IEA Shadow Monetary Policy Committee

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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

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Shadow Monetary Policy Committee votes five/four to raise Bank Rate in January

In its email poll closing Thursday 2nd January, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) recommended **by five votes to four** that Bank Rate should be raised on January 8th, including four votes for a rise of ½% and one for a rise of ¼%.

Those advocating a rise contended that current low inflation is the result of one-off factors (such as oil price falls) that do not change the basic story of an opportunity to normalise rates in a healthier economy.

Those that preferred to keep rates on hold noted that inflation is well below target, monetary growth is low and some contended that the real debate should be whether policy might be loosened further in the months ahead, with one suggesting he might soon favour the resumption of QE.

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 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

Below-target CPI should not deter a rate rise

CPI inflation is considerably below target. However, it is likely that the fall will level out and reverse in the forecast period. We should not be worried that inflation is currently below target: it is important not to treat the target as a floor.

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

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.

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

I would therefore raise interest rates, starting now, with an increase of ½%. 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 rates
Bias: Add more QE if required

Bank regulation has limited monetary growth since 2008

A dominant theme in the monetary situation since 2008 is that the tightening of bank regulation has prevented banks from growing their risk assets (or even to some extent obliged them to reduce such assets), leading to very low increases in the quantity of money growth (or even stagnation/contraction of money). The low money growth/stagnation of money has in turn been accompanied by the lowest increases in nominal GDP since the 1930s, confirming the validity of the monetary theory of national income determination. The pattern has been found across the G7 group of industrial nations, although mercifully it has been less evident in those G20 nations that do not belong to the traditional G7. (The non-G7 countries can happily "do their own thing" in many policy areas, regardless of the latest follies and inanities from the world's international bureaucracies. UK officialdom has been a champion of the tightening of bank regulation, apparently oblivious to the wider consequences of their actions in holding back recovery.)

Excessively tight capital and liquidity requirements have been offset by loose monetary policy

Nevertheless, policy-makers have offset the contractionary and disinflationary effects of the low money growth/money stagnation by large-scale central bank asset purchases. Such purchases have boosted banks' safe assets (i.e., their cash reserves in particular) and, when made from non-banks, have directly added to the quantity of money. Without these purchases, which have gone by the name "quantitative easing", the disinflationary pressures would have been more intense.

Recent agreements on prudential regulation may lead to deflation

Eurozone members will undoubtedly experience deflation in early 2015, and it is plausible that both the UK and the USA will also experience 12-month declines in consumer price indices, if not to the same degree as in the Eurozone. It might be expected that officialdom could at last put two and two together, and realize that the tightening of bank regulation and banks' consequent restrictive attitude towards risk assets are the basic causes of the weakness in money growth and the prolonged macroeconomic malaise. But, no, at the Brisbane G20 meeting Mark Carney, governor of the Bank of England and chairman of the Financial Standards Board, secured agreement for further substantial rises in capital/asset ratios for banks that are deemed to be systemically important (i.e., "too big", in the sense understood by the phrase "too big to fail"). According to the FSB's new prescription (to which the banks must respond by early February), the next five years are to see the rises in the capital/asset ratios take effect.

There is the prospect of five more years of monetary stagnation

I am not a banker and I may have misunderstood something. But my verdict is that – unless officialdom can be somehow alerted to the ineptness of its own actions and made to rethink – the prospect is for another five years of weak money growth/money stagnation. True enough, Japan has embarked on aggressive QE and other countries may go down that route, as and when macro conditions deteriorate. True also, in 2014 US banks did expand their risk assets (i.e., loans and non-government securities) and broad money growth ran at an acceptable 4% - 5% annual rate. But the impression I have is that US banks are only now appreciating the threat posed by the latest FSB proposals. (Or perhaps smaller banks are making hay, while the big banks suffer more under the regulatory cosh. I don't know.)

UK monetary growth continues to be too weak, rescued only by low inflation

Let me now focus more specifically on the UK. In the three months to November M4x rose by 0.5% (i.e., at an annualized rate of 2.0%), while banks' loans (excluding loans to intermediate other financial corporations) dropped slightly. (In fact, this concept of lending – to be precise, "M4 lending excluding intermediate OFCs" – is at present little changed from two years ago.) Obviously, if this rate of money growth continues and prices fall by, say, 1%, real money balances rise at an annual rate of 3%, which is not out of line with the economy's trend rate of growth. (The Pigou effect to the rescue, as some of us – not many of us, sadly – might say.) However, I am worried about the FSB's proposals. I am in favour of no change in interest rates and my bias is to be prepared to resume QE if macro conditions disappoint in 2015.

Comment by Jamie Dannhauser

(Ruffer)
Vote: No change
Bias: No bias
One year view: Bank Rate at 0.75%; QE unchanged

International events are the main news

In terms of the monetary policy backdrop, there have been two developments of note over the last month. The first is the continuing slump in crude oil prices; the second is the failure of the incumbent Greek administration to install its preferred presidential candidate, a turn-of-events that automatically precipitates an early general election.

The Greek elections increase the rise of the Eurozone crisis returning

The political dangers emanating from Greece should not be underestimated. Syriza, the hard-line left-wing party led by Alex Tsipras, is 3-4 percentage points ahead in the polls. It remains favourite to come out of the end-January election as the largest party, although there is considerable uncertainty as to how far it will be able to pursue its radical agenda. The leadership has toned down its inflammatory rhetoric in recent months. Nonetheless, Mr Tsipras' party remains committed to a series of policy steps that are unacceptable to the Troika. A win for Syriza at the end of the month has the potential to re-ignite market concerns about the viability of some peripheral countries' continuing membership of EMU. While an announcement of additional monetary easing from the ECB is expected soon, this may be insufficient to contain the fall-out from a Syriza win. Downside risks to demand in Britain's largest export market have clearly increased.

Falling oil prices will bear down upon inflation

How monetary policy should respond to the collapsing oil price is less clear cut. The direct effect of lower petrol prices is set to push headline inflation well below 1% in coming months. By the end of the November, pump petrol prices had fallen 7½% from their July peak. Given moves in Brent crude prices in recent weeks (to £36 per barrel from £53 at the end of October), petrol prices could drop by another 10%. This alone will take another 30 basis points off the headline inflation rate (which registered 1% in November). Indirect effects through domestic utility bills and other energy-intensive items in the CPI basket will also bear down on headline inflation.

Falling oil prices are probably mainly an economic stimulus

But to the extent that the reduction in crude oil prices reflects an exogenous 'supply' shock in the oil market, rather than a hit to (actual or expected) global demand, it is likely to be supportive for real private sector spending. Because the UK is a producer of oil and gas, it will benefit less than countries without a domestic energy sector. Nonetheless, the stimulus provided by such a massive decline in crude prices should not be underestimated.

Current below-target should be "seen through" as temporary

The MPC has so far been minded to 'look through' the collapse in oil prices, stressing the beneficial effects for the real economy alongside the drop in headline inflation. This is the correct approach. The one-off drop in price level only matters for a forward-looking inflation-targeting central bank to the extent it either alters the balance between demand and potential output or expectations of future inflation. There has been some suggestion that the zero lower bound on short-term nominal policy rates creates an asymmetry in the optimal policy response, i.e. that there is a risk is not responding to a one-off drop in price level now because of a lack of monetary ammunition tomorrow, if inflation expectations do get dragged downwards. But since additional monetary stimulus can be imparted via central bank asset purchases (and a range of other tools) it is not obvious why this asymmetry exists in practice.

Recent events do not justify further easing

Inflation expectations should be monitored more closely than usual during the coming months; but at this stage monetary policy should be at least as attentive to the growth-enhancing effects of the oil shock as it is towards the inflation-depressing effects. Risks of another Eurozone panic should not be dismissed but for now should not alter the monetary policy stance. With underlying inflation (across a range of measures) still low, the case for considerable monetary accommodation remains. Recent developments do not justify an easing of policy from here though. Indeed, given the economy's current trajectory, some withdrawal of stimulus should be justified by year-end.

Comment by Anthony J Evans

(ESCP Europe Business School)
Vote: Raise rates by ½%
Bias: To raise

With below-target inflation the natural window of opportunity for rate rises has been missed

Although below target rates of inflation can have a positive impact on household's finances and on the wider economy, they present a dilemma for policy makers in the current situation. Regrettably, it seems that ultra low interest rates have become so embedded that normalisation will only occur once the economy is obviously overheating. This has meant that a lengthy window of opportunity to make moderate rate rises has been squandered. Now that inflation has fallen to a 1% growth rate the rationale for rate rises becomes somewhat incoherent. But this may say more about the inflation-targeting regime in which we live than the correct outlook for policy.

Economic statistics suggest the economy no longer requires emergency monetary policy

The UK economy continues to grow at a strong rate. In the third quarter of 2014 NGDP rose by 4.7% compared to 2013, and we have experienced above 1% quarter on quarter growth rates for over a year. The Divisia monetary aggregates show strong growth and in October the broad money supply growth rate slowed, (compared to September), but remained above 3%. These all support the notion that the economy no longer requires emergency monetary policy.

International events might justify easing but their risk does not justify not tightening

There are some important threats that can be used as excuses for procrastination, such as a Russian currency crisis and a particularly delicate Greek election. But these are part of prevailing issues namely Russian geopolitical activities and the Eurozone sovereign debt crisis. If we are waiting for them to be resolved before raising interest rates, they will be permanently low. If those situations deteriorate such that growth expectations fall, then monetary policy should be eased. But it shouldn't remain loose just in case.

Current low inflation is a boon not a threat

I have no qualms about low inflation, or even deflation, provided nominal income isn't falling. Indeed it is important to consider why this particular inflation rate is low. It could be as a result of low aggregate demand, or it could be the result of a positive supply shock. Events in the oil market imply that it is the latter, in which case constrained inflation is a beneficial side effect of a productivity gain.

If inflation falls below 1% rate rises should be delayed but not yet…

Having said this, interest rates decisions are made within an inflation-targeting regime and this rests on credibility and communication. Whilst I believe that NGDP growth and monetary aggregates are a better gauge of the monetary stance than CPI, the interest rate decision is intended to be driven by the latter. Given that inflation expectations remain above target, I believe that there is no necessity to loosen policy. If CPI falls below 1% then any attempt to raise interest rates should be put on hold. I am also open to more QE should the economy falter in 2015. However I still believe that the balance of risks implies that greater harm is coming from low interest rates, and that the economy is strong enough to cope with a moderate rise.

Comment by Andrew Lilico

(Europe Economics, IEA)
Vote: Hold
Bias: Hold

Money and lending growth is low and easing

Broad money growth (on the Bank of England's preferred M4ex measure) fell back again to 2.9% in the year to November 2014 and lending growth (M4Lx) was just 0.5% — with the apparent spike of a few months ago now exposed decisively as a blip. The lack of any acceleration in money or lending growth despite rapid economic growth and the huge expansion in the monetary base since 2007 continues to represent (alongside the performance of the labour market) one of the two great economic mysteries of our age. Very tight capital and liquidity requirements must be a contributing factor, but that simply pushes the mystery out one stage — why do the regulatory authorities believe that setting capital and liquidity requirements excessively tight whilst keeping interest rates artificially low is a desirable policy? Calling this combination "financial repression" is just giving a mystery (or an error) a name.

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

Whatever the rationale, financial repression is, at least for now, proving a success in its own terms. Savers are under-remunerated; new capital projects are starved of opportunity; underlying supply growth is restricted — and yet, unemployment falls without any apparent pressure on nominal wages; GDP growth (buoyed by the rise in the labour force) continues apace; and with oil prices dropping like a stone and monetary growth nugatory, inflation is now well below target.

We've made this monetary bed; now we shall lie in it

I continue to believe that it would have been better to edge up interest rates in 2011 when UK financial conditions stabilised, or failing that to edge them up from mid 2012 when growth resumed, or failing that to raise them in 2013 when strong growth became established. We shall never now know how holding rates at, say, 1.5% (as I would have liked) for three or four years would have worked relative to holding rates at 0.5% for six or more years. But having come this far, I am now inclined to play the game out to its (sadly, probably bitter) end. If we would not raise rates when inflation was 5%, how shall we raise them when inflation is below 1%? If we would not raise rates when GDP growth was 3% and the Eurozone crisis in abeyance, how shall we raise them when GDP growth is slowing and the Eurozone/Greek crisis back with a vengeance? Alas, having come this far I now fear we must keep rates on hold until inflation rises or some other factor forces our hand. I surrender. My vote is now to hold.

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

The consensus on monetary policy remains cautious

Many in the monetary policy community of the UK are still cautious about raising interest rates and withdrawing QE stimulus. Their reasons are a mixture of traditional fear that so soon after recession the economy will 'slip back' into recession and worries about the pace of money/credit growth which are still weak.

There is little risk of slipping back into recession

The first of these we can dismiss as quite inappropriate and indeed traditional: it is due to the dominance of recent memory but we know from a lot of evidence that recoveries do not generally 'slip back'. We are now several years into recovery and over a year since we passed the original peak. During this early recovery period there was no slipping back, in spite of scares about 'double' and even 'triple' dips into recession. By now with growth close to 3% the chances of slipping back have disappeared entirely. Remarks by Mr. Cameron about 'red lights flashing' around the world are also wide of the mark, and presumably designed for political effect; world growth is in the 3-4% region, quite typical for this stage of a recovery and fairly healthy in the context of rather recent commodity shortages. Also we would argue that in the next decade the world's economies should avoid the sort of credit boom that occurred in the 2000s and pushed world growth regularly above 5%.

Mainstream lending growth is low because of regulation

The second set of concerns about money and credit growth are less easily dismissed. It is clear that banks in the UK are still prevented from expanding their balance sheets strongly by regulation as well possibly as internal reorganisation to prevent future meltdowns. In particular small businesses are largely frozen out of bank credit by the new regulations that heavily penalise risk, even though socially such risks are classically diversifiable. Nevertheless it is also clear that QE has driven down yields on government debt and on equities to loss levels where investors are hunting decent returns elsewhere. This has opened up new channels of lending in the form of wealth management groups or trusts and peer-to-peer lending. Statistics on these new channels are naturally hard to come by, but indicators from individual firms operating in these markets suggest rapid, even explosive, growth. Furthermore retained profits of larger corporations are swollen by recovery and the slow expansion of investment. Thus some of the lack of credit growth (viz to these larger firms) is demand-led. In short we have a situation of growing 'shadow banking'; this is a healthy response to the flat feet of the new bank regulators.

Lending growth is finding new channels and adding further monetary stimulus is unwise

So my judgement on this second set of worries is to point to these new channels through which monetary ease is flowing and to raise the alarm. I think that to go on pouring monetary stimulus into the economy when there is this evidence of natural substitution with recorded credit and money is unwise. It could well as in the past lead to excesses that are only recognised well after the event. It seems extraordinary that so long into our palpable recovery interest rates on safe assets are negligible. This is causing a devil-may-care attitude among investors which is dangerous and unhealthy. It goes against the precept we have gleaned from our research into past crises of the last 150 years: that what is needed is an old-fashioned monetary policy of keeping monetary conditions from either being too cool or too hot: 'taking away the punch bowl when the part is getting merry' and vice versa. Sadly in sophisticated modern economies there is no foolproof statistic on which we can hang our hats. Monetary policy remains an art of interpretation in such a slippery environment. While the defenders of zero rates are honest in attaching themselves to monetary statistics, we thus point to the reality of substitution which has regularly occurred for these in the past decades.

The UK outlook is good

The UK outlook is good. With the contraction of high productivity sectors, including North Sea oil and banking, there is a productivity challenge. A good response by UK policymakers would be to restore a fair tax environment for the North Sea which has been bedevilled by Treasury opportunism- sad considering that the same Treasury has argued so robustly for low marginal tax rates generally; and to roll back some of the more deformative regulation on banks, one of our most profitable industries for all its recent lapses. The productivity problem seems to be partly mis-measurement by the ONS, now gradually being corrected, and partly this one-off adjustment due to these sectors' falling off; in fact productivity growth in other sectors seems to be continuing at its usual slowish rate.

Some comments on inflation

Let me end by commenting on the inflation environment. The fact is that since inflation targeting got under way in 1992 UK domestically-generated inflation has been close to the target rate of 2%. This can be put down to the massive credibility produced by the new institutions, contrary to general expectations that inflation would continue to be volatile and hard to control. What inflation we have had above and below the 2% rate can be seen now to have been due to external inflation rates, mostly from commodities, that the Bank refused to respond to. This remains true today when commodity prices are declining rapidly. What we have discovered from the inflation evidence of the past two decades is that inflation is a poor guide for monetary policy. This yet again illustrates the Lucas critique, echoed in Goodhart's Law, that once you shift the policy basis and in particular target an aggregate, its behaviour changes and can cause you to miss your true policy targets.

There should be some normalisation of monetary policy

Hence in conclusion I would argue that monetary policy now needs to be returned to normality for reasons of basic monetary prudence; growth is strong and the punch bowl should be slowly withdrawn. Interest rates should go up in regular small steps from now on; and QE should be gradually reversed to restore the Bank's balance sheet to a state where it is no longer the main holder of the government's bonds but instead merely a residual holder for reasons of open market operations.

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 few months.
1 Year View: Depends on election outcome; on no-policy change assumption, raise Bank Rate to 1½% by late 2015.

Pre-Christmas data revisions have already invalidated the Autumn Statement forecasts

It is unusual for an important policy event such as the Autumn Statement, the accompanying forecasts from the Office for Budget Responsibility (OBR), and the government's main political pitch as the 'growth-master' of the G7 leading economies to be sandbagged within twenty days by data revisions from the Office for National Statistics (ONS). However, this happened on 23rd December, when the ONS announced an armada of revisions to the national accounts data published on 26th November, which had formed the base for the OBR's projections. These revisions were particularly infuriating because they closely followed the official move to the ESA-2010 system of national accounts on 30th September, which had itself represented the greatest data upheaval in a generation. The 23rd December revisions to UK GDP generally extended back to 2013 Q1. However, there have been additional revisions to the general government accounts from 2003 Q2 onwards, mainly as the result of a less tendentious treatment of tax credits, plus some noticeable adverse revisions to the post 2013 Q1 figures for the balance of payments.

UK Growth was probably only 2½% last year, rather than the widely expected 3%

In the light of the new data, it now looks as if the market-price measure of real GDP expanded by only some 2½% on average last year, rather than the 3% or slightly above that most people were expecting based on the 26th November data. The relative growth pattern between 2014 and 2015 has also altered. In particular, 2015 now looks as if it could enjoy a slightly faster expansion than 2014. Previously, the consensus view was that growth would decelerate by ½ a percentage point or so between the two years. It also looks as if the prospective balance of payments outcome for 2014, together with the prospects for subsequent years, has worsened. This outlook adds to pre-existing concerns about the UK's twin deficits; particularly, as these deficits are likely to stretch ahead indefinitely and will need to be plugged by borrowing on the international capital markets. This is potentially dangerous given the political risk now attached to investing in Britain. There would be no need for any active capital flight to cause a route in UK government bond and sterling, simply a cessation of new inflows on the scale that has been observed until now.

Summary of BEF New Year Forecasts

At the time of writing, it is not possible to know how other economic forecasting organisations have responded to the rush of pre-Christmas data releases. However, the consensus forecast could shift noticeably once the revised data have been digested and the various January forecast comparisons have been published. The revised data have been run through the Beacon Economic Forecasting (BEF) macroeconomic with the following results. Firstly, economic growth is now expected to accelerate from last year's 2.6% to 2.9% this year before slowing to 1.8% in 2016 and fluctuating in the 1¾% to 2% range up to 2025 (when the BEF forecast horizon ends). Second, the latest monthly data show that the annual increase in the officially preferred Consumer Price Index (CPI) had slowed to 1% in November. CPI inflation is expected to reach a trough of 0.6% in 2015 Q1, and end the year at 0.9%, before rising to 1.7% in 2016 Q4 and 1.8% in 2017 Q4. Our longer-term projections show CPI inflation fluctuating between 1½% and just over 2% thereafter. These predictions assume that the price of a barrel of Brent crude averages US$70 next year, compared with US$57.9 on 29th December, before rising by US$1.5 in each subsequent year. All macroeconomic forecasters tend to agree that predicting the price of oil is impossible. These numbers are simply a reasonably bland forecasting assumption. Numerous aspects of the forecast would shift if different assumptions for the future price of oil were employed.

The UK's stubborn twin deficits problem

Third, while the outlooks for growth and inflation look reasonable, the prospects for Britain's 'evil' twin deficits look anything but, even on the assumption that present policies survive the May election. Where the first evil twin is concerned, the latest BEF projections indicate that the current account payments deficit was some £96.3bn in 2014 (it was £73.8bn in the first three quarters alone). The current account gap is expected to ease temporarily, to £86.3bn in 2015, but deteriorate to £94.2bn in 2016 and £100.8bn in 2017. Where the other evil twin is concerned, the latest BEF projections show Public Sector Net Borrowing (PSNB) of £93.4bn in 2014-15, being followed by deficits of £85.3bn in 2015-16, £78.5bn in 2016-17 and £73.9bn in 2017-18. This is much slower progress than Mr Osborne predicted in his 3rd December statement. However, even the BEF projections assume a tight spending control by historic standards. This assumption of parsimony could clearly be invalidated by a change of government. A final fiscal comment is that an 'urban myth' appears to have developed that Mr Osborne's spending plans represent 'a return to the 1930s'. A rebuttal was published on the Politeia website (www.politeia.co.uk/) immediately before Christmas for anyone who wants to investigate these issues further.

Political uncertainties weigh heavily on the rate decision

As far as the outlook for the financial markets is concerned, any attempt at projection is likely to be undermined by the political uncertainties. As with the price of oil, a more thorough analysis would require running several distinct scenarios, which would require far more space than is available here. Our no-policy change projections suggest that the sterling index could strengthen slightly over the next few years – this is essentially because the relatively large fall in domestic inflation has raised the real interest differential in favour of the pound – and that Bank Rate should end 2015 at around ¾%. Presumably, the return to power of the Conservatives or a renewal of the present Coalition would be accompanied by a relief rally in sterling, equities and the gilt-edged market and the unleashing of capital investment plans put on hold because of the political uncertainties. This could confront the Monetary Policy Committee (MPC) with a reverse 'stagflation' situation in which the pound was strong and inflation weak while home demand was threatening to boil over. A Labour government, or a Labour dominated coalition, would presumably have the opposite consequences, forcing the MPC to choose between the inflationary effects of a weak pound and a desire to stabilise the domestic bond market and equities.

Slowing broad monetary growth a possible dovish indicator

In the past, financial markets have often proved astute at anticipating political developments with the result that market prices have discounted the electoral outcome before the event. However, the recent emergence of multi-party politics in Britain means that few political experts have much feel for the prospective election result at present. Where the MPC is concerned, the main problem now is that the election is well within the lag between cause and effect where rate setting is involved. It would require a miracle for the Bank Rate set on 8th January to be appropriate to the economic conditions that will be prevailing after the election. One specific cause for caution has been the recent slowdown in the yearly growth of the M4ex broad money from 3.8% in September to 3.3% in October (the November data will be released on 2nd January, after this submission has gone to press). On balance, and without any strong conviction, a modest ¼% rate Bank Rate increase in January seems marginally preferable to a further hold, even if 'no change' seems the almost certain outcome, not just this month but throughout most of the first half of 2015.

Comment by Peter Warburton

(Economic Perspectives)
Vote: Raise rates by ½%
Bias: To raise Bank Rate in stages to 2%

The longer interest rates are kept too low the more damage is done

Since the plunge in the crude oil price, economic forecasters have pushed back their views on the timing of the first rate increase towards the end of 2015. It is commonly asserted that there are no costs to leaving UK Bank Rate 'lower for longer'. The longer that this experiment is sustained, the greater is the likelihood that these underestimated costs will be revealed. There are financial stability costs, frictional costs in the money markets, costs relating to the inefficient allocation of borrowed capital and to moral hazard in the household sector.

There are financial stability costs…

Financial stability costs arise when an industrial sector or type of borrower exploits the easy availability of credit to indulge in an over-expansion of productive capacity or final demand. Energy exploration would be an example of an industrial sector and car buyers, an example of the latter. Credit defaults will mount even in a near-zero interest rate climate.

…frictional costs…

Frictional costs arise in the money markets at very low interest rates as liquidity is hoarded rather than lent into the interbank market. There is a gain to economic efficiency when excess money balances are pooled.

…capital allocation costs…

There is empirical evidence to suggest that, although only a minority of small and medium-sized businesses use external finance, the reallocation of credit within the SME sector is stymied in an environment of very low interest rates. It is the pressure of market interest rates that drives capital away from poorly performing businesses towards those with greater dynamism and better prospects.

…and mortgage sustainability costs

The longer that mortgagors enjoy untypically low loan rates, the greater is the risk that they will be incapable of servicing their mortgages when rates eventually normalise. As disposable income is reallocated from mortgage payments to other uses, the harder it will be to reverse the process when the time comes.

Homeowners could cope with a rate rise

The latest NMG Consulting survey on households, conducted on behalf of the Bank of England and published in the Bank's Quarterly Bulletin, confirms that most homeowners could cope with a rate rise. Even their worst case scenario (in which Bank Rate rises immediately by two percentage points and is passed through to households in full), only lifts the proportion of vulnerable mortgagors marginally higher from 1.3% to 2.5% of all households, well below peak levels. Under their alternate scenario, where household income also increases, the share of households with a mortgage debt service ratio above 40% (which has been identified as a trigger point for rising mortgage arrears) remains below its long-run average. Encouragingly, the Bank believes that these estimates may even overstate the true impact of a rate rise since they assume an immediate pass through to both fixed term and variable rate mortgages. In reality, around 50% of mortgagors would avoid the initial impact, thereby slowing the transition into the 'vulnerable' camp. Moreover, the structure of interest rate futures suggests that Bank Rate will reach 2.5% in 2019, five years later than the survey presumes.

Households are adjusting to the new economy

Positively, the proportion of mortgagors experiencing problems in servicing their loans has continued to fall, from 19% in September 2013 to 14% in September 2014. Regardless of this, borrowers have remained cautious, with around a quarter reporting that they had cut spending as a result of concerns about debt. Promisingly, accordingly to the survey, those with higher debt service to income ratios had reduced spending by more, were more inclined to avoid taking on additional debt, and were seeking additional employment. Although this could be interpreted as a reflection of households' incomes already being under pressure, any action in anticipation of rate rises is surely commendable.While there is a great deal of uncertainty around the likely distribution of future household income growth, workers in London and the South of England (where property price to income ratios tend to be most stretched) are currently enjoying faster wage growth than the UK average. This should help to offset the disproportionate downward drag from Bank Rate normalisation that the South is expected to suffer due to its generally higher household debt. All in all, even if the Bank hiked rates by the full two percentage points tomorrow, those most vulnerable to debt delinquency would account for less than 2.5% of all households, equivalent to around 600,000 homes.

The breaking of the 0.5% taboo is long overdue

The Monetary Policy Committee is in danger of missing its best opportunity to break the 0.5% Bank Rate taboo. 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. 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

The UK economy is decelerating and inflationary pressures are diminishing

UK economic conditions continue to suggest, broadly speaking, a slowing economy with diminishing inflation pressure. To be sure, the ease in the pace of economic growth still leaves it at an above trend rate, with no signs at this point that it will drop below this. Even a downward revision to the Q4 annual pace of growth from 3% to 2.6% leaves the UK one of best performing of the major developed economies. But the global headwinds to growth are persisting: stagnation in the Eurozone, recession in Russia, continuing issues in the Middle East and slowdown in China. Together, these indicate that policy should stay loose.

Falling oil prices and weakening global growth mean even lower inflation

If inflation indicators are taken into account, the case for leaving rates on hold is even stronger. Easing commodity prices will add nearly 1% to global GDP in time, but in the short term are lowering price pressures, allowing official monetary policy to stay on hold for longer. This would have been an opportunity to tighten policy if growth was at an above trend pace at the global level but as pointed out, it is not. Instead, the drop in oil prices gives a chance for some economies to get a boost that they badly need and does not warrant tighter policy stances.

Inflation will fall below 1% and stay there for some time

In the UK, price inflation will fall well below 1% in the next few months, and stay there for some time. While wage inflation is above 1% now, we should not get carried away with the risk this entails for inflation in the medium term. For one thing, it is well below the long run average and the real rate is barely positive. In addition, any upside risk to long run inflation is modest as economic growth is moderating to a sub 3% range.

Keep rates on hold

Money and credit trends do not suggest any worrying issues, other than that business in particular continues to repay debt. This suggests a continuing risk to growth from low productivity, albeit medium term. Looking to 2015, the big picture is of UK annual growth settling around 2½%, accompanied by a tighter fiscal stance. This means that financial market bets that official rates will not rise until well into the second half of 2015 at the earliest are not inconsistent with current economic date. With that backdrop, I would leave rates on hold and the APF at £375bn.

Policy response

1. On a vote of five to four, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in January. 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 ½% but one members wanted a more modest rate rise of ¼%. On standard Monetary Policy Committee voting rules, that would imply a rise of ¼% would be carried.

3. All those who voted to raise rates expressed a bias to raise rates further. One of those who voted to hold expressed a bias to resume QE.

Date of next poll

Sunday February 1st 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
2 Lord North Street
London
SW1P 3LB

www.iea.org.uk