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# IEA Shadow Monetary Policy Committee

## October 2014



Institute of  
Economic Affairs

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

In its email poll closing Friday 3<sup>rd</sup> October, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) recommended by **six votes to three** that Bank Rate should be raised on October 9<sup>th</sup>, including five votes for a rise of ½% and one for a rise of ¼%.

Those advocating a rise felt that although inflation is low and monetary growth weak, current growth strength and falling unemployment provided an opportunity for some normalisation in rates.

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 rates 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 2<sup>nd</sup> November and 7<sup>th</sup> December, respectively.

## Votes

### Comment by Philip Booth

**(Institute of Economic Affairs and Cass Business School)**

**Vote: Raise Bank Rate by ½% and hold QE**

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

**Inflation below target is  
not a good reason for  
not raising rates**

The 2% target for Consumer Price Index inflation is symmetrical. Therefore, we should not be worried that inflation is currently below target: it is important not to treat the target as a floor. 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%). Given the leverage of many households, there are significant dangers in leaving interest rates at too low a level and then having to raise interest rates quickly. There are also huge dangers from the central bank implying that interest rates might well be left very low for a prolonged period and then having to raise them. Influencing expectations in that way may well induce borrowing in ways that are not sustainable in the long term and then, when interest rates are raised, the damage will be that much greater.

**Keep QE where it is  
for now**

I would therefore raise interest rates slowly starting now, with an increase of ½% 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 M4ex 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)**

**Vote: Hold Bank Rate and QE**

**Bias: To raise rates in 2015**

**1 Year View: No view**

**Early 2014 started quite  
well for the British  
economy**

Early 2014 started quite well for the British economy. In contrast with the Eurozone with its paralysed banking system and very low broad money growth, and with severe tensions between the member states, the UK has its own currency. It has therefore been able since the Great Recession to organize monetary policy according to the needs of its own economy. Money growth is positive, at a rate which is about right, and demand and output have been growing steadily for some quarters.

**However, in the last three months the economy has slowed, inflation is lower, oil prices are down and money supply growth has eased**

**I have decided to reverse my recent conversion to an interest rate rise. Bank rate should be kept at ½% for the time being**

**Tentative evidence has emerged that UK growth is soon to peak. Nonetheless, the outlook for growth over the next 6-12 months is still positive**

However, in the last three months M4x (the appropriate aggregate to monitor in current circumstances) has increased by just under 0.8%, with an annualized growth rate of 3.1%. Arguably, this is a bit on the low side. The recent growth of M4Lx (i.e., the credit aggregate that corresponds to M4x, lending by banks to the non-bank private sector excluding the awkward “intermediate other financial corporations”) has been even less. Moreover, several companies have reported a slowing of business, relative to expectations, in the weeks since staff members have returned from the summer holidays. This slowing of business may be related to the stresses and strains in the Eurozone rather than any meaningful weakening in the UK’s own demand conditions. All the same, the dip in Eurozone demand matters to the UK economy and cannot be ignored. Also important is that commodity prices have been falling recently, with the oil price down \$20 a barrel from a \$115-a-barrel peak earlier in the year, very depressed prices for natural gas and coal, a slump in the iron ore price and lower prices of most agricultural commodities.

The Eurozone is heading for outright deflation in early 2015. In the UK the annual increase in the consumer price index should go under 1% later this year and may even go negative next year, as in our neighbours, depending on energy prices from here. 2015 should be one of the best years for UK consumer spending since the onset of the Great Recession, but the latest developments argue that the housing market is cooling down after a busy phase in early 2014. I have decided to reverse my recent conversion to an interest rate rise. Bank Rate should be kept at ½% for the time being, although I do expect to advocate moves towards interest rate normalization (i.e., towards a Bank Rate of at least 2%) in 2015.

## **Comment by Jamie Dannhauser**

**Vote: No change in Bank Rate or QE**

**Bias: No bias**

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

Tentative evidence has emerged that UK growth is soon to peak. Nonetheless, the outlook for growth over the next 6-12 months is still positive. Recent momentum has been considerable. Major revisions to the National Accounts, especially to the profile for business investment, have altered the historic picture somewhat; but rapid growth over the last six quarters is still evident in the last vintage of the GDP data. The preferred measure of UK economic activity – market sector real gross value added – has expanded at an annualised rate of 3.6% over that time period, despite the persistent contraction in financial sector output. Broadly speaking, non-government activity has been growing far quicker than the pre-crisis average since the middle of last year.

This surge of activity partly reflects the release of pent-up demand. Such growth rates are unlikely to be achieved in the next 4-6 quarters. But on the basis of forces originating in the domestic economy, most obviously monetary developments, expected growth should be solid.

**But inflation remains low, with the headline rate well below 2%. Inflation seems well-contained**

Inflation trends remain weak. Headline inflation is comfortably below the 2% target, core inflation a little lower. In part, this is down to sterling's appreciation over the last year, the effects of which will be felt through next year as well. But there is little evidence that domestic price pressures are building. Given the speed of the turnaround in the UK economy, this provides some confirmation that past beliefs about significant slack in the economy (and/or effective supply failures keeping prices higher than they otherwise would be) were reasonable. Some survey data suggest marginal wage growth is rising; but a host of other indicators of domestically-generated cost and price inflation remain depressed. Intense price competition within the UK retail sector is another factor likely to be holding down underlying inflation as we move through 2015. In addition to this, global commodity prices have taken another lurch down.

**On balance, it has not been reasonable to withdraw monetary accommodation over the last few months. It still seems wise to keep rates on hold**

On balance, it has not been reasonable to withdraw monetary accommodation over the last few months. It seems even less reasonable today. Inflation in the UK and elsewhere is surprising on the downside. Market inflation expectations have turned down markedly. Similar trends are evident in surveys of household expectations as well. The eurozone recovery appears to be stalling. At a global level, there are some signs that the growth cycle has peaked: for instance, leading indicators of world industrial activity suggest a slowdown as we move into Q4.

As the UK economy moves closer to its underlying potential, the need for higher interest rates will arrive. That moment is not here yet. It is likely to come in the next twelve months but the case for a gradual withdrawal of stimulus is strong. In terms of balancing prospective policy errors, it still seems wise for monetary policy to err on the side of doing too much at this stage.

## Comment by Anthony J Evans

(ESCP Business School)

**Vote:** Raise rates  $\frac{1}{2}\%$

**Bias:** Further rises

**Private sectors agents have already begun to prepare themselves for rate rises**

Given that the period of “emergency” monetary policy has become so firmly entrenched, it is no surprise to see fear regarding tentative steps towards a more neutral stance. However there is evidence that the public, as well as many economists, are getting somewhat bored by the waiting game. The August release of the Bank of England/GfK Inflation Attitudes Survey suggests that the public are factoring in rate rises. A fifth of people surveyed believe higher rates would benefit the economy (compared to 14% who think they should go down), and more people believe they would be better off from rate rises than worse off (23% compared to 22%). On the surface, this supports the idea that things should stay as they are. However those economists who do agitate for a rise, point to dangers that are building up for as long as rates remain low. It isn’t like a diver waiting for the water to calm down before making their jump. The act of waiting is making the jump more difficult and perhaps contributing to the imperfect conditions. Low interest rates can cause low growth (by retarding capital formation), but they can also cause bubbles (by encouraging capital consumption). The main danger of the waiting game is that we alternative between these outcomes. The conditions for a cautious rate rises should be based on whether the economy is reasonably robust, and whether public expectations are broadly in line. Forward guidance has intended to reduce uncertainty about when rates will rise, but has less impact on the uncertainty surrounding their impact. It might be worthwhile to deal with this head on. To the extent that lenders have already begun to factor in rate rises, and that they could (and should) be interpreted to signal higher medium term growth, a rise could provide a boost. Ultimately we don’t know, but we experimented with emergency policy, so it’s unlikely we can exit without a little experimentation as well.

**Monetary growth has been a little weaker and inflation low**

Whilst M3 growth remains a concern other monetary aggregates continue to grow strongly. The Divisia measures are high and broad money is growing. However, there is a little concern about August’s figures. The household measure of Divisia ducked slightly below 8% in August, and M4ex has fallen from 3.8% in July to 3.4% in August (using non seasonally adjusted data). Ideally we would want to see these pick up again, but even though they’re not sending a clear signal of loose monetary conditions, they’re not suggesting tight ones either. Similarly, CPI seems to have settled slightly under target and RPI is not causing any inflationary alarm. But it seems to underline the change in reference over the last few years if these figures are considered “low”. Inflation expectations certainly don’t imply that we’re heading off target. Ordinarily I would include a discussion of the National Accounts and in particular NGDP growth. However the recent changes have dented confidence significantly. We entered into the Great Recession with confusion

and uncertainty about what our main monetary aggregates were telling us. It appears that our output measures were sending similarly misleading figures. Perhaps the best response is to take a step away from a myopic study of official data and focus more on the underlying, long-term causes of prosperity. The goal of monetary policy should be to prevent interest rates from fluctuating from their natural rate.

**Raise interest rates but  
leave QE for now**

Although I think monetary policy is too loose I don't think any surprise action should be taken on QE. The main argument against it was the ad hoc way in which it was introduced, and the removal needs to be carefully communicated and follow a normalisation of interest rates. Indeed there is a convincing argument that the influence of the central bank relies on control of the monetary base, and therefore the Asset Purchase Facility should replace Bank Rate as the main policy tool. But the prospect of impending tightening (or rather, less loose monetary policy) is generating enough uncertainty for now.

## **Comment by Andrew Lilico**

**(Europe Economics, IEA)**

**Vote: Raise Bank Rate by ½%**

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

**One Year View: 1¾%**

**Lending growth has  
slowed again and  
inflation is still low**

Lending growth may have flattered to deceive in June and July. In the three months to August, lending growth (on the M4Lx excluding intermediate OFCs measure) fell back to 2.3% from the heady 4½% figures of June and July. That is still stronger growth than over much of the past five years but no longer signals a step change in lending. August inflation was down to 1.5%. There seems to be no immediate inflationary threat or rapid monetary growth that would force interest rates to rise.

**The case for a rate rise  
is normalisation not  
inflationary pressures**

Yet, to repeat a familiar refrain, it is a mistake to believe that the purpose of rate rises at this stage should be responding to inflation. When there is no compelling reason for stimulus or tightening (and there is no compelling reason for either at present), the proper tendency should be for rates to drift back to their "natural" or equilibrium level. For the UK that level is somewhere between 3% and 5% at present. That does not mean that rates should be instantly raised to 3% or more. It does mean that they are clearly far away from their equilibrium level. Keeping rates greatly distant from their equilibrium level induces damaging distortions in economic activity and expectations, damaging medium-term growth.

**Conditions allow  
for a rate rise whilst  
maintaining stimulus**

UK GDP in the second three months of 2014 was up 0.9% on the first quarter and up 3.2% on a four-quarter over four-quarter basis. Unemployment continues to fall. The banking sector (though lending remains poor) has been relatively stable for some time. The stock market is healthy. The corporate bonds market is liquid. There is undoubtedly scope to raise rates. Such rate



risers will of course have implications for some heavily indebted households and may also further accelerate the rise in the international value of sterling (up around 15% on a trade-weighted basis in the fifteen months to July 2014). But such implications are, by and large, an economically desirable element of the economy's returning to a sustainable equilibrium position with interest rates at their natural level. We have a chance to raise rates. We should take it.

## **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**

**There is an argument to leave rates on hold until the labour market strengthens, but I think that capacity is less than it was and this will cause inflation pressure to rise**

There is a credible argument to keep the base rate at its current position until evidence of a hardening of the labour market appears. Certainly the weakness in broad money growth and coincident indicators of nominal GDP growth such as narrow money or retail deposits, give no grounds for concern about a sudden increase in inflation. The assumption behind this policy is that there is sufficient capacity in the economy to accommodate a policy of continued cheap money. The problem is that is no good measure of capacity and what little we know suggests that it is now less than what we thought it was. A famous economist once said that the 'lags are long and variable' and the same economist is supposed to have said that there is no such thing as macroeconomics; all economics is microeconomics. It is the microeconomic argument that prevails in the recommendation that interest rates should start to move upwards. Evidence from past financial crises suggests that GDP growth does not always return to trend because of capacity destruction. Therefore given the state of the current UK recovery, the economy may be below capacity or as suggested by various business surveys, it may be at capacity – we simply do not know. But we do know that the lags are long and variable.

**But low rates are damaging the economy's adjustment and Bank rate at this level means monetary policy has no traction, and rates cannot be cut if required**

However, the argument for a rise in the base rate is not macroeconomic but largely microeconomic. The long period of low interest rates has stifled the process of capacity rebuilding by hindering the mechanism for the re-allocation of resources from the low productive sectors surviving on cheap credit to high productive sectors starved of credit. It is true that a reversal in the current state of financial repression will take time for capacity to be re-built and for the supply-side to respond. This is why interest rates have to be raised slowly. There are macroeconomic arguments also for raising rates. At current rates monetary policy has lost all traction. The euro crisis has abated but not resolved. At some point in time this might flare up again and at 0.5% there is no space for interest rates to fall. The economy needs to get back to equilibrium at a positive real rate of interest. Raise rates by ¼%. Hold QE in reserve, Bias to raise further in short steps.



## Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

**Vote: Raise Bank Rate ½% 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 failed to maintain adequate liquidity during the banking crisis**

It seems hard to argue that central banks were the central factor causing the banking crisis. Yet consider this argument put forward by Anthony de Jasay in a recent book (*Economic sense and nonsense — reflections from Europe 2008-2012*): the total value of sub-prime mortgages were in the range of \$400-600 billion and the losses on them could be gauged at some percentage of this, at some tens of billions. Compare the latest fine just levied on the Bank of America of about \$17 billion; not to speak of previous ones on Bank of America and ones of similar order on many other banks levied by the various US regulators. These have made but a dent in current bank profits and are a tiny percentage of total bank assets. So how could sub-prime losses have brought down the world banking system? De Jasay argues that they could not; and he must be right about that, simply because the amounts are far too small. What brought down the banks was the effective closure of the world's interbank market, so that banks could not borrow from each other to carry out their normal day-to-day operations. This in turn happened because central banks failed in their key duty: to keep open the world system of liquidity of which this interbank market was a central component. The market closed because of a lack of trust between banks: bank A did not know whether bank B had a sound balance sheet, fearing it might be a major holder of sub-prime assets. So it refused to give it credit on the interbank market. This became general. Yet central banks are supposed to stand behind such systems and assure member banks that they will maintain the creditworthiness of participating banks. They did not do this, particularly for foreign banks on the market; for their own banks they may have been willing to offer such assurances but this was not enough. So they failed to coordinate their support of the system.

**Bank over-extension was to some extent a self-fulfilling criticism of government officials**

Instead de Jasay argues that central banks allowed officials in government to spread doubt about banks' solvency and start at once on a tightening of regulation. The initiative moved to bureaucrats who have a vested interest in new controls that enhance their power. They put it about that banks had overreached themselves and that many of them were insolvent. Once this had occurred central banks lost control. When Lehman could not raise money in the marketplace, the Federal Reserve could not persuade enough banks to help it provide the necessary funding. Part of the problem was the unwillingness of the Bank of England to support Barclays' desire to buy a big chunk of Lehman. This again bears witness to a central bank failure of coordination- had the Bank of England been acting as part of a cooperative team confronting the Lehman threat it could have helped avoid the collapse. As it turned out this collapse was the trigger for the crisis proper, leading to a dramatic fall in world trade and GDP over the succeeding six months. So we got a story in which a small global loss spiralled into a snowball that brought

**Governments have interfered too much in the banking sector, making a bad situation worse**

down the world banking system. Of course after the collapse of the system bank losses also spiralled in the recession, so apparently validating the bureaucratic claims of massive over-extendedness. But the appearance is highly deceptive.

Replaying history like this might be too simple; there could have been other factors, such as the slowing of the world economy, that were creating broader losses for banks than just on sub-prime mortgages. In our Cardiff research on the crisis we have found that the world business cycle was indeed in trouble, as evidenced by the huge peaks in oil and other commodity prices. It looks as if there was too much credit in the previous boom, allowing it to get rather out of hand and so feed the following bust. However recessionary tendencies are one thing; collapse of world banks is another. We have had plenty of recessions in the post-war period but only in this one have we had a major banking collapse. It points the finger straight at central banking failure. If this is correct, then the huge rise in regulation since the crisis looks quite unjustified. Instead governments should have improved central bank international coordination, and reviewed their ability to support world liquidity. They should have looked at ways of restraining money and credit directly in the boom stage of the cycle. They should also have looked at better rules for managing interest rates. More work we have done suggests that with such rules and firm central bank support of markets economic stability could be hugely increased; intrusive regulation of banks both is unnecessary and sabotages the credit mechanism. As for all these fines levied by all the different, competing US regulators, they too are a damaging bureaucratic intrusion on the banking market. The US itself, having once been supposedly the home of free markets, has become a major intervener in markets worldwide in pursuit of political objectives such as sanctions and popular retribution, with the Dodd-Frank Act too a source of an ever-growing interference in the banking system.

**Recent recovery is partly attributable to reduced pressure for bank-bashing**

We must hope that this regulative backlash produces its own horrified reaction. It seems that this has happened earliest in the UK where we have had attempts to alleviate the worst effects of regulation with schemes like Funding for Lending and Help to Buy. Our newfound recovery may owe a lot to these attempts. In the US the existence of state and local banks has helped credit to start flowing in spite of the problems of the large money-centre banks. Still the US is suffering from a stuttering recovery which seems closely related to a sharp rise in political uncertainty about future intervention, with a President keener on it than any predecessor.

**The Eurozone is an ongoing policy-induced and policy-exacerbated tragedy, but UK growth will survive it**

As for the Eurozone it is a tragic tale of the overweening ambition of a small elite who forced monetary union on reluctant nations and then has followed it up in the crisis with measures that have put the preservation of that union above the interests of the union's citizens, on the pretext that abandoning it would 'create chaos'. Sadly the citizens have bought the lie but their misery is untold. Their banks have had to absorb huge amounts of government debt; and ironically that very debt is undermining their credit status. EU bureaucrats

are busy condemning them as 'capital insufficient' which in turn wrecks the credit mechanism of the Eurozone. Its growth has stopped, deflation is moving in, and the crisis is worsening again. The hope is that 'reform' will trigger growth; yet without credit it is impossible to turn reform into growth because the new firms and industries encouraged by reform cannot obtain the means to invest. Just as Japan effectively has ceased to be an element in world growth over the past two decades, wrecked by a cocktail of deflation, lack of competition and low productivity growth, so the Eurozone is imitating it now. It looks as if it will be written out of the world growth script over the next decade at least. The UK in particular has had to turn to other markets and that will continue. As the FT writer Wolfgang Munchau has frequently observed, the UK may be agonising over in-out referendums on the EU but it has already de facto left. It remains to formalise the new relationship and tidy some difficult loose ends like totally free EU immigration and aggressive EU financial taxation. World and UK growth will survive the EU's problems, just as they have survived Japan's problems. Our Cardiff forecasts remain positive for the survivors. Indeed the very fact that some countries' growth is weak makes it easier for other countries to grow in a world dominated by periodic resource shortages.

**Normalisation of interest rates is long-overdue and there should be a schedule for the elimination of QE**

For a long time now I have argued for a return towards normal interest rates and open market operations. But of course this is only possible if the regulatory authorities are doing their proper job. Clearly they are not in the Eurozone. Instead they are aggravating the shortage of credit. In the US the competition from regional banks seems to be a saving grace. Here in the UK there are signs of a return to a more balanced approach, money growth has reached 4% and credit is finally growing, if only slightly. Certainly the economy is growing strongly and core inflation is close to 2%. Wage growth is still weak but inflation can rise with weak wage growth if capacity tightens and margins rise; also the labour market is now tightening quite fast and this will start to push up real wages fairly soon. House prices are rising at over 10% a year and rather than quietening this market with direct regulative interventions, I would argue monetary policy should do it indirectly. This is no longer a fragile recovery; the risks of higher inflation are rising while the risks of slowing the recovery by a slow move towards normalisation are falling. In my view normalisation should have begun some time ago and I continue to press for it now: because of delays I suggest a 0.5% initial rise in base rate, together with resale of gilts to the open market at a rate of around £25 billion a quarter (which would imply elimination of QE over a period of 4 years). Further rises in base rate will be needed but the pace at this stage is hard to foresee.

## Comment by Peter Warburton

(Economic Perspectives)

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

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

**Better to tighten policy by raising rates than by impose fines**

There is a neglected aspect of monetary policy which concerns the regulatory and penal strictures applied to the banks. News that UK banks face additional fines totalling above £10bn in respect of LIBOR and foreign exchange rate rigging raises doubts over their willingness to lend freely to the private sector. If the banks suspect, as they must, that these fines amount to a de facto international tax regime, then they will continue to operate with undue caution. The long overdue increase in UK Bank Rate is the appropriate expression of monetary tightening, rather than the ad hoc plundering of bank profits by international regulators.

**Monetary growth is still low but within an acceptable range**

The annual growth of M4 money stock, excluding intermediate other financial corporations, has slipped back from 5% a year ago to 3.5% in the year to August. This weakening is entirely attributable to wholesale deposits, since the growth of retail deposits (M2) is 6.1%. Now that money supply growth has been restored to an acceptable range, consistent with nominal economic expansion, this poses no obstacle to the raising of Bank Rate. M4 lending, excluding IOFCs, continues to register very low (1%) annual growth.

**GDP revisions make claims of a negative output gap even less convincing**

Profound revisions to the UK national accounts, principally to reflect the capitalisation of research and development expenditures, make it even harder to justify the inactivity of the MPC. The assertion of a negative output gap is even less convincing on the re-casting of the statistics. Essentially productivity growth has been downgraded for the decade 1995-2005 and raised thereafter, reducing the contrast with the post-2009 experience. Tightening labour market indicators confirm the inflationary dangers associated with staying on the present policy course. At 1.5%, the UK still has the joint-highest inflation rate in Europe. The private sector components of the retail price inflation rate are still running above 3%, as against sub-2% prior to 2009.

**A rise in Bank Rate is long overdue**

A rise in Bank Rate is long overdue: the justifications for delay are insubstantial and the costs of delay, though largely unseen, are nevertheless serious and likely to be cumulative. My vote is for an immediate increase in Bank Rate of 0.5%.

## Comment by Trevor Williams

(Lloyds Bank Commercial Banking, University of Derby)

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

**Bias: Neutral**

**UK economic growth is slowing, especially in the manufacturing sector**

UK economic growth is slowing from an above quarterly trend rate of around 0.8% to below trend at 0.6%, assuming a trend rate of 0.65%. In latest data from the ONS, the economy grew by 0.7% in Q1 2014 and 0.9% in Q2, leaving the H1 average at 0.8%. But latest estimates from NIESR suggest that growth in the quarter to July and August was 0.6%, respectively. This suggests that growth in the second half could be 0.6%. The most obvious sign of this slowing is shown in the manufacturing data, where not only is the PMI slipping but so is actual production. Manufacturing output appears to have been flat in Q3. This trend is a sign that the effects of a strong pound and weakness in our key export markets in Europe, compounded by slow growth in global trade, are leading to an easing in the pace of activity in the UK economy. Admittedly, retail sales and domestic confidence levels amongst households and business remain elevated so domestic demand is not slowing as much, as shown by our widening current account deficit.

**Monetary growth is weak and there is no inflationary pressure**

Although this slowing is of course no reason in of itself not to raise rate - that would depend on inflation trends as well – especially as the ONS revisions now show that the economy is 2.7% above its pre crisis peak, rather than 0.2% as suggested in the previous data. But money supply growth is weaker, as is the pace of wage inflation. Annual headline M4 growth was minus 1.5% in September, while M4ex IOFCs on a three month annualised basis was 3.1%, down from a downwardly revised 3.4% in August (from 3.8% previously) and 4.5% in June. Average weekly earnings inflation was just 0.6% year over year in July, with the rate ex bonuses at 0.7%. There is no inflation pressure here. Nor do leading indicators suggest this is about to change any time soon, from pay settlements to pipe-line inflation trends. Producer prices inflation on the input basis was minus 7.2% year over year in August and output prices were down 0.2% on the same basis. Actual CPI inflation was 1.5% in the year to August, with current trend suggesting it could bottom out at between 1 and 1 ¼% later in the year or early 2015.

**The case that rates should have been raised earlier seems to have been refuted**

None of this is to suggest that the economy is about to slip back into weak growth, it is not, but it does show that the pace of growth is losing momentum. Moreover, this is occurring at time when inflation pressures are still subdued. Think what would have happened to price inflation if official rates had been raised to 1 to 2% a year ago? Those MPC members that voted for a rate hike cited above trend growth and a narrowing output gap for wanting to see higher rates as they saw an inflation threat to pay and then to prices. Well, there appears little of that at present, not least because output gap estimated cannot be trusted, as shown by the re-writing of history by the latest ONS data revisions. Growth seems higher but inflation is still where it was and productivity is no better or worse.

**Rates will rise some time  
in the next year, but it is  
still too early yet**

Moreover, looking ahead, growth looks like it will stay at trend or below and inflation muted for the next few months at least. No doubt, a rate rise will be necessary at some point in the next 6 to 12 months but that point is not now in my view. I would leave rates at 0.5% 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. Five voted for an immediate rise of  $\frac{1}{2}\%$  but one member wanted a more modest rate rise of  $\frac{1}{4}\%$ . On standard Monetary Policy Committee voting rules, that would imply a rise of  $\frac{1}{2}\%$  would be carried.
3. All those who voted to raise rates expressed a bias to raise rates further.

## Date of next poll

**Sunday November 2<sup>nd</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, 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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