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# IEA Shadow Monetary Policy Committee

## September 2014



Institute of  
Economic Affairs

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## **Shadow Monetary Policy Committee votes six/three to raise Bank Rate in September**

In its email poll closing Thursday 27<sup>th</sup> August, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) recommended **by six votes** to three that Bank Rate should be raised on September 4<sup>th</sup>, including four votes for a rise of ½% and two for a rise of ¼%.

Those advocating a rise acknowledged that inflation is low and wage pressures are limited. Their case was that with growth strong and unemployment falling, this is an excellent opportunity to attempt some limited normalisation of interest rates (thereby reducing the economic distortions such low rates create) whilst still maintaining them very low and monetary policy in general highly accommodative.

Those that preferred to keep rates on hold noted that not only is inflation low, but pipeline inflationary pressures are also low, as are wage growth, money growth and credit growth. For them there remains inadequate reason to raise yet.

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. To ensure that nine votes are cast each month, it carries a pool of 'spare' members. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a result, the nine independent and named analyses should be regarded as more significant than the exact overall vote. The next two SMPC e-mail polls will be released on the Sundays of 28<sup>th</sup> September and 26<sup>th</sup> October, respectively.

## Votes

### Comment by Roger Bootle

(Capital Economics)

**Vote: Hold rates**

**Bias: No bias**

**There are risks to the economy but inflation remains low**

The UK housing market, the weakness in the Eurozone and the UK balance of payments continue to provide important risks. However, with inflation low and potentially falling further – perhaps even forcing Governor Carney to write a letter explaining why inflation has fallen below 1% - there is no good reason to raise rates yet.

**Hold rates until later – there will be time to raise when necessary**

The amount of slack in the economy is difficult to observe directly and one should be wary of hubris in declaring that the elimination of slack is a good reason to raise rates. If the underlying potential growth rate had fallen, there should be more evidence in the labour market (employment and wages). If rates are kept low and there is no slack, wages will rise and inflationary pressure will be visible in good time to allow rates to be raised in response. There is no need to rush.

### Comment by Jamie Dannhauser

(Ruffer LLP)

**Vote: No change**

**Bias: No bias**

**One year view: Bank Rate at 0.75%; QE unchanged**

**The real economy is growing rapidly**

The UK economy is growing rapidly. While GDP has been expanding at an annualised rate of 2¾-3¼% in recent quarters, private sector activity, which monetary policy can influence, has been surging ahead. Annualised growth of around 4% has been registered in each of the last two quarters. Official for National Statistics (ONS) data may even understate the strength of the recovery: there has been a puzzling disconnect between official figures for goods and services exports and the numerous surveys published by private sector providers. The construction sector has also been underperforming of late, despite buoyant qualitative indicators.

**Broad money growth is weak and overall monetary conditions are not consistent with sustained above-trend growth**

Prospective growth in the near-term looks set to remain well above its historical average. Were this a normal economic environment the case for monetary policy tightening would be overwhelming but current circumstances are far from normal. After the deepest downturn in two centuries, Britain's recovery, all things told, has been very disappointing. Only recently was the early 2008 peak in output achieved. Despite an exceptional dose of monetary stimulus, overall monetary conditions are not yet consistent with a sustained period of above-trend growth: nominal broad money growth remains stuck at around 4%; while bank lending to the private sector has started to grow, prospects for a revival in monetary growth are not assured.

**The degree of slack in the economy is debated but the weakness across a wide range of indicators suggests there must be material slack remaining**

**No move in rates is warranted yet but one rise is likely to be reasonable within twelve months**

The release of substantial pent-up demand has provoked a rapid response in output. However, the conditions for a lasting upswing, while much closer to being met than a year ago, cannot be taken for granted.

There remains an intense debate about the degree of slack in the economy. The current central banking fad for focusing on labour market indicators is unhealthy; but for the moment the conclusions drawn from it are reasonable. The lack of a revival in productivity in recent quarters is puzzling: one surely has to have less confidence in a strong endogenous response in potential GDP. However, it still seems likely that effective supply will in part be determined by the strength and persistence of the recovery in demand. The ongoing weakness evident across a range of nominal indicators – CPI inflation, wages, output price inflation, unit labour costs – seems hard to square with the idea that there is little slack in the economy. Anecdotal reports suggest pricing power is still limited. Moreover, the recent weakness of inflation is notable given evidence that consumer-facing firms have been increasing margins over the last year.

Disinflationary pressures from stagnant commodity prices and the rise in sterling are considerable. Given the normal lags, there could be sizeable additional downward pressure on CPI inflation through 2015. Indicators of pay growth at the margin have picked up but average earnings growth remains lacklustre. Exporters do not report a hit to volumes from the rise in the pound, but do suggest that any further move from here would act as a constraint. An early rise in Bank Rate would surely help sustain the pound's appreciating trend. No move at this point in time or in the near-future is warranted. One 25bps hike within the next twelve months appears reasonable given the likely profile for the UK economy, however.

## Comment by Andrew Lilico

(Europe Economics, IEA)

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

**Bias: To raise further; QE neutral**

**One Year View:  $1\frac{3}{4}\%$**

**Little has changed  
but time**

The basic pattern of the UK economy has not changed for nearly a year. Quarterly growth is consistent with above-3% annual growth. Monetary growth remains low (though lending did pick up in the three months to June 2014). Unemployment continues to tumble. International risks remain. Inflation is not rising yet. Wage growth is weak. The government budget deficit remains high. These factors were collectively sufficient to justify a rate rise a year ago and they remain sufficient today. All that has changed is that, by being sustained over time, they have given policymakers greater confidence that they were not a passing moment.

**Interpretation of the first  
rate rise is important**

Given the key role that the signals from monetary policy changes play in managing the real economy, it will be important for the first rate rise not to be misinterpreted. The MPC should not wait until inflationary pressures force rates up. That would make the first rate rise a bad news story. It would also mean that economic agents would quickly price in a long series of rises. Instead, the first rise should be a baby step towards normalisation, take in an economic environment where policymakers still had the scope to keep rates lower if they chose to do so. That should have been done long ago. But there is perhaps still time for at least a little pause after the first rise and still some scope for the first rise to be a chosen small step to normalisation rather than the first forced step in a series of rapid rises.

## Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

**Vote:** Raise rates by ¼%; no further QE but can be held in reserve for the next euro crisis

**Bias:** To raise

**The balance of argument favours a small initial rise now**

Although there are short-term arguments for keeping rates on hold so as to avoid hindering the recovery, an earlier rise would both reduce the risk of more rapid rises being necessary later and also create scope to cut rates in the event of some negative shock. At the same time, keeping rates so low is likely to be distorting efficient decision-making by economic agents and damaging productivity. A small initial rise is now appropriate.

## Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

**Vote:** Raise Bank Rate 0.5% and start to reduce the stock of QE gilts

**Bias:** Further rate rises and more run-down of QE

**One year ahead:** No view

**Central banks remain nervous about tightening**

Central banks have remained extremely nervous about the strength and self-sustaining power of the recovery. The Fed still maintains it will keep printing money, if at a slower rate, while interest rates remain on the floor. The Bank of England has stopped printing money but is loath to raise rates, though two members of the MPC have now voted that it should make a start. The ECB is faced by falling inflation and ongoing weakness of the euro-zone (fuelled by problems with the banks and credit supply) and so is thinking of ways to increase monetary stimulus now that rates cannot be driven any lower. It is no wonder that equity markets are so buoyant, with growth proceeding (even in the euro-zone to a small degree) and yet no prospect of monetary tightening.

**Geopolitical risks are varied and significant**

Into this picture have stepped the sanctions on Russia over Ukraine, virtually mandated by the tragic shooting down of flight MH17. Problems in China continue to fester, with bad debts accumulating, growth slowing and a destabilising campaign by the new leadership of Xi Jinping against 'corruption' (among his old guard opponents). In this environment there will be setbacks to world growth.

**Parallels with the early 1980s in adjusting to a quarter-century of growth**

The parallel to consider is the early 1980s. Then too there had been bad recession, the oil crisis of the mid-1970s and then the recession of 1980-82 as world inflation was tamed by tight money. Unemployment was high around most of the West; in the UK it reached 12%. World commodity prices, both oil and non-oil, had reached huge peaks in real terms and were just beginning to come off them. Then from around 1982 until 2006 the world economy grew relentlessly, year in year out, with no general recession until the global crisis starting in 2008. Of course, there were regional recessions and difficulties such as: a small US pause in 2001 on collapse of the dotcom boom; in the

UK the ERM-provoked recession of the early 1990s, and the Asian crisis of 1998. But individual countries and regions will always have their own particular episodes of difficulty or overreach. The point is that was an astonishing quarter-century of uninterrupted world growth, which was then due to come to a brutal stop in the following crisis.

**It is naïve to assume that every recession or slowdown is a deviation from trend rather than a reversion to trend**

Why the long expansion and why the following stop? It is usual to treat expansion as if it is normal and the stop as due to bank bust after credit excesses. Whatever the role of banks in worsening the crisis was, this reading is naïve. Could we really expect world growth to barrel on regardless for another quarter century - some 'normal' continuation of rapid global growth? Surely not, as commodity prices were signalling that the world was running out of resources. When this commodity scarcity started to slow growth down, would one not expect banks to lose money on bets made when growth was fast and unchecked? Thus the bank crisis was as much brought on by world slowdown as world slowdown was worsened by bank problems.

**Economies exhibit cycles and today we appear to be at the start of one such**

The post-1982 expansion mirrored rather faithfully the post-WWII expansion; it too was largely uninterrupted for 25 years and came to halt in a commodity crisis of the 1970s. These developments also mirror earlier business cycles going back to the late 19<sup>th</sup> century. This is the subject of ongoing work. Meanwhile it seems that since WWII a pattern can be seen in the behaviour of the world economy and the commodities that ultimately power it. It takes time and high prices to generate the large-scale capital and research effort needed to increase the supply and economise on the demand for commodities as growth proceeds. There seems to be a cycle of plenty fuelling fast productivity growth in the non-commodity economy; this plenty arising from previous large investments in commodity production and associated technology. Then as growth proceeds capacity in commodities is used up, prices rise until shortages become acute again. There is then a stop on growth, and a 'crisis'. With prices so high commodity investment resumes and the cycle repeats itself. Today we appear to be at the start of such a cycle. Prices of commodities have peaked but are coming down as investment in plant and technology begins to occur. With the Great Recession non-commodity output is well below its previous trend, helping commodity prices to fall. Growth is thereby encouraged but the commodity bind may well not be repeated for another quarter century.

**Credit growth remains extremely weak and by some measures is declining**

This means that monetary policy needs to return to normality fairly soon. Growth and recovery look assured (expect for the euro-zone which the great mistake of monetary union will continue to haunt for some time to come). Central banks in the majority of countries need to worry about triggering another boom by losing control of monetary conditions. As before I suggest raising interest rates in small steps, moving steadily towards normality; and the gradual selling-back of the Bank's huge holding of government bonds.



## Comment by David B. Smith

**Vote: Raise Bank Rate by ¼%; hold QE**

**Bias: To raise Bank Rate in small ¼% increments**

**One Year View: Depends on May 2015 election outcome;  
on a no-policy change assumption, raise Bank Rate to  
1% to 2% by next summer, and carry on until 2½% to 3½%  
is achieved**

**Recent UK data  
compare favourably  
with the golden era of the  
1950s and early 1960s**

In the olden days of Keynesian demand management – and politically induced business cycles – a Chancellor of the Exchequer this close to a general election would have felt reasonably complacent when confronted with an annual growth rate of 3.2%, ‘headline’ retail price inflation of 2.5% (and 1.6% on the officially preferred CPI), and an 820,000 (2.8%) increase in Labour Force Survey (LFS) employment over the past year. Indeed, some aspects of the recent UK data are reminiscent of the nation’s golden age under the Conservative governments of the 1950s and early 1960s. During the twelve years from 1953 to 1964 – i.e., after the Korean War induced inflation of 1951 and 1952 had abated and the Chancellor RA Butler’s liberal market reforms had been implemented – UK economic growth averaged 3.6%, retail price inflation averaged 3% and claimant count unemployment averaged 408,000 (1.4%). The latter figures can be compared with the 1,007,500 (3.0%) recorded in July 2014.

**Reasons why we are not  
back in the golden age**

However, there are four major differences between the UK’s current economic performance and that of the golden age. Some of these help to explain why the Coalition parties are not doing better in the opinion polls. The first major difference is that the favourable performance of the 1950s and early 1960s was sustained for well over a decade. This contrasts with the current situation where growth has only picked up recently and from a low output base. Using the present chained 2010 price national accounts, real GDP has grown by only 1½% per annum since 2010, when the Coalition took office, while non-oil GDP has expanded at an annual rate of 1¾%. These increases would have been classed as a ‘growth recession’ before the first oil price shock in 1973. Likewise with inflation, where annual CPI inflation only returned to its 2% target as recently as December 2013, following a long period of overshooting.

**Britain has a huge twin  
deficits problem, unlike  
in the golden age**

The second major difference is that both the current account balance of payments and the public finances were in broad balance throughout the 1950s and early 1960s. This contrasts with the current situation, which is one of extremely large deficits by historic standards. Furthermore, there is little sign of any improvement in the recent data. Thus, the UK trade deficit on goods and services was running at an annualised rate of £24.8bn in the first six months of 2014, compared with a deficit of £28.5bn during 2013 as a whole, while the underlying PSNB totalled £32.4bn in April to July 2014, compared with £23bn in the corresponding period of fiscal 2013-14. The need to finance these twin deficits for the foreseeable future, and to maintain



unbroken financial market confidence while doing so, gives rise to serious reservations about the sustainability of present policies, let alone what would happen under a putative left-wing Labour administration.

**Harmful effects of big government explain slow growth and chronic fiscal deficits**

The third major difference between the present situation and the golden age is the larger role of the contemporary state. In addition, rather than having a supply-side enhancing ‘bonfire of controls’, as the early 1950s Churchill administration did, the Coalition has presided over a damaging ‘bonanza of controls’, including in the financial area, albeit often at the behest of the European Union. The constant re-definition of national output by the official statisticians makes it hard to be precise. However, it looks as if general government expenditure was absorbing around 36% to 37% of GDP throughout much of Britain’s economic golden age compared with some 52% at its peak in 2009-10 and 2010-11, 50% in 2013-14 and around 49% currently (the GDP measure used excludes indirect taxes and government subsidies for consistency). There are good reasons from supply-side economics to believe that the increased share of national output absorbed by government since the golden age has crowded out private capital formation, and with it embodied technical progress, leading to the slow growth of output per head which has puzzled many commentators.

**Adverse international background, including weak world trade, is constraining UK economy**

The fourth major difference with the golden age, which does absolve the Coalition to some degree, is the less benign international background, particularly in our main Continental European export markets. This uncertain background has the potential to de-stabilise a small, open and trade dependent economy, such as Britain’s, and was referred to several times in the Governor’s Inflation Report press conference. A specific problem is the apparent difficulty of financing international trade in a situation where counterparty trust has not recovered from the financial crash. Increased official regulations are another influence encouraging commercial banks to concentrate purely on their domestic markets. Businessmen tend to blame the poor price competitiveness associated with a strong pound for their export problems. However, the statistical evidence suggests that competitiveness effects are weak and slow acting, while the demand effects represented by the volume of international trade are relatively powerful and rapid. The volume of aggregate imports in the Organisation for Economic Co-operation and Development (OECD) area as a whole – which is a reasonable and timely proxy for real world trade – was only 7.3% higher in the first quarter of 2014 than it had been in the first quarter of 2008. However, it was 4.2% greater than at the start of 2013. It is possible that the helpful effects of this development on UK exports are yet to work through.

**Looming general election likely to cause a collapse in standards of political discourse**

These serious supply side issues facing the British economy have been emphasised because the looming May 2015 general election means that the already low standards of political discussion of economic matters are likely to descend into pure political hyperbole in the coming months. Whoever wins the 2015 election will have their options constrained by the fact that, having inherited the worst ever peacetime fiscal crisis from the previous

Labour government, the Coalition has only done the bare minimum required to keep the show on the road in the short run – but nothing like enough to restore a healthy and sustainable long-run performance. However, all comments on the UK economy are subject to the caveat that the current figures may look very different once the ONS has introduced the new ESA-2010 chained 2011 price national accounts on 30th September. Some preliminary figures covering the period up to 2009 show that the new figures have made the boom-bust cycle associated with the financial crash look less extreme in both directions. Unusually, the ONS did not release an expenditure breakdown of GDP when it published its second estimate for 2014 Q2 on 15th August; this represents a serious problem for macroeconomic modellers who usually build up their forecasts from this data. However, the latest output based measure of GDP introduced revisions back to 2011 Q1. These revisions have typically been upwards by 0.2 percentage points in the more recent quarters. This means that the old expenditure figures, which have not been updated, are clearly inaccurate and that any output gap (economic slack) is smaller than was previously believed. However, the main story is the need to beware of the risk of a major re-writing of recent economic history and the current economic conjuncture after the new ONS accounts are released on 30th September and people have had time to digest them. The latter may take several weeks because of the complexity of the changes. All existing macroeconomic forecasting models will almost certainly have to be re-built from scratch, for example.

### **Reasons for holding Bank Rate in September**

The highly uncertain international background and the likelihood of major data revisions in the near future provide two valid reasons why the MPC might wish to hold Bank Rate in September on a 'wait and see' basis. It is also probable that there are further benign inflation developments still to come as a result of the recent reduction in the price of crude oil and the continuing effects of the stronger pound. It has been argued previously that the latter are underestimated in the official forecasting framework, which seems more appropriate to a large Continental economy than a small, open and trade-dependent one. Certainly, the latest producer output price data – which show core output prices (excluding food, beverages, tobacco and petroleum) up only 0.9% in the year to July while total output prices eased by 0.1% over the same period and total input costs fell by 7.3% – appear to be more consistent with 'Scandinavian' models of the price level, which emphasise the importance of the exchange rate and overseas prices, than the Bank's nebulous concept of economic slack. There is also the much commented on question of the very weak trend shown by average earnings, with total earnings in the second quarter actually 0.2% down on the year. Nevertheless, there may be question marks over the official data. Furthermore, one might expect earnings to lag the main business cycle; in part, because new wage settlements usually only occur annually.

## Political considerations and risks

This commentary was prepared before the Scottish referendum to be held on Thursday 18th September and it was necessary to assume that the 'no' vote prevails; otherwise, this comment would have become an extended exercise in scenario analysis. The opinion polls suggest that the Scottish referendum vote will be close enough for the issue to remain a political running sore for many years, even if the 'no' vote wins. However, the forthcoming 2015 general election is also casting a long foreshadow over the current monetary policy decision. This is because the reaction in the financial markets to the election outcome is likely to be bi-modal or even multi-modal. A Conservative victory, or a renewal of the present Coalition, would presumably lead to a period of capital inflows, a stronger pound and justify a lower Bank Rate than otherwise. A Labour victory would, however, be likely to induce some capital flight – unless the party was credibly pledged to an ultra-orthodox fiscal and monetary stance, which seems unlikely – a lower exchange rate and possibly require a higher Bank Rate for a given inflation target than would be the case otherwise. One question facing the Bank, therefore, is whether they would rather go into the period of putative election turbulence next May with Bank Rate still at  $\frac{1}{2}\%$ , risking a reputation damaging series of rate hikes after the election, or whether they should have slightly higher rates by then, leaving open the possibility of cuts if sterling bounced after the election.

## Reasons for a modest Bank Rate hike in September

On balance, the political and reputational risks suggest that, if the nettle of a higher Bank Rate has to be grasped in the foreseeable future, it is better to do it imminently while doing everything in the authorities' power to mitigate any adverse effects on business confidence. This suggests that the initial rate increase should be a  $\frac{1}{4}\%$ , rather than the  $\frac{1}{2}\%$  advocated by some SMPC colleagues and that future increases should be phased in as a series of small  $\frac{1}{4}\%$  increases every couple of months. The annual growth of the M4ex broad money definition was 3.9% in the year to June. This is broadly in line with the trend since last November, and implies that monetary growth is not so slow as to indicate a rate hold is required. Finally, the 10.2% annual increase in the ONS house price index over the same period was slightly down on the 10.4% rise in May, but remains rapid by most normal standards, and provides a further justification for a moderate monetary tightening sooner rather than later.

## Comment by Peter Warburton

**(Economic Perspectives)**

**Vote: Raise rates by ½%**

**Bias: To raise Bank Rate in stages to 2%**

**The Bank of England has been timid**

The Bank of England's Monetary Policy Committee (MPC) has lost its nerve and lost its way. To defend its interest rate passivity with reference to the stances of the US Federal Reserve or the European Central Bank is to deny its independence of action. Central banks in Australia, Canada, Scandinavia and Asia have made numerous adjustments to their interest rate benchmarks during the past 5 years. The Bank of England's timidity and predictability has spawned complacency among tracker-rate borrowers and dismay among tracker-rate savers, whose interest income has been decimated.

**Governor Carney's "headwinds" story is not conclusive**

The MPC has failed to respond to a variety of economic signals that have been associated consistently with Bank Rate rises pre-2008. None of the 'headwinds' and 'dynamics' that Governor Carney has recently (23rd July) identified as obstacles to a Bank Rate increase, either individually or in combination, amount to a veto over the process of interest rate normalisation from its emergency low level.

**Sterling has risen, but has done so because of expected interest rate rises**

The appreciation of Sterling is often advanced as a reason why Bank Rate cannot be raised. Sterling has appreciated 10% on a trade-weighted basis over the past 12 months, gaining 10% against the US Dollar and 12% against the Euro. Surely, this misses the point: it is market expectations of higher Sterling interest rates – informed by the MPC's previous reactions to economic signals – that have propelled the currency upwards.

**The new Bank of England and MPC members should leave the sterile past behind**

Governor Mark Carney's major reshuffle of Bank personnel has been a costly exercise in terms of loss of experience and expertise. However, the new members of the MPC have the opportunity to plough the deep furrows left behind by 5 years of sterility and to usher in the normalisation of interest rates that should properly have begun a year ago. Indeed, with one exception, the IEA's Shadow MPC has voted to raise Bank Rate consistently since February 2013.

**Four key costs of the MPC's neglect**

The costs of neglect are not always immediately apparent. There are numerous costs and risk arising from the failure to begin the interest rate normalisation. Four spring to mind: heightened medium-term inflation risk with the particular risk of labour market overheating; additional fiscal costs as savers are demotivated and fail to make adequate financial provision for later life; elevated financial stability risks as retail investors reach for yield in risky assets, and money market dysfunctionality as liquidity is hoarded rather than traded in a zero-interest rate environment.

**Policy-based investing  
has replaced analysis  
of true economic value**

Over the past 5 years, the rewards to entrepreneurship in the UK have been poor. Policy-based investing has trumped all other investment styles. Companies that have returned capital through share buybacks and enhanced dividend payouts have outperformed those that boosted their capital expenditures. Indeed the weakness of investment spending can be traced, in part, to the adoption of unconventional monetary policy and the amplification of uncertainty regarding the prospective real return on invested capital.

**Comment by Mike Wickens**

**(University of York, Cardiff Business School)**

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

**Bias: Start to unwind QE and slowly raise interest rates as  
the economy grows**

**The MPC should be  
more forward-looking**

The decision facing the MPC has not changed in the last month: should the current levels of price and wage inflation determine the current outcome for policy, or should the Committee look further ahead and respond now to the increasing strength of the economy and hence the likelihood of higher price and wage inflation in the not too distant future? In earlier years the MPC would have decided to tighten monetary policy on the grounds that it takes time for policy to work. In recent years the MPC seems to have stopped looking very far ahead and been much more influenced by the current inflation levels.

**The MPC is shifting**

What has changed is that two members of the MPC with business and macroeconomic forecasting experience have voted for an increase in interest rates. This is encouraging for those of us on the Shadow MPC who have been urging such a step for some time.

**Much of the huge  
monetary stimulus  
since 2008 has leaked  
into asset prices**

It remains clear that the current policy of cheap and plentiful money has not brought about as much of a real economic recovery as the MPC expected. The main effect seems to have been to raise asset prices, particularly house and equity prices. The recovery that is now gathering pace is due more to increased business investment, which reflects confidence in the future, than in a monetary stimulus to household consumption.

**Time to normalise  
monetary policy**

The MPC appears to pay little regard to the need to return interest rates to long-run equilibrium levels or to unwind QE. As it would be best to do this in an orderly way, this strengthens the case for tightening monetary policy sooner rather than later.



## Comment by Trevor Williams

(Lloyds Bank Commercial Banking, University of Derby)

**Vote: Hold; no change in QE**

**Bias: Neutral**

**The MPC is split whilst pipeline inflation pressures abate further**

There have been two big pieces of news in the UK since the last meeting of the Monetary Policy Committee (MPC) in July. One is the split on the MPC itself. After a long period of unanimity that rates did not need to change, Martin Weale and Ian McCafferty voted for a rate hike - the first time any MPC member has broken ranks in favour of a rate rise since July 2011. This ended any perceived 'taboo' surrounding the subject. But the overall tone of the minutes themselves when they were published two weeks later were much more dovish than the 7:2 split vote in favour of leaving rates on hold suggested. The other big news is that wage inflation continues to fall, as pipeline price inflation abates further.

**Weak wage growth means there is little need to raise rates**

Starting with the MPC decision at the August meeting, for the majority of the Committee, there were a number of reasons for keeping rates on hold. These include the weakness of inflation; the downside risks to growth; the vulnerability of the household sector; the possibility of an unwelcome appreciation of sterling, and structural changes in the labour market. It appears several members attach particular importance to the latter, citing the possibility that rising participation of older workers (and other factors) may have led to a structural increase in labour supply. If so, this could continue to bear down on wage growth and inflation and negate the need for a rise in interest rates. For these members, broadly speaking, more convincing signs of a rise in inflation were needed to justify raising rates.

**Labour market tightening and policy lags are the best arguments for raising rates early**

By comparison, the minutes devoted relatively little coverage to the arguments of the two dissenting voters. Their decision was based on the assessment that unemployment is continuing to fall rapidly and that survey evidence of tightening labour market conditions raises the prospect that wage growth may pick up. They also felt that given the historic lags in both wages and policy, it would be inappropriate to delay tightening just because prevailing wage growth is weak. Overall, for these two, the continued absorption of spare capacity poses an upside risk to inflation which a modest policy tightening would counter. They also argue that a small rate increase now would reduce the likelihood of having to raise interest rates more aggressively in the future – a key goal of the MPC's current forward guidance. They are unlikely to convince enough of their colleagues to follow suit and vote for a rate hike at least this year in my view. Take the financial market view based on break even rates, which have fallen along the curve. It suggests that financial markets are lowering the bet that price inflation will break out any time soon.

**It's hard to see where inflation could come from**

The reason is that it is hard to see where the inflation pressure is coming from in the UK or globally: the other piece of news. Oil prices are resting at just under \$103 dollars a barrel and global commodity prices are weak. Wage inflation is negligible, with labour supply outweighing labour demand.

### **CPI Inflation is falling**

UK CPI inflation resumed its downtrend in July, with the annual CPI dropping from 1.9% to 1.6%, almost fully reversing the previous month's surprise rise. The drop in inflation occurred amid a sharp fall in oil prices and anecdotal reports of aggressive supermarket prices wars. In the previous month, headline inflation had jumped from 1.5% to 1.9%, primarily in response to what was believed to be delayed discounting by clothing retailers. This, indeed, appears to have been the case, with a 5.6% fall in clothing and footwear prices leading the decline in July inflation. Non-seasonal food and alcohol prices also posted sharp falls, with the weakness of both likely to have been at least partly due to the World Cup. Notably, despite a sharp fall in oil prices over the past month, energy and transportation prices rose more rapidly than we expected. Petrol prices rose by 0.5% on the month, while airfares rebounded by 14% m/m. The latter are highly volatile, however, and should fall back over the coming months as seasonal price increases reverse.

### **Other measures of inflation are falling as well**

Other measures of inflation also eased back, albeit by slightly less than the headline CPI. The "core" rate of CPI inflation (excluding food and energy) dropped 0.2ppt to 1.8%, while the RPI and RPIX fell from 2.6% to 2.5% and from 2.7% to 2.6%, respectively. The relatively smaller drop in the headline RPI than CPI was largely due to shifts in the relative weights of the two measures – in particular clothing and footwear, where price declines were especially steep, accounts for 6.2% of the CPI but only 4.5% of the RPI.

### **Inflation may even fall further by the end of the year**

This suggests that UK CPI inflation is likely to drop below 1.5% by the end of the year. Pipeline price pressures continue to ease, with factory gate input and output prices dropping in July by 1.6% m/m and 0.1%, respectively. Over the past twelve months, PPI output prices, which lead CPI goods price inflation, have risen by just 0.2%. The combination of falling energy prices, the lagged impact of sterling's strength and continued price discounting suggest CPI goods price inflation, currently 0.8%, is likely to fall further. In the services sector (which accounts for 46% of the CPI) inflation remains stickier. In July, service sector inflation was unchanged at 2.5%. Nevertheless, it is still well below 3%+ rate of inflation experienced over much of 2013. With wage growth stagnant, and the strength of sterling and fall in oil prices likely to exert an indirect effect, the risks to service sector inflation is also biased to the downside.

### **Keep rates on hold**

By the end of the year, annual CPI and RPI are likely to have dropped to 1.2% and 2.3%, respectively. The relative underperformance of the RPI over the balance of the year is largely due to rising house prices. Over the following year, the continued absorption of economic slack, coupled with a fading of energy and exchange rate base effects, is likely to push both measures of inflation a little higher, but the CPI is still expected to remain below the MPC's 2% target throughout both 2015 and 2016. On this basis, I vote to leave rates on hold and the APF at £375bn.



## Policy response

1. On a vote of six to three, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in September. The other members wished to hold.
2. There was disagreement amongst the rate hikers as to the precise extent to which rates should rise. Four voted for an immediate rise of  $\frac{1}{2}\%$  but two members wanted a more modest rate rise of  $\frac{1}{4}\%$ . On standard Monetary Policy Committee voting rules, that would imply a rise of  $\frac{1}{4}\%$  would be carried.
3. All those who voted to raise rates expressed a bias to raise rates further.

## Date of next poll

**Sunday September 28<sup>th</sup> 2014**

## Note to Editors

### What is the SMPC?

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

### Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is Andrew Lilico (Europe Economics, IEA). 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 (Institute of Directors), Patrick Minford (Cardiff Business School, Cardiff University), David B Smith (Beacon Economic Forecasting), 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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