Scottish referendum, to be held on Thursday 18th September, does seem to be putting the wind up the UK establishment, however. This is partly because the outcome remains unpredictable in a situation where opinion

polls are likely to prove unreliable. A personal view is that the overriding concerns in the Scottish referendum for the rest of the UK (RUK) are geo-political and strategic, while the economic issues can be finessed with mutual good will on all sides. However, it is hard to see how RUK would be defensible, if Scotland were neutral, let alone hostile, in the event of any serious conflict. This does not seem a risk at present. Nevertheless, Harold MacMillan's 'events' always tend to come out of the blue. True statecraft requires being concerned with long historical sweeps over decades and not just winning the next election. It is surprising that this crucial strategic interest of RUK in the Scottish referendum has not received more attention.

And a Labour victory in May 2015 would produce very different prospects

A specific forecasting worry about the May 2015 general election is that the 'no policy change' assumption underlying nearly all macroeconomic projections would be invalidated if Labour won and imposed the policies that currently it is advocating. Furthermore, any additional governmental spending under Labour would be imposed on a high and unsustainable starting point. This is because the Coalition has only timorously reduced the share of government spending in GDP from its all-time peacetime peak in 2009. With a large balance of payments deficit to be financed, as well as budget deficits, the probability of 'a non-linear' financial-market event after the May 2015 election looks disconcertingly high. However, a contrary risk is that businesses in politically exposed areas are holding back from investment because of the political and regulatory risks over the next eighteen months. A Conservative victory (or a continuation of the Coalition) might then open the investment floodgates and inject substantial new demand into the economy. The Bank Rate response appropriate to a 'no policy change' assumption after May 2015 could cease to be appropriate in other plausible scenarios. However, the Bank's current preference appears to be to hold Bank Rate throughout.

Background to the March Budget

As far as the 19th March Budget is concerned, it seems better to reserve comment for next month's SMPC contribution, after the detailed fiscal information in the OBR *Budget Report* has been fed into the BEF model. Because much of the essential Budget information is tucked away in OBR Annex Tables, most instant Budget comments tend to miss something. While the OBR creates its own independent forecasts at Budget time, these are normally reasonably close to the consensus. The February HM Treasury compilation of independent forecasts shows a consensus growth forecast for this year of 2.7%, followed by 2.4% in 2015, and a projected Public Sector Net Borrowing (PSNB) of £99.3bn in 2013-14, being followed by a deficit of £87.9bn in 2014-15 and £72.6bn in fiscal 2015-16. The consensus forecast then suggests that growth will run at 2.4% per annum between 2016 and 2018, while the PSNB is expected to gradually decline to £19.1bn in 2017-18. However, this assumes that current policies are maintained after the 2015 election, presumably.

Forward Guidance II is vulnerable to margin of error on estimated economic slack

In contrast to the MPC minutes, the SMPC report contains individual named contributions. Thus, it was significant that most SMPC members independently expressed reservations about the Bank of England's original paper on Forward Guidance in our September 2013 report. Many of these reservations have subsequently been proved valid. In particular, the unwarranted emphasis on the Labour Force Survey (LFS) unemployment measure in the 7th August Bank document has now been replaced by a wider range of indicators. This new framework represents a de facto return to the previous, predominantly discretionary, approach. Given how difficult it is to interpret the, often flawed, official statistics, and the extent to which any set of multiple time series can generate contradictory signals, such a discretion-based approach is possibly all that can be done, even if it lacks clarity. However, the bigger picture gives rise to some serious concerns about the macroeconomic approach underlying 'Forward Guidance II'. This is especially so when the proposals emanate from a central bank – whose prime emphasis should be on inflation control and monetary conditions – rather than from a department of industry, who might be legitimately most concerned with real activity. The emphasis in Mr Carney's *Inflation Report* address was on the need to absorb the 1% to 1½% margin of slack that the Bank believes remains in the labour market. This looks disconcertingly similar to the 1960s Keynesian demand-management fine-tuning, which got the UK into such difficulties in the subsequent decade. A specific concern is that the margin of error attached to any estimate of economic slack is likely to be many times greater than the amount of slack that the Bank currently estimates is in existence.

Flaws in the theory justifying output gap approach

More fundamentally, Forward Guidance II reveals a continuing faith in the US-inspired Conventional Theoretical Macroeconomic Model (CTMM) in which the output gap – however defined – plays a central role. However, the CTMM is horrendously flawed as a description of an open, trade-dependent economy, with a large government sector, and extensive financial regulations impinging on the supplies of money and credit. As a result, the CTMM is a misleading intellectual framework for central-bank decision makers. The CTMM was also responsible for the undue complacency of the US Federal Reserve and the Bank of England ahead of the financial crash, which a more traditional central bank approach would have ameliorated if not obviated (Editorial Note: the reasons were set out in David B Smith's May 2007 Economic Research Council Paper, *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence* (www.ercouncil.org)).

Stabilisation of M4^{ex} growth had more to do with UK recovery than Forward Guidance

It is noteworthy also that Mr Carney hardly mentioned inflation in his Inflation Report address, apart from noting the recent undershoot. The Governor also seemed to regard the exchange rate as a nuisance variable that distorted the relationship between the output gap and inflation – rather than as a key part of the monetary transmission mechanism in an open economy – and did not mention the money supply once. Mr Carney argued that the first phase of Forward Guidance had helped the stronger pattern of activity in the second half of last year. However, an alternative explanation is that it

reflected the acceleration in the annual growth of M4^{ex} broad money from some 2¾% in the first quarter of 2012 to just over 5% or so in the first half of last year – in which case, the slowdown to 3.7% in the year to December may be a cause for concern about the continuing strength of the recovery.

Bank Rate recommendation

If it were not for the expectations of a long period of Bank Rate stasis engendered by forward guidance, it would be unambiguously appropriate to start on a progressive but gentle process of Bank Rate normalisation, until a rate of 2% or 2½% was achieved. At that point, Bank Rate would reacquire the leverage over money-market rates that it has lost in recent years and it would be reasonable to pause for consideration. The question is whether such pre-announced modest rate increases would destabilise confidence? The two main worries where business is concerned are probably: 1) rate uncertainty in general, and 2) not knowing where lending costs could peak. On balance, it is hard to see that modest and pre-announced increases in Bank Rate to a known ceiling should be more damaging to confidence than a longer period of stasis, followed by a possibly abrupt catch-up rise in rates, perhaps after the 2015 election. Bank Rate should be raised by ¼% in March, and then increased cautiously in a pre-announced fashion, by ¼% every second month or so. Likewise, the appropriate approach to QE is to allow it to unwind gradually as stocks mature, through a process of partial re-placement, but not to be too aggressive. However, a weather eye should be kept out for M4^{ex} broad money. Any rate recommendation would be distinctly less hawkish if the recent deceleration in its yearly growth rate, which is probably caused by the over-regulation of the financial sector discussed in previous reports, continued.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by ½%.

Bias: Raise Bank Rate in stages to 2%.

Bank of England's new forward guidance approach

In its restatement of the policy framework known as Forward Guidance, the “Monetary Policy Committee (MPC) is for the first time providing guidance that it is seeking to absorb all the spare capacity in the economy over the next two to three years.” As anticipated, the Bank of England has steered interest rate guidance away from a narrow focus on the unemployment rate, and broadened the list of variables it considers when making decisions on Bank Rate. Its new framework is based on selected indicators of labour market ‘slack’. It will maintain Bank Rate at ½% until slack is virtually eradicated. The aim is “to close the spare capacity gap over the next few years”. The MPC believes that slack within the labour market accounts for the majority of the 1 to 1½% of total slack within the economy. (At the press conference, this was phrased slightly differently, implying that the labour market accounted for all of the slack, taking account of both unemployment and underemployment.) The *Inflation Report* asserts that the medium-term equilibrium rate of unemployment is 6% to 6½%. On the basis of a benign forecast of inflation,

‘Slack’ and ‘spare capacity’ are indefinable concepts

the MPC asserts that “there remains scope to absorb spare capacity further before raising Bank Rate.”

It is a matter of extreme regret that the MPC is pursuing its hapless quest to define slack and ‘spare capacity’, and has placed these nebulous concepts at the heart of its decision making. In its recent *Green Budget* publication, the Institute for Fiscal Studies published a table of estimates of the prevailing UK output gap ranging from zero to 6%. This wide variation of opinion as to the degree of slack, if any, in the economy carries drastically different implications for policy settings.

MPC is effectively unconstrained and is pursuing purely discretionary policies

The MPC’s difficulty in defining labour market slack gives it complete discretion to reach whatever rate decision it chooses. Slack is so riddled with measurement error that it cannot serve a practical policy purpose. Furthermore, the empirical evidence is weak that any of the measures of slack – the amount of it – has a significant role in the determination of inflation. I concede only that an *increasing degree* of slack is a disinflationary force and a *decreasing* degree of slack, an inflationary one. Furthermore, it perpetuates the myth that UK monetary policy should be based purely on domestic considerations. Rather, policy should be modified in the light of international inflationary pressures – for example, food and energy inflation – so as to be tighter when such pressures are benign, as now, and looser when they are malign.

Change in short-duration unemployment may be best measure of labour-market pressure

One of the best measures of labour market pressure is probably the change in the level of short-duration (less than six months) unemployment. This total represents people recently employed and who are likely to be readily re-engaged. There is at least some (inverse) correlation between this measure and the annual growth of real wages. The flaw in the MPC’s new framework is that it fails to recognise how much faster the economy would have to grow in order to absorb unemployed persons that have been out of work for years rather than months. To wait until all the part-time employees who would prefer full-time work have been accommodated would imply an epic dereliction of duty towards inflation.

Sweep away Bank Rate taboo

It is high time for the taboo surrounding a Bank Rate increase to be swept away. A rise in Bank Rate would not inflict severe damage on consumer, much less business, confidence. Nor would it countermand the assistance to homebuyers that has been provided by the mortgage guarantee. The access to and cost of the best value mortgages would be undisturbed. My vote is to increase Bank Rate by ½%, with a target rate of 2% by end-2014.

Comment by Mike Wickens

(University of York and Cardiff Business School)

Vote: Raise Bank Rate by ½% and decrease QE to £250bn.

Bias: Start to unwind QE and slowly raise Bank Rate as economy grows.

Steadily improving UK economy

The February Bank of England *Inflation Report* confirms that the economy is steadily improving. Most of the signals are positive. CPI inflation fell to 1.9% in January – for the first time since the depths of the recession in 2009. All major components of inflation contributed to this development, but especially food. The easing in the price of food (much of which is imported) was, probably, itself a reflection of the appreciation of sterling.

Growth likely to be sustained and now embracing business investment

The growth of UK non-oil real GDP in the fourth quarter of 2013 sustained its third quarter rate of 0.8%, suggesting that the recovery is likely to be sustained. Household consumption increased by 0.4% in real terms in the fourth quarter, although its annual rate of increase eased from 2.7% to 2.4%. A major contributor to consumption growth has been the continued steady recovery of durable expenditures from their nadir in 2009 and 2010. At the same time, overall household indebtedness has fallen even as the savings ratio declined and household loans increased, while the cost of credit has continued to ease. After a 2% increase in business investment in the third quarter of last year, there was a further increase of 2.4% in the fourth quarter to 8.5% up on the year. Investment intentions surveys suggest a further pick-up in the future.

But the UK's poor trade performance remains a drag

The main cloud on the horizon until recently has been the poor performance of trade, with the deterioration in net exports shaving 1.1% off real GDP in the third quarter. However, exports were up 0.4% and imports were down 0.9% in 2013 Q4, adding 0.4% to GDP. Sluggish exports probably reflected the weaker growth of the Euro-zone, the 10% appreciation of sterling since last March and the 3½% appreciation of sterling since November. The trade balance is unlikely to show much improvement until the rest of the world has stronger growth.

MPC has effectively opted for discretion rather than a rule

A further positive sign is the fall in the rate of LFS unemployment close to the MPC's policy threshold of 7%. With inflation also falling, it reinforces the historic dangers of tying monetary policy to the relation between inflation and unemployment. With unemployment having failed as the single indicator of inflation – as was widely predicted – the MPC appears to have replaced this with twenty-two indicators. The claim that such indicators add transparency to the MPC's policy actions will be difficult to sustain. It would be wiser to continue to assume that the MPC uses discretion rather than a rule.

Changing Bank Rate less damaging than using quantitative controls on bank balance sheets

With the economy recovering nicely and inflation falling there is a temptation to leave monetary policy unchanged. This is, of course, what the MPC will do. Nonetheless, sooner rather than later, it will become necessary to normalise the level of interest rates and reverse QE. Although conscious of not wanting

to stall a nascent recovery, I still think that the time has come to start the process of unwinding. If needed, a cover for this is the rise in the price of existing houses due to the mistaken Help to Buy scheme. At present, the Bank is claiming that it has other quantitative tools ready to use to control this rise. This is, however, a blunt instrument; price signals are better.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking and University of Derby)

Vote: Hold Bank Rate and maintain QE stock at present level.

Bias: Neutral.

Latest GDP statistics

UK growth is getting on to a sounder footing. The latest GDP figures for the fourth quarter of last year, published on 26th February, showed that, whilst overall growth was unrevised at 0.7%, it was no longer dependent on consumer spending. Fixed investment rose 1.1% over the quarter, adding a further 0.2% points to growth. Following the third quarter's 2.0% rise, business investment jumped by 2.4% in the fourth quarter, with growth over the year now reported at 8.5%. However, the average growth rate in 2013 as a whole was revised down a smidgen, to 1.8% from 1.9%, because second quarter growth was revised down from 0.5% on the quarter to 0.4% (interestingly, this was the original ONS figure). The other piece of good news was that net trade contributed positively to growth for the first time since the first quarter of last year, contributing 0.4 percentage points to the overall GDP increase recorded in the quarter. However, the challenge will be to maintain this performance in the face of a stronger currency and still weak, albeit better, demand in Europe. On the negative side, although the rate of inventory accumulation slowed in 2013 Q4, its level remained high. Whilst this could be revised away in future releases – through a rise in final demand, say – the risk that some of this could be genuine, poses some downside risks to growth prospects over the coming quarters.

Service sector output appears stronger in PMI than in ONS data

In terms of output, industrial production was modestly weaker than in the first estimate and is now shown to have risen by 0.5% in 2013 Q4 the same increase as in the third quarter. Whilst construction output is now estimated to have risen by 0.2% quarter on quarter, against 2.6% in the third quarter, the larger services sector growth estimate was left unchanged at 0.8%. Yet, services output was softer than suggested by the services Purchasing Managers Index (PMI) for the quarter and hence may not perform as strongly as the survey suggests in the coming quarters.

Britain has had a very weak recovery compared to the US and Germany

It is worth noting that, after the 26th February data release, UK GDP was still 1½% or so below its 2008 high. This compares to the US, where the level of GDP is some 7% to 8% above its pre-crisis peak, and Germany, where it is 5% above. Yet, they have not raised interest rates. With annual UK CPI inflation at 1.9% in January, and likely to either remain around 2% or fall further over the next few months, the case for an immediate rate rise remains thin. Wage inflation remains close to 1%, so real pay continues to decline, and the unemployment rate ticked up to 7.2% on the wider LFS basis in January. Pipeline price pressures also remain weak. Bank rate should remain on hold and the asset purchase facility (APF) be left unchanged at £375bn.

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 until April 2014 is David B Smith (Beacon Economic Forecasting and University of Derby) after which Andrew Lilico (Europe Economics) will take over. 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 (Legatum Institute), 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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