
IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes six/three to raise Bank Rate by ½% in April

In its most recent e-mail poll, which was finalised on Tuesday 1st April, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 10th April. This time, all six SMPC members who voted for an increase wanted to see a rise of ½%. Unlike in previous months, nobody advocated a ‘compromise’ ¼% increase in April. This more hawkish stance was partly to compensate for past delays in raising rates. However, one third of the IEA’s shadow committee still wanted to hold Bank Rate at ½%.

There were a number of reasons why a majority of the IEA’s shadow committee wanted a Bank Rate increase. One consideration was the belief that the home demand recovery had advanced far enough – relative to weak potential supply – for the need for ‘emergency use only’ interest rates to have passed. The twin deficits on the balance of payments and the government’s fiscal position were seen as imposing further limits to monetary stimulus, if market confidence in British government securities and sterling was to survive. Potential destabilisers included the political uncertainties over the next year or so and the disappointing progress with respect to fiscal retrenchment. Most comments on the March Budget welcomed the liberalisation of personal pensions. However, public borrowing was expected to come down more slowly than the Chancellor expected, even if current policies were persevered with after the May 2015 election. Several SMPC members expressed concern about the apparent slowdown in the annual growth of M4^{ex} broad money since mid-2013, even if some recovery was apparent in the February 2014 figure.

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 and signed 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 1st June and 6th July, 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.

CPI inflation target is symmetrical and 2% should be treated as the desirable mean rate not the floor

The 2% target for Consumer Price Index (CPI) inflation is symmetrical. Therefore, we should not be worried about inflation dipping below it: it is important not to treat the target as a floor. Also, we should be looking forward a couple of years. As the economy returns to normal in terms of business investment, confidence and so on, we can expect the level of interest rates necessary to keep a given monetary stance to normalise (i.e., move towards 5%). There are significant dangers in leaving interest rates at too low a level and then having to raise interest rates quickly. This could set the economy back several years.

Raise Bank Rate by $\frac{1}{2}\%$ but QE should be conditioned on broad money

I would therefore raise interest rates slowly starting now, with an increase of $\frac{1}{2}\%$ in the first place. Regarding Quantitative Easing (QE), the decision with regard to QE should be driven by what is happening to the quantity of broad money. The stock of $M4^{\text{ex}}$ should correspondingly be monitored on a month-by-month basis. However, the existing stock of QE should be kept where it is for the moment. My bias would be to raise interest rates further in due course, although I have no quantitative bias with regard to QE, only a conditional one.

Comment by Tim Congdon

(International Monetary Research Ltd)

Vote: Hold Bank Rate and QE stock.

Bias: Alter Bank Rate and QE to maintain stable growth of $M4^{\text{ex}}$ in the low or mid- single digits at an annual rate.

UK economy doing reasonably well, despite more difficult global background

The British economy is doing reasonably well at present, against an international background which is more difficult than expected by the consensus forecast at the start of 2014. Falls in base metals prices and some slippage in energy prices reflect weaker-than-forecast growth in China and other developing economies, as well as continued stagnation in the Eurozone. The good news on commodity prices and a supermarket price war signal continued beneath-target UK consumer inflation.

Credit boom is a myth

Some commentators and even the Bank's Governor, Mark Carney, have expressed concern that the very low interest rates may stimulate an unsustainable credit boom. However, official data show that nothing of the sort is actually happening. In the year to February 2014, $M4^{\text{ex}}$ lending (i.e., bank and building society lending to the UK private sector, excluding that to intermediate 'other financial corporations') declined by 0.1%. In the three months to February, the stock of such lending also fell, although only very slightly, with the annualised rate of decline being 0.5%.

Property bubble largely confined to London

The stagnation of bank credit might have been expected to be accompanied by similar stagnation of the quantity of money. The data show that $M4^{ex}$ was up by 3.7% in the year to February. In association with practically zero short-term interest rates, this low rate of money growth has been consistent with healthy asset price gains, robust balance sheets, decent demand growth and rising employment. However, to talk of a general boom would be preposterous. The London housing market has been very active and 'bubble' is a word justified by central London property prices. But this is only part of a larger national property market which is not experiencing a bubble at all.

Broad money growth is decelerating

The three-month annualised rate of change of $M4^{ex}$ in February was 3%, compared with 3% to 4% numbers for much of late 2013 and 5% to 6¾% numbers in the opening months of 2013. With money growth possibly decelerating, the case for an early increase in base rates seems unconvincing. On the other hand, the seeming strength of the real economy argues against a resumption of QE operations. The implied verdict is "steady as she goes". The British banking system – like the banking systems of other countries – is still restraining balance-sheet expansion, in order to come closer to the Basel III capital requirements.

Comment by Graeme Leach

(Legatum Institute)

Vote: Hold Bank Rate and QE.

Bias: Neutral.

Broad money growth has slowed but alternative money measures indicate a stronger picture

The latest figures for the $M4^{ex}$ money supply measure, which excludes the distorting effects of deposits with so-called 'intermediate other financial corporations', showed an easing in the twelve-month growth rate from around 5% last November to 3.1% at the beginning of 2014, although it has since picked up slightly to 3.7% in February. Does this sluggish monetary expansion suggest that the outlook for nominal GDP is easing? Not in 2014. One reason is that alternative monetary measures – such as divisia money, which weights the different forms of bank deposit according to how liquid they are – are telling a stronger story.

Real incomes are recovering and economic confidence has improved

A shift from time deposits to more liquid short-term deposits has helped accelerate household sector divisia money from 4.3% in October 2012 to 8.5% in February 2013. For private non-financial companies, divisia money growth has accelerated from 5.3% to 13.6% over the same seventeen months. These numbers suggest firm nominal GDP growth this year, supported by a reversal in the real income squeeze – due to falling inflation and stronger productivity led earnings growth – improved economic confidence and wealth effects from the housing market.

CPI inflation will ease further this year

With inflation heading south in 2014 – due to a wide range of factors including a continued output gap, the recent appreciation of sterling, global commodity price movements, the response of energy utilities to political pressure and supermarket price wars – towards 1.5% or below by year end, thereby reducing the pressure on the Monetary Policy Committee (MPC) to tighten policy. However, as we move into 2015 the picture looks less favourable with an expectation of a modest upturn in inflation and the first signs of a normalisation of monetary policy.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by ½%; keep QE at £375bn for now.

Bias: To raise Bank Rate.

UK well into a boom

The UK appears to be well into a boom now. UK 2014 growth appears likely to be around 3% and some estimates for 2015 have been in excess of 3.5% even with interest rate rises. As 2013 base effects dropped out, inflation has fallen slightly below target through one-off factors, but should provide no comfort. If inflation of 0.1 or 0.3 of a percentage point below target is a reason not to raise rates, why wasn't inflation of 1% to 3% above target a good reason to raise them? If inflation being below target now is a pretext for not raising rates, we are saying that the inflation target is not symmetrical – that inflation being below 2% is much worse than inflation being above 2%. No explicit such indication exists in the target as set.

Discrepancies between different GDP measures

The latest Office for National Statistics (ONS) estimates for GDP vary markedly according to whether one uses expenditure-based or output-based figures. On the expenditure basis, national output is now just 0.7% below the pre-crisis peak but it is still 1.9% down on an output basis. Either way, though, the pre-crisis peak seems certain to be exceeded this year. Similarly, given the growth rate of potential output is currently probably still below 2% – although it should return to around 2.3% in the next two to three years as the Office for Budget Responsibility (OBR) suggests – growth of 3% to 3.5% in 2014 should eliminate 1.5% to 2% of any remaining output gap. In other words, we are likely to reach equilibrium output later this year.

The equilibrium interest rate

The policy ideal is to reach equilibrium output with inflation on target and interest rates at their equilibrium level, also. The equilibrium interest rate is, at a first iteration, given by the sum of the inflation target and the rate of growth in potential output. So if potential output is growing at 1.5% and the inflation target is 2% then ideally we would have reached equilibrium output with an interest rate of 3.5%. Instead, rates are ½% and there remains great reluctance to contemplate moving them at all – indeed the effort of forward guidance remains that of persuading markets that rates will rise even later than the very late stage they still expect.

'Unhealthy' low Bank Rate risks inflationary boom and mal-investment

This is not healthy. If we reach potential output with interest rates at 3% (or perhaps more) below their equilibrium level, that can only induce inflationary boom and mal-investment with another recession necessary down the line. A strange terror has arisen about changing rates at all, as if a ½% Bank Rate were some magical unstable figure that, if deviated from at all, would bring disaster upon us. It's just an interest rate number. The taboo needs to be broken. The sooner it is broken the better for the economy.

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; unwind QE by £25bn per month.

UK growth likely to average around 3% this year

The latest data is supporting a UK forecast for 2014 of around 3% growth. Services are growing strongly, business investment is kicking in, and even exports are beginning to look stronger. The housing market boom has triggered tut-tutting noises from the Financial Policy Committee (FPC). The current account of the balance of payments has gone to a deficit of over 5% of GDP. None of this is a reason for embarking on heavy monetary restraint, however. The current account deficit is partly related to a drop in returns on foreign investments, related to sell-offs in emerging market stocks during the recent 'Fed taper' furore. Anyway, the measurement of invisible net exports is notoriously unreliable. Real house prices are still well below their past peaks.

Time to move from unprecedented monetary ease

The point really is that the data suggest it is time to move away from massive and unprecedented monetary ease. It would be pathetic if the Bank, out of fear of a 're-normalising' of monetary conditions, turned instead to direct controls on house lending for example – which is now being broadly hinted at. We know that such controls distort the market and are liable to be ineffective because of market ingenuities – when money is plentiful it finds its way into many channels.

Even if banking sector is still being weighed down by excessive regulation

About the only reason left for not tightening money somewhat in the direction of 'normal' is that bank lending is still being weighed down by the regulative backlash from Whitehall and the international community led by the Basel III agreement. Yet we know that large corporations are deliberately reducing their take-up of bank loans on grounds of expense. Small and medium-sized enterprises (SMEs) are another matter. However, here too there are the stirrings of revolution: 'peer-to-peer lending' is growing rapidly as it becomes better organised and more familiar. Their needs are now high on the political radar and may well get the same Osborne treatment as housing did with Help to Buy. As so often, markets are undermining regulation, in this case by bypassing the banking system, in the process building up a 'shadow banking system' in the west, to rival the one in China.

Sitting on Bank Rate has been a recipe for disaster in the past

Critical as I have been of the bank regulative backlash, in common with many colleagues on the SMPC, I do not feel that we can use it any more as a reason for refraining from moving monetary conditions back towards normal. The Bank's ideas on forward guidance – which amount to a desire to keep money as loose as possible for as long as possible – have been a recipe for monetary disaster in past historical episodes. They are the classic cliché of too little too late in tightening that marked so many episodes back in the 1960s and 1970s; each time a Keynesian central bank was reluctant to slow a recovery because it got too close to its political masters, nervously longing for a recovery as strong as possible. Today's politicians and central bankers will scornfully reject any analogy with those highly inflationary periods. Nevertheless, they are foolish to do so, because at the start of the 1960s too there was no inflation to speak of. Our policies today remind one of the excesses of stimulation after the 1970s oil crisis against a 1960s background of low inflation.

Raise Bank Rate by ½% in April, with further ¼% rises to follow

Thus again I would suggest that we should move to a raising of Bank Rate, by ½% now because of past delays; followed by a bias to further small moves of ¼% each in the following months. By the end of this year I would expect rates to be over 2%. Turning to QE, it seems to me that the total Bank holding of gilts must be steadily reduced. There are two main reasons for this. The first is simple monetary arithmetic: bank reserves are excessively high and conducive to poor lending practices. As the recovery turns into boom, banks will be sucked in by these vast reserves.

Siren voices recalling Weimar

The second is political: too many commentators are attracted by the idea of 'consolidating' the Bank's holdings with the Treasury's debts, on the fiscal grounds that such a 'monetisation' tax would be harmless and reduce the pressure of debt on future spending and taxation. The longer this Bank holding lies around, apparently without dire consequences, the more traction this argument will gain. This directly parallels the arguments of the Weimar politicians before the great hyper-inflation that engulfed them. It is essential in my view that this holding be got rid of fairly fast now to stall such a frightening set of possibilities.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)

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

Three major developments

There have been three major domestic developments since last month: the 19th March Budget; the release of revised fourth quarter UK GDP figures and the new balance of payments data for the same period, released on 28th March, and Governor Carney's re-organisation at the Bank of England. None of these developments has substantially altered the prospects facing the UK economy or required major adjustment to last month's view about the desirable rate of interest. However, the revised GDP data have already slightly invalidated the OBR Budget day forecasts, because of revisions to the starting point for the OBR's projections. If anything, the balance of payments figures for the fourth quarter released alongside the revised GDP figures, which showed the current account deficit averaging some $5\frac{1}{2}\%$ of market-price GDP in the second half of last year, suggest that the case for a hike in Bank Rate is stronger than it was previously. However, the possible slowdown in the growth of $M4^{\text{ex}}$ broad money supply since mid-2013 suggests that any monetary tightening needs to be cautious and phased in gradually.

The March Budget

The 2014 UK Budget followed on unusually quickly from last year's December Autumn Statement. There was little in the way of surprises during the intervening period to change the broad parameters set out in the Chancellor's earlier report. The main Budget event was the freeing up of pension funds and the extension of the limit on ISAs. Both reflect sensible market liberalising reforms and should be welcomed. However, the manner of the announcement, as a political 'coup de theatre', caused serious windfall losses for individual annuity providers. Responsible Chancellors – as distinct from 'mere' politicians – should avoid the imposition of windfall losses and gains because of the arbitrary political risk that they introduce into commercial transactions. It might have been better if the Budget pension changes had been preceded by a consultation paper, especially as some people will have taken out annuities shortly before the Budget who would have waited if the measures had not come as a surprise. More generally, the problems faced by annuitants were largely caused by the sustained abnormally low Bank Rate and QE; this is because annuity yields are a $\frac{1}{2}$ a percentage point or so above the fifteen or twenty year gilt yield. So, what we have here is a reform that largely occurred because of the distortionary effects of official policies elsewhere. Another cause was the Conservatives' political desire to keep older voters on side and out of the embrace of UKIP, of course.

Cuts in beer duty and bingo tax justified on Laffer-curve grounds

Mr Osborne's cuts in the duties on beer and bingo have attracted some derision as being a reversion to Harold MacMillan era 'toff paternalism'. However, both measures can be defended on the 'Laffer curve' grounds that the previous duty rates were so high that they were leading to the slow demise of the pub trade and bingo hall industry. Until now, the Prime Minister and the Chancellor have suffered from a tin ear when it came to the adverse effects of high tax rates on the supply-side of the economy. The off-shore oil and gas industry has been another situation where increased taxes have led to a contraction in output and reduced revenues for the Exchequer. Indeed, the UK economy as a whole may be on the wrong side of the aggregate Laffer curve nowadays. This implies that Mr Osborne should have been bolder in reducing high marginal tax rates. One urgently needed reform is to replace the present 'slab structure' of stamp duties with a threshold structure similar to income tax, so that the new higher rate only applies above the threshold. It is significant, from a political viewpoint, that the Conservatives ratings in the opinion polls were enhanced after they had introduced a significant market liberalising measure in the Budget.

Budget arithmetic depends on 'Rosy Scenario'

Unfortunately, the detailed numbers given in the Annex to the OBR Budget report suggest that the Chancellor's fiscal arithmetic is as dependent on the politician's disreputable friend 'Rosy Scenario' as last year's Autumn Statement. Between 2013 Q4, when the OBR forecasts commence, and 2019 Q1 (when they end), the OBR forecasts show the volume of general government consumption – which accounts for roughly one half of total government expenditure – falling by a total of 4.3% and its cost rising by 1.1% during a period in which the volume of tax-rich household consumption is forecast to rise by 12.9% and its price by 12.2%. During the same period, the volume of general government investment is expected to rise by 7.1%, according to the OBR, while real business investment is projected to rise by 50.6% and private dwellings by 58.2%. Likewise, the cost of general government investment is forecast to decline by a total of 6.7% between 2013 Q4 and 2019 Q1, while the price deflator for all fixed investment (including by government) is forecast to rise by 6.8%. The projected longer term outlook for the public finances is heavily dependent on the compounding effects of these OBR forecasts over the next half decade. However, such parsimony is unlikely to be achieved, even if the coalition remains in office after the May 2015 general election, let alone under a Labour government.

GDP data revised since Budget day

The OBR forecasts incorporated the second estimate of 2013 Q4 GDP, released on 26th February. The revised estimate, published on 28th March has altered the picture as far as the 2013 Q4 starting base for the OBR forecasts is concerned. In particular, the volumes of household consumption, general government consumption and real GDP at market prices in the fourth quarter have been revised down by 0.3%, 0.5% and 0.1%, respectively, while the volume of imports has been revised up by 0.9% and the figure for exports by a noteworthy 2.9%. There have also been a noticeable downwards revision to the volume of stock building in 2013 Q4, and an upwards revision of 4.9% to 'non-profit institutions serving households', which includes a

large slug of (part) publically funded institutions, including universities and charities. The real ‘nasty’ in the 28th March ONS data releases, however, was the upwards revision of just over £3bn to the estimated current account deficit in the first three quarters of last year and the announcement of a £22.4bn deficit in the fourth quarter, to give an annual total of £71.1bn in 2013 compared with an upwards revised £59.7bn in 2012. Net exports of goods and services actually improved from a deficit of £33.4bn in 2012 to one of £26.6bn last year. However, these gains were offset by a jump in the deficit on investment income from £3.8bn to £20.5bn and an increase in the deficit on government transfers from £16.3bn to £20.5bn.

Post-Budget forecasts for UK growth and inflation

In the light of the new information, the latest forecasts generated by the Beacon Economic Forecasting (BEF) model suggest that UK GDP will grow by an average of 2.7% this year – compared with a downwards revised 1.7% in 2013 – 2.3% next year, and 2% in 2016, before settling on a trend growth rate of 1.8% or so in subsequent years. These growth forecasts are within spitting distance of the OBR ones for the next year or so of cyclical recovery. Nevertheless, the longer-term growth trend is well below the 2.5% assumed by the OBR, with consequent adverse implications for public borrowing. The BEF macroeconomic model suggests that CPI inflation will ease to 1.5% in the final quarter of this year, before rising to 2.2% late next year, and 2.7% in late 2016. Longer term, CPI inflation is expected to fluctuate within a 2¼% to not quite 3% band in the later years of our decade-long forecast horizon. Bank Rate is expected to rise gradually, possibly hitting ¾% by the end of this year, 1½% late next year, and 2¾% subsequently, with low interest rates overseas helping to hold down borrowing costs in this country.

The ‘twin deficits’ problem will not go away

However, the balance of payments is likely to remain a continuing worry, even if there is some improvement in net investment income – where the UK used to run a substantial surplus – with a current account deficit of £65.5bn expected for this year, £68.6bn in 2015, £75.2bn in 2016 and with continuing large imbalances thereafter. Unfortunately, the outlook for Public Sector Net Borrowing (PSNB) has become confused by the number of different definitions now being employed. On our preferred definition, which excludes the Bank of England Asset Purchase Fund and Special Liquidity Scheme (ONS data bank code J511 with sign reversed), the PSNB is expected to be £110.3bn in 2014-15, £100bn in 2015-16 and £91.7bn in 2016-17. Thereafter, the PSNB continues to fade away slowly. However, that reduction is conditional on the assumption that the volume of general government current expenditure is held constant at its 2013 Q4 level throughout the next ten years.

And will cause massive problems for a putative Labour government

The political risks to the economic outlook were discussed in last month’s SMPC submission. However, the scale of the twin deficits likely to confront the UK authorities after the May 2015 general election poses major problems for a putative Labour government, which would probably not be given any benefit of the doubt by the financial markets. A Labour administration could

Monetary policy considerations

face the bi-modal policy choice of either unambiguously strong fiscal orthodoxy or a stabilisation crisis and a run on the pound. Unfortunately, there is little evidence that Mr Milliband and Mr Balls are even thinking about the unpleasant choices they would face if they achieved office, let alone that they have prepared an appropriate response.

Turning now to monetary policy, and Mr Carney's reform of the Bank of England, the striking thing to a former Bank employee from the late 1960s and early 1970s, is that some of the shunting around of personal appears to be a revival of the idea of the Bank of England 'lifer', who was expected to move to any department of the then Bank over a four-decade career, rather than stick within a particular specialisation, such as economics. This approach had the disadvantage that it was not always possible to keep in touch with the latest developments in a particular narrow field but had the great benefit that Bank officials were not simply ivory tower intellectuals but knew how to implement their ideas in the messy real world of financial markets and regulatory supervision. This model for a Bank career was destroyed by the tri-partite dismemberment of the Bank that followed the granting of operational independence three weeks after the 1997 election. The Bank's earlier dismemberment was one reason why it performed so badly in the run up to the fiscal crisis of 2007 and 2008. Meanwhile, the substantial leakage of excess home demand overseas revealed by the balance of payments deficit suggests that Bank Rate should be raised by $\frac{1}{2}\%$ in April and then increased cautiously in a pre-announced fashion, by $\frac{1}{4}\%$ every second month or so, until it reaches 2% to $2\frac{1}{2}\%$. Likewise, QE should be allowed to unwind gradually as stocks mature, through a process of partial re-placement. However, a weather eye should be kept out for $M4^{\text{ex}}$ broad money, whose annual growth rate hit a recent peak of 5.2% in May 2013 but had eased back to 3.1% in January, before recovering to 3.7% in February.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by ½% and switch £25bn of QE from gilts to infrastructure investments.

Bias: Raise Bank Rate towards 2%.

Flow of positive data surprises but continued fiscal imbalance

The flow of positive data surprises (activity and retail sales stronger, inflation weaker) continues to buoy UK asset prices and sterling, creating a virtuous circle for the government and the central bank. The Bank is able to argue that the stronger pound is helping to reinforce domestic pricing discipline. So far, so good. However, the Budget has revealed a worrying lack of ambition in bringing down public sector borrowing in the next fiscal year in the context of a 2.7% projected economic growth rate. From an expected outturn of £108bn for 2013-14, the planned deficit is just £13bn less at £95bn, or 5.5% of nominal GDP. Much heavy lifting in terms of public expenditure restraint has been deferred to the next parliament.

Blue sky official growth forecasts

The volume of business investment is projected by the OBR to grow annually by 8% or more in each of the next five years, despite serial and significant disappointments to forecasts in the past three years. The usual blue sky forecasts of 2.5% economic growth year-in, year out, and the acquiescence of inflation to a target that has plainly been relegated, with the entire monetary policy function, within Mark Carney's restructured governance of the Bank of England. Financial policy is no longer the Cinderella. She has received her invitation to the ball.

OBR has ignored deceleration in potential growth

It seems that the Bank of England has conceded ground on the potential sustainable growth rate of the UK economy (in its February *Inflation Report*), but that the OBR is unable to follow suit, despite overwhelming evidence. If the sustainable annual growth rate of the economy is closer to 1.5% than 2.5%, as we believe, then inflationary pressures will accumulate far sooner than the Treasury expects. A ballooning balance of payments deficit is the first port of call, with the risk that sterling will again fall under critical examination by the financial markets. Private sector inflation has levelled off in recent months but has not continued to fall. Commodity price effects, favourable currency effects and fuel duty freezes will not be enough to keep inflation low.

Overwhelming justification for a rise in Bank Rate

In summary, the case for raising Bank Rate immediately is overwhelming. Forward guidance obstructs the short-term path to higher short-term interest rates but this stance is likely to become untenable as the year wears on. The Bank should also remind the government of its negligence in reducing the borrowing requirement. Swapping £25bn out of gilts into infrastructure investments should do the trick.

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.

Three important macroeconomic developments

Three developments that occurred in the last month are of especial interest to commentators on the macro-economy. The first is the further fall in CPI inflation below its target, to 1.7% in February, its lowest level for four years. At first sight, this may seem to justify the refusal of all but Martin Weale on the MPC to tighten monetary policy. This, however, would be to miss two significant things. The basis of the MPC's interest rate policy has always been that it takes two years for inflation to fully respond to interest rates. (A new Bank of England paper suggests two to three years.) As it is widely agreed that the economy has already embarked on a strong recovery, with Help-to-Buy causing a marked, and very likely unsustainable, rise in both new housing starts and house prices, the probability is that inflation is set to rise shortly. Now, therefore, is the time to nudge up interest rates in order to maintain inflation at its target level, and not 2015 when inflation would almost certainly be above target.

Normalise rates

A further argument is that interest rates must return to normal sooner rather than later, and a smooth transition is less harmful to the economy than a sharp increase later.

Mr Carney's re-organisation of the Bank

The second event of note is the Governor's re-organisation of the Bank. Particularly intriguing to MPC watchers is the swap in roles of Andy Haldane and Spencer Dale. Does this signal a change in attitudes to monetary policy from the Mervyn King regime in which for many years Spencer Dale has presided as chief economist? Maybe the Bank's recent poor inflation forecasting record has been a factor.

Catch 22 when trying to forecast inflation

Although the Bank under-estimated the rate of inflation for a period of about three years from 2010, in its defence it should be pointed out that many one-off, exogenous and unpredictable, events were partly to blame. In general, neither forecasts based on macroeconomic models nor pure time series forecasts are accurate at turning points in the business cycle. This is because turning points are almost entirely due to exogenous and almost entirely unpredictable events. The moral is that the Bank's inflation forecasts, although the central activity of the MPC, are highly unreliable except when the economy is not subject to large shocks, in which case forecasting inflation does not require great expertise or resources.

Abandonment of Mark 1 Forward Guidance should be welcomed

Another factor in the job swap at the Bank might be associated with internal opposition to the ill-fated policy of the Governor to link changes in interest rates to the rate of unemployment. Instead of increasing transparency in monetary policy, this Mark 1 version of Forward Guidance only increased it. Its apparent abandonment so soon after being announced will be widely welcomed. One can only speculate about what the reasoning behind the swap was. Let us hope that it was for technical and not personal reasons.

Bank's commitment to engage more with academic community

At the same time, it was announced that the Bank would seek to become more open and to engage more with the academic community. This is very welcome. A fuller explanation of the changes in personnel would be one way to start being more open. Prior to Mervyn King's tenure, initially as chief economist, the Bank had a thriving, though not that distinguished, research output. Over time this has declined. The contrast with the European Central Bank (ECB) is marked: the latter has a huge research output, much of which is contributed by outside academics. I, for one, would like to see the Bank restore its position as a leading centre for research into the macro-economy.

But HM Treasury appears to have given up researching the macro-economy

I would also like to see more presentations to the outside world of the Bank's research, perhaps through regular workshops. The situation is, however, far worse as regards the Treasury. Previously, open to inter-changes with the academic community through the, now defunct, Treasury Academic Panel, with the transfer of macroeconomic policy to the Bank, the Treasury seems to have largely abandoned research on the macro-economy or any dialogue with academics. Perhaps the Bank of England could take a leaf from the Treasury of old and start its own academic panel.

Budget measures to free up pensions

Somewhat ironically, after the above comments, the third event is the Budget and the unexpected change in pension arrangements. This will have huge implications for fiscal policy and the economy generally. It makes it all the more surprising that there was no discussion with external experts, including the academic community, prior to the announcement. Nonetheless, dropping the requirement that people had to take out an annuity on retirement is very welcome as it corrects a major financial distortion that hugely disadvantaged pensioners. It allows pensioners to benefit from the historically better long-term performance of equities than gilts. Recent monetary policy, with its rock-bottom interest rates, has of course been partly to blame for the size of the financial distortion and resulted in a large transfer of wealth from savers (mainly for pensions) to borrowers.

Pension changes should boost equities but could hit gilts

Comment on this change seems to have focused more on the short-term implications than those for the long term. It has been claimed that it will result in increased household expenditure and also increased savings. This appears to be contradictory, but, if returns are higher, then both could be true. The increase in demand for equities may be expected to raise stock prices while the reduction in the demand for gilts may raise long-term interest rates.

Both private and government sectors could save more if the UK payments deficit is reduced

Any increase in savings would occur against the background of further fiscal tightening and hence higher public saving. Some commentators have said that if the government seeks to increase savings then households should be induced to reduce savings. This would not be necessary, and both could save more, provided that the country runs a sufficiently large current account surplus when, in effect, net private sector savings would be in foreign assets. However, the UK ran a current account deficit of 4.4% of GDP in 2013, and one of 5.5% in the fourth quarter alone.

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.

Upwards revision to net exports

On the surface, the economy seems to be on a solid enough footing to justify an immediate rise in interest rates. Growth was 0.7% in 2013 Q4 and for the year as a whole it averaged 1.7%. Consumer demand is expanding. Overall, however, the figures paint a picture of a more balanced economy in the fourth quarter. Business investment was left unrevised at 2.4%, its fourth consecutive quarterly increase. But the big surprise was inventories and exports. Exports were revised up sharply from growth of 0.4% to 2.8%, boosted by a large increase in financial services exports. Overall, net exports are now reported to have contributed 1.0% to fourth quarter growth compared with 0.4% in the previous release, a very big revision.

Decline in household savings ratio has boosted consumption

The corollary to the increase in exports was a downward revision to inventories – hence, overall GDP growth remained unchanged. Inventories include an alignment adjustment – effectively a residual that ensures the expenditure accounts balance with the more accurate output estimate of quarterly growth. As more data have become available, it is clear that a large part of this residual has been allocated to exports. Still, the recovery remains heavily dependent on the consumer. Household spending was revised up a notch in 2013 Q4, from 0.4% to 0.5%. However, and against the backdrop of an ongoing squeeze in real incomes, the household saving ratio fell further – from 5.6% to 5.0%. A declining household saving ratio has been a key theme of the recovery over the past eighteen months and is likely to remain so, especially as households feel confident enough to save less amid rising house prices and a more buoyant economy.

National income growth has gone to corporate profits rather than earnings

While there are signs that households incomes are gradually recovering, the income generated from the growth in the closing quarter of last year accrued mainly to corporate profits, not wages. Employee compensation in the form of wages and pensions rose by 0.3% in nominal terms in 2013 Q4 – representing its thirteenth consecutive increase – but the gross operating surplus of corporates rose by 5.4%. The relative outperformance of corporate versus employee income has been another key theme of the recovery. From a sector standpoint, the corporate sector remains a net lender to the rest of the economy. The household, and more particularly the public, sectors remain net borrowers.

Balance of payments threat

Irrespective of the upward revision to net exports, falling overseas investment income caused the current account to record a deficit £22.8bn in Q4, which is equivalent to 5.4% of GDP and the second highest outturn on record, even as a net positive trade contribution was recorded. Clearly, the overseas sector is a big net lender to the UK. The implication is that the UK continues to spend more than it earns and, as a result, has to borrow money from abroad. Hence, a sharply increasing current account deficit. For now, financing the current

account deficit has been relatively easy. From a structural standpoint, however, the deficiency of domestic savings manifest in a falling saving ratio and a rising current account deficit, pose potential threats to economic recovery. The Budget reforms to pensions and savings will do little alter these trends.

Promising trends in 2014 Q1

UK economic growth in the first three months of this year seems to have got off to a good start. A fall of 2% in the volume of retail sales in January 2014 did not reverse a rise of 2.7% in December 2013, and was followed by a rise of 1.7% in February. Employment continued to rise and unemployment to fall. Employment gained 68,000. In February, the three month unemployment rate on the Labour Force Survey (LFS) basis was 7.2% and the single month rate was 6.9%.

Economy still smaller than before the crash

Actual weekly average hours worked by those in their main job was 32.1m in February, still shy of the 32.8m hours worked in the third quarter of 2008 but edging towards it. Manufacturing output has risen by a solid 0.7% in each of the last three quarters, and the annual rate was 2.8% in the final quarter of 2013. It is worth reiterating that, despite all this, the economy is still 1½% smaller than in 2008. Although this level should be regained this year, it does not make up for the lost output, nor does it take away from the OBR forecast that growth next year will slow from 2.7% this year to 2.3%. Admittedly, the consensus is for 2.5% next year but thereafter the view is that annual economic growth settles at close to 2% than 2½%.

Inflationary pressures abating

Meanwhile, price and wage Inflation remain low. CPI inflation has been under 2% for two months (it was 1.7% in February) and wage inflation is just 1.3% ex bonuses. A rate rise two years ago would have been unwise and unproductive. It could even have led to worries about deflation. However, this is not to say that a rate rise now would not be necessary, as monetary policy should be forward looking. What argues against it is not just that price inflation is low, and likely to slow further in the months ahead, but that the underlying trends in the monetary statistics are starting to worsen; suggesting that the growth rates we are seeing could be at risk. This is not to say that economic growth is about to collapse: it is not, but the pace of economic growth may slow if these trends do not reverse soon. The Budget did little to change these trends.

Recent monetary trends

In February, total M4 broad money grew by 0.7% on the year, but what is interesting is the detail. Holdings of M4 by households were 3.8% up on the year, and their borrowing rose by 1.5%, suggesting that they are still net savers. A breakdown of the 1.5% showed a rise of 1.1% in borrowing secured on dwellings and one of 4.8% in consumer credit. That does not suggest a runaway consumer or housing market borrowing binge. Private sector non-financial corporations (PNFCs) holdings of M4 rose by 7.6%, representing a continuation of the high trend of savings, while borrowing was down 2.2% on the year. The latter was a continuation of a long-standing trend though not inconsistent with some increase in business investment spending from current savings.

**Time enough to raise
rates in the future**

Other financial corporations (OFCs) reduced deposits by 0.8% in the year to February, a slower rate of fall than the 3.4% seen in January. This caused the boost to overall M4 growth from the annual negative rate of 0.2% recorded in January to the positive one in February. In terms of borrowing, OFC's recorded a yearly decline of 4.1%. Total M4 lending fell by 2.6% in the twelve months to February. M4^{ex} went up by 3.7% in the year in February, but a rolling three month trend suggests that the annual rate of growth may be slowing. With all this in mind, I would vote to leave Bank Rate on hold; and maintain QE at £375bn, with a bias to neutral. There is time enough for rates to be raised to head off any inflation threat.

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 his forthcoming retirement on 15th April, is David B Smith (Beacon Economic Forecasting and University of Derby). After 15th April, Andrew Lilico (Europe Economics) will take over as SMPC Chairman. Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), 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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