
IEA Shadow Monetary Policy Committee

December 2014



Institute of
Economic Affairs

For further information please contact:

Andrew Lilico	+44 (0) 20 7831 4717	andrew.lilico@europe-economics.com
Philip Booth	+44 (0) 20 7799 8912	pbooth@iea.org.uk
Richard Wellings	+44 (0) 20 7799 8919	rwellings@iea.org.uk

For distribution enquiries please contact:

Tom Crew	+44 (0) 20 7246 7808	tom.crew@lombardstreetresearch.com
----------	----------------------	--

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

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

Those advocating a rise contended that more rapid economic growth is an opportunity to normalise rates. Some emphasized that such normalisation should be combined with a relaxation of bank capital and liquidity requirements so as to encourage more market-oriented lending. Others noted the political uncertainties associated with the 2015 General Election. Several noted that recent very low inflation is driven by one-off factors that may reverse and policy acts with a lag.

Those that preferred to keep rates on hold noted that not only is current inflation below target (indeed, perhaps there may even be a Governor letter soon), 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.

It is noteworthy that two of those advocating a rise suggested they might revert to a hold or cut position in forthcoming months (either because of a Eurozone crisis or weak monetary growth) whilst one of those advocating a hold indicated he might soon switch to voting for raising rates if stronger economic growth continues.

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 4th January and 1st February 2015, respectively.

Votes

Comment by Jamie Dannhauser

(Ruffer)

Vote: No change

Bias: No bias

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

Inflation has fallen and is low

Headline UK inflation has been below the Bank's 2% target throughout 2014. The latest reading (for the year to October) placed it at 1.3%. In an accounting sense, lower food and energy price inflation explain a sizeable chunk of the downward shift in UK inflation. The CPI food sub-index, for instance, showed food prices down 1.2% over the last twelve months, the biggest annual decline since 2000.

Inflation has been driven down by falling commodity prices and will probably go below 1%

Broad-based weakness in global commodity prices in the second half of 2013 has been an obvious depressing factor on UK inflation this year, given the usual lags in global supply chains. Over the last six months, food and metals prices have declined further, suggesting additional disinflationary pressures from imported raw materials. But the most conspicuous factor set to hold down future UK inflation is the recent collapse in the oil price. In sterling terms, the cost of Brent crude oil has slumped by 25% in the last three months. Indeed, more than half of this fall has happened since the MPC last released its economic projections in which CPI inflation was expected to drop to 1% early next year. As such, it is all but certain that Mark Carney will have to write a letter to the Chancellor within the next few months explaining why inflation has dropped more than 1% below the Bank's target.

MPC did not raise rates when inflation above target but may be deterred from raising when below target

How should the MPC respond? In the past, the MPC has 'looked through' upward spikes in global commodity prices, arguing, quite reasonably, that such 'cost shocks' had little bearing on medium-term inflation. For much of the 2010-2012 period, UK inflation was well above the 2% target because of imported price pressures. The MPC judged that such forces would have a one-off effect on the level of consumer prices but no lasting effect on the inflation rate. That view turned out to be the right one. One might assume that today the committee should once again 'look through' an imported cost shock and the (temporary) prospect of uncomfortably low inflation. But for many MPC members, the existence of the zero lower bound on short-term interest rates cautions against a symmetric response. Indeed, the latest Inflation Report effectively validated an asymmetric reaction to the recent move in commodity prices, especially oil.

Concerns about overly-low short-term inflation may be misplaced; commodities-driven falling prices may be stimulatory

Whether such asymmetry is justified is far from clear. The zero-bound is not an effective constraint on monetary stimulus given the toolkit of unconventional measures that the central bank could undertake. Moreover, if recent declines in global commodity prices are supply-driven, as it seems they are to a large extent, they may well be a net positive for UK domestic and external demand, through their effect on domestic and foreign consumer real incomes and consumer confidence more generally. With UK inflation expectations well anchored, as all available indicators point towards, the case for a monetary response is unproven. Indeed, just as the first signs of a slowdown in UK consumer demand emerge, these developments should provide a material fillip to household sentiment.

Underlying inflationary pressure in the UK is overly low; this is more of a concern

The greater concern is the weakness of underlying inflation in the UK. There is enormous uncertainty about the degree of slack in the UK economy, the sensitivity of inflation to that slack and even the extent to which the inflation process is affected by our current notion of spare capacity. But what is clear is that a wide array of measures, which act as proxies for underlying, domestically-generated inflation, remain markedly below levels consistent with the Bank's inflation target. 'Core' CPI inflation (excluding government administered prices) was 1.4% in October, its lowest level since early 2009. Price pressures in consumer-facing services, where domestic forces play an even bigger role in price determination, remain very weak by the standards of the pre-crisis (1992-2007) era. The same message emerges when one looks at broader measures of inflation across the private sector (for instance, the market sector value added deflator).

Low underlying inflation justified keeping policy exceptionally accommodative

It is the weakness of underlying inflation, not the prospective downward pressure on non-core items in the CPI, that justifies the case for exceptionally accommodative monetary policy, despite the likelihood of ongoing solid real GDP growth. Downside growth risks from developments in Britain's trading partners are growing; but these are potentially offset by the boost that lower oil and raw materials prices will provide for private domestic demand. If there is evidence of even greater weakness in underlying inflation, a case for additional monetary stimulus might be made. But for now it is right to look through the price-level effect that lower commodity prices will cause in the near-term. Indeed, given the expected evolution of the economy, it is still likely to be desirable for some withdrawal of policy stimulus within the next year.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold rates

Bias: Only raise rates if money and credit growth move into double digits

The UK private sector is growing well and global risks are balanced

The UK economy has continued to recover, but the pace of recovery has slowed slightly in recent months. Even so, contrary to the view recently expressed by the Prime Minister that the warning lights on the dashboard of the economy were flashing red, the UK private sector is steadily healing and the only real dangers are from a re-emergence of a Eurozone crisis or from a major conflict in the Ukraine leading to a shut-off of oil and gas pipelines to western Europe. On the other side, the US economy continues to make solid progress as reflected in the recent upward revision of real GDP growth in the third quarter to 3.9% on a quarter-on-quarter annualised basis. This will provide major support to most of the economies of the developed world.

The UK has ample slack and there is no need to raise rates yet

Furthermore, the delay in closing the UK budget deficit - although disappointing - is not a threat to the economic upswing. In summary, with inflation well below target and still ample available slack in both the labour force and the productive capacity there is no need to be raising interest rates yet.

Comment by Andrew Lilico

(Europe Economics, IEA)

Vote: Raise Bank Rate by ¼%

Bias: To raise further; QE neutral

1 Year View: 1¾%

UK growth is strong

UK growth is strong and has shrugged off Eurozone weakness over the past year. There has long since ceased to be a weak-growth-based justification for keeping interest rates so low.

Broad money growth continues to be weak

However, the growth rate of broad money has been remarkably weak, given strong real-terms economic growth, an extremely strong labour market, zero interest rates, solid business investment prospects and the huge increase in the Bank of England's balance sheet via QE and other measures. Bank of England statistics give the twelve-month growth rate at just 3.9% for broad money (M4 excluding intermediate OFCs) and 0.7% for aggregate lending (M4Lx excluding intermediate OFCs). The failure of broad money growth to pick up despite the improving economy must go down alongside the eccentric performance of the UK labour market as one of the two great economics conundrums of recent years.

**Commodity price
deflation**

To the backdrop of these weak underlying inflationary pressures from monetary factors, over recent months one must add (or subtract) the deflationary impact of commodity price falls. These have dragged short-term inflation below target and may even threaten what would once have been treated as the “lower bound” of the Bank’s inflation target — the 1% threshold below which the Governor must write letters to the Chancellor explaining why inflation is so low.

**The inflation target has
provided little constraint
upon MPC decisions
since 2007**

Does an undershoot of the 2% target or the 1% “lower bound” really matter? Once upon a time one would have thought it did. In those days it was thought that the inflation target was 2% and the $\pm 1\%$ thresholds was the range of discretion the Bank had to “see through” short-term fluctuations from factors such as commodity price movements. But since April 2007 (when inflation was first revealed as having reached 3.1% and the first Governor’s letter was written) the inflation target has been redefined such that the $\pm 1\%$ thresholds were not a constraint upon the Bank’s freedom to allow short-term fluctuations from target. Interest rates were not raised to prevent inflation reaching 5% in 2008 or 2011. Indeed, it is doubtful whether a single MPC decision since April 2007 can be regarded as having been in any material way constrained by the desire to meet the 2% target or to stay close to it.

**A significant under-shoot
of inflation should be
avoided**

It is tempting, therefore, simply to ignore current low inflation, declaring that what’s sauce for the over-shooting goose should be sauce for the undershooting gander. Yet there remain good reasons to wish that the inflation target could be restored as a genuine constraint upon MPC policy-making and therefore to be at least somewhat constrained by it. A large inflation undershoot does matter for the Bank’s credibility and should be avoided if it can be.

**Keep recommending a
rate rise for now – but
how much longer?**

This is doubly so in the current environment in which the behaviour of the monetary data is so confusing — indeed, sufficiently mysterious that if it continues I, for one, will eventually regard it as a threat to my theoretical paradigm. The inflation target gives us something to steer by when other data are mysterious and our theoretical understandings fail. For now, I shall continue to assume that, eventually, underlying monetary growth must accelerate when economic growth is so strong and monetary base expansions (QE etc) has been so enormous. I therefore maintain my recommendation of a 0.25% rise in rates. But if monetary growth does not accelerate within the next few months I shall need to revisit that recommendation.

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

It would be better to have interest rates higher so they can be cut if the Eurozone crisis flares up again

Even a stopped clock gives the right time twice a day and we may be fast approaching the situation that in the event of another euro crisis the Bank would commit interest rates to remain on hold for even longer in addition to a further bout of QE. Events in the Eurozone have increased the likelihood of another euro crisis but the return of a euro crisis is not news. The Eurozone will go through periods of crisis and calm for the foreseeable future and possibly for decades to come but that does not mean the UK interest rates should remain on hold while Europe sorts itself out. Interest rates have to be normalised to rebalance the economy and for the reasons articulated in previous submissions. There is still time to act now to raise the base rate in ¼% stages so that if the Eurozone crisis flares up later than sooner a cut will be effective. Nothing has happened to change my position from the previous period. Interest rates should rise by 0.25bp in stages and QE to be held in reserve in the event of a euro flare up.

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

Market movements are news-driven

In the past month we have seen the equity market drop on fears- about what? The end of Quantitative Easing by the US Fed; Ukraine's fallout on the Eurozone, especially Germany; China's excessive indebtedness and overcapacity; 'secular stagnation' suggestions and more besides. Equity prices are now recovering again, as the sky did not fall in when the Fed announced the immediate end of QE and then the Bank of Japan suddenly decided to have another large tranche of its QE. So it goes on from day to day, with news buffeting what has actually been a steadily rising stock market.

Opinions on the fundamental outlook are divided

For some market-watchers it is only loose monetary policy that is keeping equities going and price-earnings ratios have risen too high. For others we are on a growth and recovery path so that equities are discounting better future prospects.

There is a 30 year "Long Wave" in commodities markets

In Cardiff we have been doing work on the world economy, looking at the last 150 years; and there are two key factors we find one should look at: money and commodities. The big underlying picture is of the commodities Long Wave, whereby the commodities cycle of investment in capital and technology lags

behind the main cycle of world spending and production; periodically world production overtakes commodity capacity and there is a crisis, and then after a recessionary pause commodity capacity, boosted by the period of commodity scarcity and high prices, overtakes world production again and there is another long world boom as production benefits from low commodity prices. The cycle is then repeated; but it is a long one, of roughly 30 years from trough to trough.

In monetary policy, don't be the 1930s or 1970s

We are now some five years from the last trough (2009) which implies that a run of 25 good years lies ahead. That then brings us to the second factor which if handled well can stop the Long Wave becoming unstable- money. There are two bad monetary episodes that stand out as 'Lessons in what not to do with money': the 1930s and the 1970s. In the 1930s the world's central banks, mainly the Fed, allowed the money supply to contract sharply with huge numbers of bank failures. The result was prolonged world slump, lasting throughout the 1930s. In the 1970s world central banks responded to surging commodity prices by printing money rapidly (growth rates went into double digits) in order to keep down unemployment: the result was a sharp rise in inflation, and this prolonged the slump of the mid-1970s into the early 1980s because inflation had to be brought down by a sharp monetary squeeze.

Central bank policy combines excessively tight prudential requirements with very loose interest rate and money supply policies

What then is the current monetary outlook? The answer is that it is a varying mixture of partially offsetting factors depending on exactly which parts of the world you look. Poorly thought-out regulation is clobbering banks in the developed world, especially the Eurozone where the euro crisis has worsened the banks' already weak balance sheets. But in some developed countries the credit-killing effects of this bank-clobbering have been mostly offset by massive QE programmes- again the exception is the Eurozone where QE has not yet occurred because in its usual form (ECB buying government bonds) it is actually illegal. QE has bypassed the banks and fed straight into the equity market: central banks have bought government and private bonds, driving down their interest rates, and the sellers have bought equities, driving up their prices, as the yield on bonds became less attractive. While this has not led to more credit to firms, because the banks have barely expanded it, it has made firms attractive to private investors through the peer-to-peer (P2P) lending channel (via the internet). This last credit channel seems to be expanding very fast though statistics on its total are hard to generate.

On balance (by luck) money is in a tolerable middle zone

Hence on balance in the developed world money is supportive, unlike the 1930s, but because of the unintended effects of bank regulation it is also not strongly expansionary, unlike the 1970s. On balance money is in a tolerable middle zone- even if this is more the result of luck than good management. As for the developing world it is also a mixture of situations; some countries in disarray (Russia), others doing well (Singapore), and then the big ones, China and India, somewhere in the middle, with problems that do not prevent continuing moderate growth.

World growth is in a good range but there is a challenge of restoring more market-friendly regulation

We therefore currently have world growth in the 3-4% range which is a good range to be in. The prospects longer term look good and there is no madcap boom as recovery proceeds. Some Keynesians, like Olivier Blanchard the chief economist of the IMF, constantly fret when growth is not at some maximum speed. But this perspective is a bad one: growth needs to proceed at manageable rates that do not threaten to get out of hand and threaten a bigger crisis when the pause has to happen. The challenge for the developed countries who dominate the worlds' money and banking is to move towards an environment where bank lending resumes under a market-friendly regulative system and where money growth is controlled to prevent the type of credit/money boom of the mid-2000s.

We must combine less tight regulation of banks with tighter interest rate and money supply policies

How can we manage this re-entry? First the regulatory vice on banks must be eased. Second, we must restore interest rates to more normal values, as the SMPC has been urging for a long time. Third, we need to restore central bank balance sheets to normality too: this means that they sell off their huge stocks of mainly government liabilities.

Alas at present none of these three things is being done

For this to work well all three steps are needed. Unfortunately what is happening is that there is no action on any of them; the lack of joint action on all three effectively prevents action on any one of them. For example with the banks inert under the pressure of regulators, central banks fear that stopping low interest rates or reversing QE will stall the economy. Yet under pressure from public opinion governments fear loosening bank regulation.

Absent normalisation banks will be bypassed by P2P lending

In the absence of any action my prediction is that the banks will increasingly be bypassed by P2P lending and that the near-zero interest rates and continued QE stock will then prove to be far too loose a monetary environment. We will create another credit boom, P2P deposits will count as another near-money and will grow in line, and world growth will move back to high rates in the 4-6% region. This will shorten the time to the next commodity crisis.

Raise rates; unwind QE; relax bank lending curbs

My preferred course of action is therefore still for interest rates to be raised, in small steps of 0.25%, until they get back to say the 2-3% range; for QE to be steadily unwound; and for the banks to be quietly released from some of the more draconian curbs on their lending activity.

Comment by David B Smith

(Beacon Economic Forecasting)

Vote: Raise Bank Rate by ¼%; hold QE.

Bias: To raise Bank Rate by ¼% increments every second month or so.

1 Year View: Depends on May 2015 election outcome; on current policies, raise Bank Rate to 1½% to 2½% by late 2015.

Monetary policy is on hold, leaving fiscal policy centre stage

In the absence of major global shocks, UK monetary policy is generally expected to be on hold until after the general election, with the financial markets apparently not anticipating any rate change before the autumn of next year. As a consequence, the main macroeconomic focus between now and the election will be on fiscal policy. In particular, there are only Mr Osborne's 3rd December Autumn Statement and next year's spring Budget still to come before the Thursday 7th May 2015 election. The monthly figures for the governmental finances during the first seven months of fiscal 2014-15 suggest that Public Sector Net Borrowing (PSNB) could turn out even higher than the £97.5bn deficit recorded in 2013-14. The excess of the cumulated PSNB during the first seven months of the current fiscal year, when compared with the corresponding figure for 2013-14, is running at an annualised rate of £6.2bn. This suggests that the total PSNB in 2014-15 could exceed the politically-sensitive figure of £100bn; this statistic will be published shortly before the election in April 2015.

3rd December OBR projections will be based on the new ESA-2010 accounts

The projections from the Office for Budget Responsibility (OBR), which will accompany Mr Osborne's Autumn Statement, will be unusually important because they will be the first OBR forecasts to incorporate the new ESA-2010 national accounts. These were generally introduced on 30th September although the government figures were switched one week earlier. The 23rd September 'Public Sector Finances Statistical Bulletin' released by the Office for National Statistics (ONS) contained a comparison of the new ESA-2010 figures with the previous statistics back to fiscal 1997-98. These contained some gob-smacking revisions. In particular, General Government Net Borrowing (GGNB), which is a preferable measure to the PSNB because it excludes a number of idiosyncratic financial transactions, was revised up by £22.6bn in 2000-01 and by £42bn in 2012-13. There was also an upwards revision of £5.6bn to the 2013-14 GGNB. In addition, the monthly Excel spread sheet released the following day contained revisions to individual government spending and receipts items back to the mid-1950s or earlier. The size of these changes indicates that most of the political debate on tax and spend issues since the Coalition took office has been based on an unduly optimistic view of the public finances.

Former measures of public spending and tax burdens are invalid

However, the issues are complex because much of the political debate is concerned with the share of government taxes and expenditures in money GDP, which has itself been revised up by more than £100bn, a re-definition that would have reduced the reported share of government spending in GDP

substantially on its own. In addition, a new item has appeared in the government spending identity 'VAT and Gross National Income based EU contributions', which picks up money paid directly to Brussels. The effect of the changes involved has been to raise the previous figure for total general government expenditure in 2013-14 from £707.7bn on the old measure to £726.9bn on the new ESA-2010 definition. However, the increase in money GDP on the new definition means that the ratio of total spending to basic-price GDP dropped from 49.1% to 47.2%, a fall of 1.9 percentage points. Likewise, the cash value of total receipts in 2013-14 was raised from £611.6bn to £625.8bn as a result of ESA-2010; the main reason was that the taxes paid directly to the EU are no longer excluded. However, the ratio to basic-price GDP dropped from 42.5% to 40.1% as a consequence of the switch – a drop of 2.4 percentage points.

Implications for the 'tax and spend' debate

There has been a longstanding, and politically highly-charged, debate on 'tax and spend' issues in Britain ever since the 1970s. During this debate certain rules of thumb have become widely accepted – e.g., that the growth maximising share of government spending in GDP is around 20% to 25%, the welfare maximising share is around 30% to 35% and that the upper limit on taxable capacity is around 38%. Nearly all of these ratios, which are derived from studies for a range of countries over many years, refer to shares of the market-price measure of GDP – usually as compiled by the Organisation for Economic Co-operation and Development (OECD) – calculated employing earlier generations of data. These rules of thumb now need to be lowered by some 1½ to 2½ percentage points (or more) if they are to be applied to today's definitions. With the entire European Union (EU) having been mandated to adopt ESA-2010 this autumn, the consequences of the new accounting practices are not just a British concern. Indeed, it was the result of earlier changes to the estimated size of GDP throughout Europe that led the EU to demand an extra £1.7bn from the UK, and reduced contributions from Germany and France, enraging Mr Cameron in the process. However, this impost appears to have been triggered by the revised measurement conventions introduced last year, which raised Britain's money GDP and cut the measured government spending and tax burdens by some ¾%. Unfortunately, this year's £100bn plus upgrading of UK national output will probably generate a further £1¾bn EU demand in late 2015.

Adverse Continental background constrains UK economy

As far as the 4th December Bank Rate decision is specifically concerned, the news content of recent data releases suggests that there is little need to change previous judgements, irrespective of whether one is a holder or a hiker. The purely domestic indicators suggest a reasonably well entrenched recovery, albeit one that may be losing a bit of momentum. However, the outlook for the Eurozone core appears to be deteriorating, most worryingly in Germany. Nevertheless, there are indications that the harsh fiscal measures imposed on the peripheral Eurozone members as a pre-condition for German backing are now bringing their returns in the form of an improved performance. This improvement in Spain, Ireland and even Greece is consistent with the

fiscal stabilisation literature, even if that might seem paradoxical to unreconstructed British Keynesians. The unfortunate irony is that Germany itself has been backtracking on the earlier Schroeder reforms, as a result of the coalition bargaining between Angela Merkel and the SPD. However, the recent fall in the price of a barrel of Brent Crude oil to US\$ 79.7 on 24th November, compared with the US\$108.1 averaged in November 2013, and the more modest 3.5% drop in The Economist's US\$ index of non-oil commodity prices over the past year, should prove both dis-inflationary and expansionary in an analogous way to a cut in indirect taxes. This development might cause the strength of the world economy to surprise on the upside in the second half of 2015. Unfortunately for Mr Osborne, this potential boost would probably occur too late to benefit the Conservatives electorally.

**Lowered inflation has
offsetting monetary
effects**

There seems to be little in recent UK broad money indicators to suggest that there is a serious monetary reason not to raise rates. The annual increase in the M4ex broad money supply was a respectable 3.9% in the year to September, although underlying credit growth was somewhat lower, at 0.7%. The recent easing in annual UK consumer price inflation to 1.3% in October – the uptick from 1.2% in September was probably a random wobble – has had two distinct monetary effects. First, it has raised the real short-term rate of interest, boosting the demand for interest-bearing broad money. Second, it means that, at any given rate of nominal broad money growth, the expansion in the supply of real broad money balances has accelerated. This combination of countervailing monetary forces helps to explain the conjunction of a relatively strong pound – sterling is sensitive to the real interest differential in favour of the pound compared to other countries – and strong private home demand where the real balance effect may be the stronger of the two. The acceleration in the annual rate of house price increase, on the ONS measure, from 11.7% in August to 12.1% in September confirms that the overall monetary stance is expansionary, as has the 4.3% rise in the volume of retail sales in the year to October.

**Political uncertainties
dominate the short-term
outlook**

An increasingly important monetary consideration is that the 2015 general election date is now well inside the lag period between the announcement of a Bank Rate change and the effect of the change working through to the wider economy. This would not matter if the putative policies likely to be implemented by the various political groupings after next May were similar. The range of possible outcomes could then be conceived of as following a broadly normal distribution. However, the acute policy divergences between the different political parties, the probability of a hung Parliament, and the possibility of bizarre multi-party coalitions emerging subsequently, suggest that the ex-ante probability distribution of possible scenarios after the election looks more like the Bernese Oberland. As a result, it is impossible for today's rate setters to pursue a monetary course that would be appropriate for the range of different political and economic circumstances that might prevail by the time their decisions take effect on the wider economy. The Bank of England has already stated that the post-election rate announcement will be postponed from the preceding Thursday until Monday 11th May. However, whether a new

government will have been formed by then seems debatable given the strong likelihood of a hung Parliament. On balance, and without any strong conviction, a modest $\frac{1}{4}\%$ rate Bank Rate increase in December still seems better than a further hold, even if 'no change' seems the almost certain outcome.

Comment by Peter Warburton

(Economic Perspectives)

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

Bias: To raise Bank Rate in stages to 2%

The 0.5% Bank Rate taboo should be broken

The Monetary Policy Committee is in danger of missing its best opportunity to break the 0.5% Bank Rate taboo. Annual growth of the services sector, representing 78.4% of the whole economy, reached 3.4% in September 2014. For business services and finance, the annual growth was 4.6%, for distribution, hotels and restaurants, 4.2%, and for transport, storage and communication, 4.1%. Surely, there can be no better time to test out the hypothesis that a small rate increase will destroy confidence and bring the recovery to a grinding halt. Once tested and refuted, then the UK can make further tentative steps towards rate normalisation.

Sterling is slipping

Sterling has slipped from US\$1.71 in July to US\$1.563 in late-November, signalling that foreign capital is getting a little bored by the MPC's failure to act in the face of overwhelming economic provocation. Observable holdings of gilts by the overseas sector have stagnated in the past 12 months.

The opportunity to raise rates might not last much longer

The prevailing GDP growth rate of 3% is well above any estimate of medium-term sustainability. How long can the good news last before gravity takes hold? The fall in the quarterly growth rate for Q3, to 0.7%, may signal that the process is already underway, but more evidence is required to confirm the validity of that judgement. While the UK's non-financial sector credit impulse remains positive, much rests on the take-up of credit in the housing context. With the advent of the Mortgage Market Review and the Financial Policy Committee, the expansion of mortgage credit will remain subdued. Furthermore, the Help to Buy and Funding for Lending schemes that played a significant role in releasing household credit constraints are likely to be curtailed. FLS has already had its wings clipped.

The MPC got unemployment wrong and may similarly be overly pessimistic about the first rate rise

The Monetary Policy Committee has been surprised and embarrassed by the explosive growth of employment over the past 18 months: unemployment has fallen by more than half a million in the past year, equivalent to the adult population of Cornwall. A 7-2 split on the MPC does not necessarily bring a Bank Rate increase any closer, but it proves at least that there is now a healthy debate around tightening. While it is possible that breaking the taboo could provoke irrational fears and damage consumer confidence, we will never know for sure until we try. My conviction is that the initial stages of rate normalisation would have very mild effects on activity and employment.

The longer the first rise is delayed, the worse the damage will be

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 Mike Wickens

(University of York, Cardiff Business School)

Vote: Raise Bank Rate by ¼% and decrease QE to £250bn

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

Inflation is expected to rise and monetary policy acts with a lag

The markets do not expect the MPC to change interest rates next month and the MPC aims not to disappoint the markets. It would therefore be surprising if rates were raised. Nonetheless, the case for a small increase remains, as it has for several months. This is based on the widespread judgement - shared by the MPC - that growth, and hence inflation and wages in the UK, are expected to increase over the next two years, and on the arguments of an earlier incarnation of the MPC that the evidence showed that it takes between eighteen and twenty four months for changes in interest rates to have an effect.

There is Eurozone-related risk aversion but that is not justified by UK fundamentals

The main factors that appear to be currently influencing the MPC are falling market bond yields, a continued weakening of output in the Eurozone countries and a fall in inflation. The yields are interpreted as reflecting a portfolio shift from riskier assets which have resulted in market expectations of lower interest rates. Given that UK consumption and investment demand are still growing above trend, it is not clear that such greater risk aversion is justified by fundamentals. The recent temporary blip in stock prices may have had a part to play by undermining confidence.

There is a threat from Eurozone weakness but the US is growing strongly

The weakness of the Eurozone is a genuine threat to the UK economy as it is such a large market for UK exports. The MPC says that this weakness is reflected in the lower external demand than it anticipated. In contrast, the US, a dominant force in world economic activity and hence of trade outside the Eurozone, has continued to grow strongly.

Productivity is a puzzle but the balance of evidence suggests spare capacity is now limited

Much has been said about the supply side of the UK economy which remains a puzzle to many: whilst employment continues to grow and unemployment to fall, productivity and wages have been flat. This has been interpreted as indicating continuing spare capacity in the economy and the lessening of price pressures. The most likely explanation is that there has been a fall in the capital-labour ratio brought about by a long period (until recently) of low investment expenditures and by rapid growth in the labour supply due to high (and rising) immigration. The recent increase in investment, which reflects growing confidence in future demand, suggests that the economy no longer

has much spare capacity. It also suggests that wages, and hence prices, may start to rise before long.

Interest rates should rise now to combat future inflations

Most, but not all of the signs, therefore, indicate a future rise in inflation and the need to anticipate this by starting to raise interest rates sooner rather than later. As the signs are not all one way, the MPC continue to have a difficult decision. This is not helped by the pressure not to raise rates before the coming election. The MPC should not just emphasise the negatives on inflation but, given the publicly announced expectation by several members, including the Governor, of having to raise rates before long, it should reflect more on the time lags in the effects of policy.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking, University of Derby)

Vote: Hold; no change in QE

Bias: Neutral

There is no sign of incipient inflation

Looking that the economic data released in November, the MC should leave rates on hold. If capacity pressures were building, and incipient inflation pressure forming as a result, we should be seeing it by now. But we are not. The reason we are not seeing such signs, in my view, is because, even on a 2 year horizon, it is not happening. Although consumer price inflation rose to 1.3% year-on-year in October from 1.2% in September, that is still well below the 2% target. Core inflation (CPI ex food and energy), also ticked up in October, to 1.6% from 1.5%. Producer input price inflation, however, fell 8.4% in the year to October, accelerating from a 7.4% decline in September. Producer output prices dropped 0.5% in the month from 0.4% in September; a clear signal that price pressure remains downward. Shop prices, measured by the British Retail Consortium (BRC), fell by 1.9% in the year to October from 1.9% in the preceding month, supporting this bias. House price inflation continued to ease back slowly, with the Halifax's three month year over rate down from 9.6% in September to 8.8% in October.

Wage growth is also weak

As for wage inflation, there was a lot of commentary around the fact that the 3 month rise in average weekly earnings over the same period of the year before picked up to 1.3% in September from 0.9% in August, 0.1% above the inflation rate for the CPI in the same month. Less was said of the fact that if bonuses are included - surely the right measure - the same month showed an annual rise of 1% in pay; admittedly up from 0.8% in August, but 0.2% below the equivalent CPI rate in September..

Underlying wage data show no indication of an inflationary pay cycle

Meanwhile, the unemployment rate stayed at 6% on the ILO basis and 2.8% on the claimant count measure. The pace of employment gains appears to be easing, albeit with employment growth in the three months to September at 112, 000 versus an abnormally low 46,000 in the previous three months. The claims count fall in unemployment was almost steady at 20,400 in October

against a drop of 18,600 in September. The point about the labour market data is that they do not look like we are on the verge of an inflationary cycle for pay. Indeed, the latest data from the Annual Survey of Hours and Earnings (ASHE) from the ONS, showed that, adjusted for inflation, real weekly earnings were 1.6% below their level in 2013. According to the Labour Force Survey (based on a different sample and more upwardly biased), since then nominal weekly earnings were £482 in the 3 months to March, £481 in the 3 months to June and £481 in the 3 months to September.

Output growth is solid but losing momentum

Industrial production recorded a 1.5% annual rate in September from a 2.5% pace in August. Manufacturing had a 2.9% annual increase in October versus a 3.9% pace in the prior month. The services PMI was 56.2 in October from 58.7 in September; the manufacturing PMI was up from 51.6 to 53.2; the construction PMI was 61.4 against 64.21, leaving the composite index lower in the month. This is consistent with an easing of capacity pressure not an increase. Third estimates of GDP showed left the Q3 rise at 0.7% and the annual rate at 3%. The detail showed that business investment in the quarter fell by 0.7%, following a rise of 3.3% in Q2. However, the annual rate was still a solid 6.3% pace in Q3, though down from 11% in Q2. Too much can be read into the figures as even quarterly data can be volatile and figures for Q2 were unsustainably strong - some unwind was to be expected. The overall investment number was still a solid 1%, only slightly down from 1.3% in Q2. What the data do suggest is that achieving a sustained rise in productivity remains a very difficult task for the UK.

Bank rate should stay on hold

The wider picture is that global growth is maintaining its pace, notwithstanding worries about Europe, little changed from the previous quarter. Money supply growth was 3.5% on the ex IOFCs, three month year over basis in September but the headline monthly rate was down by 0.7% and the year over rate was minus 2.5%. The pace of money is not accelerating, suggesting a lessening of momentum in the wider economy and a weakening of inflation pressure. Alongside a lower oil price (with further falls likely), no signs of wage inflation, omens from the UK's recent fiscal data that a tight stance can be expected in the next Parliament, continued global uncertainties and still leveraged balance sheets; Bank rate should remain on hold and the Asset Purchase Facility at £375bn in December..

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. Two voted for an immediate rise of $\frac{1}{2}\%$ but four 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 January 4th 2015

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.



Institute of
Economic Affairs

**Institute of Economic Affairs
2 Lord North Street
London
SW1P 3LB
www.iea.org.uk**