IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes seven/two to hold Bank Rate in April

Continuing its recent trend, the Shadow MPC has voted to keep rates on hold in April.

There was a variety of reasons offered for holding. Some members felt the economy remained weak. Others felt that the economy was going well and there was no good reason to change anything. Others argued that it was difficult to justify raising rates when inflation is so far below target. One member felt there should be no change until post-General Election uncertainties are resolved.

Those advocating raising rates maintained their familiar position that rates have been held too low for too long and normalisation is long past warranted.

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 polls will be released on the Sundays of 3rd May and 31st May 2015, respectively.

Votes

Vote by Jamie Dannhauser

(Ruffer)
Vote: HOLD
Bias: To hold
One year view: Bank Rate at 1%; no change in QE

Deflation is upon us

UK headline inflation dropped to zero in February. The price level, as proxied by the seasonally adjusted level of the CPI, has declined in six of the last eight months. It seems likely that the inflation rate will turn negative in the months ahead. No doubt, media hysteria about the onset of 'deflation' in the UK will increase.

Disinflation does not imply a "debt deflation trap" scenario

It is certainly true that the UK has seen broad-based *disinflation* over the last few years. This started prior to the oil price collapse and is evident is a wide range of measures of underlying inflation. It is one of the reasons why I have advocated incredibly easy monetary policy in SMPC submissions and debates. There is scant evidence, however, that the UK economy is suffering from deflation – a sustained period of declines in the price level; and even less that it is trapped in 'debt deflation', a scenario in which the confluence of falling asset prices and overstretched private sector balance sheets creates a self-feeding deflationary spiral that monetary policy can do little to arrest.

Global growth headwinds exist but do not justify further easing in the UK

At a global level, there remain headwinds to growth, not least the still growing overhang of debt on private sector balance sheets. China's credit binge in recent years is even more extreme than most of those seen before the 2007/8 collapse. Political and economic distress may emerge across the euro-area were a political accident to occur in Greece. Nonetheless, the current economic and financial market environment does not warrant an easing of monetary policy in the UK. In fact, I would expect it to be desirable to *increase* Bank Rate at some point over the next year, quite possibly before the year is out.

Deflation driven by supply cost falls should be positive for growth, not negative

The slump in headline inflation rates is predominantly due to the fall in oil prices, a substantial global *relative* price shift that should be a net positive for global growth. The suggestion that this relative price shift represents a *deflationary* impulse is far-fetched. A (supply-driven) oil price drop shifts incomes to countries and sectors where the marginal propensity to spend is likely to be higher. There is an extensive literature suggesting that supply-driven oil shocks (as this seems to be) have a meaningful effect on output, albeit with a lag of a few quarters. I see no reason for this episode to be any different *qualitatively*, even if the overhang of debt in many of the beneficiary countries may reduce somewhat its quantitative impact.

Monetary conditions are improving in the Eurozone

In addition to the growth-enhancing oil price shock, there are also signs of a meaningful easing of credit conditions in the euro area, Britain's main export destination. Monetary growth is being boosted directly by ECB QE; but we must also take account of the rapid and significant increase in access to bank credit that seems to have taken place in those parts of the euro area where credit constraints had previously been most extensive. Lending rates on new bank borrowing across the periphery have fallen sharply in recent months. Anecdotal evidence suggests non-price restrictions on bank credit have eased alongside the decline in loan rates.

US real economy and monetary indicators are promising

In addition to the structural reasons for optimism about US growth, there are also encouraging signs from the monetary data. Growth of both broad money (M2 plus institutional money market fund shares) and bank lending to the private sector, which had been moving sideways in the 5-6% range last year, have accelerated quite clearly since late-'14. A host of other monetary indicators would support the following assertion: at the very least, the US recovery is well-entrenched and there is a decent chance that private sector demand growth picks up as we move through 2015/16.

Monetary policy should look ahead not backwards

UK monetary data, while not indicating an easing of monetary conditions this year, remain consistent with decent domestic demand growth. With a good chance of a cyclical bounce in the UK's two biggest export markets, it is important that monetary policy looks ahead to prospective inflation developments, not backwards to a *relative* price shock that is temporarily pushing down on the headline inflation rate. Nor should policymakers be trying to 'talk down' sterling, as the MPC has recently been doing. Sterling has strengthened on a trade-weighted basis but its move seems eminently justifiable given the cyclical position that the economy is in relative to its trading partners.

Central banks are not out of weapons, despite zero interest rates

It would be wrong to dismiss out of hand concerns that low headline inflation are problematic when the central bank's arsenal has been partly run down. But there is scant evidence that inflation expectations are, or will become, unanchored. Fears that inflation expectations will be pulled down by (briefly) negative headline inflation should turn out to be as unfounded as the concerns expressed a few years ago when CPI inflation was "well above" the 2% target. Moreover, policymakers still have a wide array of unconventional instruments that could be deployed if a sustained period of debt deflation was upon us. It is inappropriate to talk about the asymmetry (in macro policy) of the zero lower bound on short-term policy rates.

The next move in rates should be up, but not yet

There is no case at this stage for additional monetary stimulus in the UK. Indeed, given my base case for growth in the UK's main export markets in coming quarters, and the ongoing robustness of private sector demand at home, the next move in policy should be a withdrawal of stimulus. The appropriate moment may well be later this year.

Vote and Comment by Anthony J Evans

(ESCP Europe)
Vote: HOLD
Bias: Raise once inflation returns to the 1%-3% range

Questions arise about the whole UK monetary policy framework

The recent dramatic undershoot of the inflation target has provided further opportunities to ask some fundamental questions about monetary policy. Firstly, given that 0% CPI has been widely interpreted as good news an obvious question is why do we have a 2% target rather than 0% target? Secondly, if we are supposed to permit such large fluctuations in CPI around the target provided they are supply driven, why not target something – such as nominal income – that allows all supply shocks to show up in the inflation rate? And thirdly, if the downward trend in inflation continues, and policymakers start to fret about deflation, is QE in its present form an appropriate way to conduct monetary policy?

QE has been discretionary and ad hoc

One of the biggest problems with how QE has been enacted is that it's been discretionary and ad hoc. The Bank of England's blasé approach to the inflation target makes it hard to predict the scale (and indeed permanence) of open market operations. Why not ditch the inflation target, and then tie future QE to a clearly communicated explicit nominal income target?

Below-target inflation appears the only excuse for not raising rates

M4ex continues to grow above 3% and Divisia measures remain strong. Real GDP is healthy and so it's only the decision to set a 2% inflation target that is causing attention to switch from raising rates (and a return to normalcy) to further easing. I do not see the necessity for further easing at this stage, but hope that such discussions can take a step back and reassess the whole framework, rather than continue to make modifications to the current one.

Vote and Comment by Graeme Leach

(Legatum Institute)
Vote: HOLD
Bias: Neutral

Economic risks currently run either way

Perusing the economic tealeaves at present is not easy. The spectres of deflation and/or accelerating above trend GDP growth are plausible scenarios. The latest data shows above trend GDP growth of 2.8% in 2014, thereby implying a reduction in the output gap, on the assumption of maximum potential output growth of around 2.25% per annum. However, any inflationary pressure from the narrowing in the output gap has been completely swamped by the offsetting deflationary impact from the fall in oil prices. CPI inflation reached a record low of zero (yr-on-yr) in February and could go negative. Even if the MPC looks through zero inflation or deflation as a 'temporary' phenomenon – and leaves monetary policy unchanged - what is the potential economic fall-out?

Deflation does not necessarily mean depression

In the public mind, deflation and depression are seen to run hand in hand. However, the economic reality is that historically most deflations ran in parallel with economic growth – deflation is not necessarily a recipe for depression. Simultaneous deflation and depression tend to occur when the money supply implodes. The debt deflation scenario is then intensified by nominal wage rigidity - triggering higher unemployment - and a liquidity trap.

Malign vs benign deflation

Deflation can be malign or benign, depending on whether or not it is driven by an improvement in aggregate supply (benign) or a deficiency in aggregate demand (malign). Economic theory suggests that mild deflation is optimal. Examples include the Friedman Rule and Selgin's productivity norm. Economic theory also suggests that deflations in certain circumstances can be very damaging, cf Keynes and Fisher. The positive aspects to deflation include a risk-free, tax-free reward to holding money, equal to the rate of deflation. The negative aspects to deflation include purchase postponement, an increase in the real value of debt and higher real interest rates when nominal rates are limited by the zero bound. The impact of deflation on aggregate demand depends on whether deflation is anticipated or unanticipated. Expected deflation can reduce consumption and investment because of expectations of increasing real interest rates. It can also work by increasing the returns to hoarding money. Unexpected deflation can also reduce aggregate demand via the impact on net worth, with falling asset values.

Monetary growth has been weak but does not yet suggest deflation is damaging growth

Despite the weakness in headline M4 money supply figures (-3.2% yr-on-yr in February), other monetary statistics don't point towards deflation undermining GDP growth. M4ex money supply (the Bank of England's chosen target measure) rose 3.5% (yr-on-yr) in February after 4.2% (yr-on-yr) growth in January. PNFC divisia money growth stood at 13% (yr-on-yr) in March, with household divisia money up 6.2% (yr-on-yr).

The key risks do not come from deflation but from politics and from the ongoing Greek crisis

As yet therefore the deflationary threat in the UK looks mild and indeed is likely to have a positive impact, given the boost to real earnings growth, when set against a background of nominal wage rigidity. The boost to discretionary spending power from weaker oil prices should help maintain GDP growth close to 2.75% in 2015. There is also the possibility of some form of relief rally and boost to business confidence if the Conservatives and/or the Coalition are returned after the General Election. However, the converse could also be the case, if a Labour Government was elected, with expectations of higher taxes, supply-side damage, reduced FDI and weaker growth. The relief rally scenario could push GDP growth above 3% this year. The converse scenario could reduce it below 2.5%. The elephant in the room remains uncertainty in the euro-zone and a potential Greek exit. However, in the absence of any Grexit, euro area growth prospects could yet surprise on the upside, in the wake of quantitative easing.

Vote and Comment by John Greenwood

(Invesco Asset Management)
Vote: HOLD Bank Rate and QE
Bias: Neutral. Be ready to renew QE if the economy weakens significantly, or raise rates in the unlikely event that M4x surges for a sustained period.

The recent growth slowdown suggests the recovery remains vulnerable

The recovery of the British economy slowed slightly from an average of 0.7% quarter-on-quarter (2.8% annualised) in the first three quarters of 2014 to 0.5% (2.2% annualised) in the final quarter of 2014 Q4. Although this would be a respectable growth rate under most circumstances, the fact that this moderation of growth is occurring at a time when the economy is still some distance from its full potential suggests that the recovery is still vulnerable. The weaknesses are both domestic and external. For this reason any precipitate action to raise interest rates or tighten monetary conditions now – which inevitably would affect all sectors -- would likely cause a significant setback.

Many areas of economic weakness or vulnerability remain

For every area of strength in the recovery there appears to be an associated element of weakness or vulnerability. For example, despite big improvements in the labour market, wage growth remains weak. Associated with weak wage growth, there has been an associated shortfall in tax revenues. Also, despite an 18% increase in exports of goods and services since the trough of the recession, the external current account deficit has widened alarmingly. Finally, despite a gradual improvement in the health of the banks, money and credit growth remain disappointingly low. This is the fundamental driver behind the fall in CPI inflation to 0%.

Jobs growth is strong but wage growth is weak

The labour market has improved notably in recent quarters. For example, LFS employment continues to rise, reaching 30.940 million in the three months to January 2015, a rise of 617,000 over the year, or up by almost two million since the recession low. Similarly, unemployment has continued to fall, reaching 5.7% of the labour force in January, or 1.86 million persons, a fall of 479,000 over the year. In spite of these favourable trends, youth unemployment among those aged 18-24, although down from its peak of 20% in November 2011, was still at 14.3% in the three months to January. More generally, wage growth remains anaemic. In the latest data average weekly earnings increased 1.6% (excluding bonuses) year-on-year in the three months to January, and by 1.8% when bonuses are included.

Weak wage growth reflects global trends

The weakness in wage growth for middle and lower income workers is part of a world-wide trend connected with the entry of large emerging economies such as China and India into the global trading system, and cannot be attributed to national UK policies. Although the recent UK wage increases have increased above CPI inflation at current rates, they will need to rise further to ensure sustained real wage growth when inflation picks up again.

Weak wage growth and hence weak tax receipts are a factor in poor fiscal outturns

Associated with the weakness in wage growth, tax revenues from income tax have undershot Coalition expectations, thereby causing the budget deficit to remain wider than expected, and the national debt to remain close to its peak levels. (In the Budget there was a token reduction in the overall level of national debt thanks to the sale of government shares in Lloyds Bank.)

UK trade is vulnerable to poor Eurozone performance

The economy also remains acutely vulnerable to external weakness, especially in the Eurozone, Britain's largest trading partner. In contrast to the United States where the current account has not deteriorated (as a % of GDP) since the start of the current upturn thanks to improvements in competitiveness and the exploitation of shale oil and gas, in the UK both the overall current account and the visible trade deficit are running at record levels. The UK's visible trade balance is running at monthly deficits of £10 billion, while the current account deficit widened to £25.3 billion in the fourth quarter of 2014.

Broad money growth is weak

Finally, broad money and credit growth remain weak – barely enough to sustain current real GDP growth rates plus the targeted 2% inflation rate. This is despite the two government credit promotion schemes ("Funding for Lending" and "Help to Buy"), and near-zero interest rates. M4x, the sum of money balances held by households, non-financial companies and non-bank financial companies excluding certain bank-like intermediaries, is only growing at 4.3% year-on-year, while M4, a wider definition which includes the money balances of all financial companies declined at 3.2% year-on-year in February. On the lending side M4 Lending declined at 3.9% year-on-year in February, with loans to households increasing marginally, but loans to financial and non-financial companies declining.

Nothing in the data suggests a rate rise is necessary to cool off any overheating

Under these conditions there can be no danger of a surge in credit, a surge in growth, or any inflationary outburst. On the contrary, the risks are currently tilted towards slower growth and deflation. It would therefore be unwise to raise interest rates or otherwise tighten monetary conditions. Rate increases at this stage would damage the prospects for economic recovery, and should be delayed until the recovery is substantially more vigorous in both real and nominal terms.

Vote and Comment by Andrew Lilico

(Europe Economics and IEA)
Vote: HOLD
Bias: To wait to raise rates until inflation rises.

The UK's monetary policy credibility has been casually tossed aside as worthless

The Chancellor's welcoming a further fall in inflation to 0% as good news only days after setting a 2% "target" was a further confirmation – if such were needed – that the UK's "inflation target" is no such thing. The Bank of England is not supposed to attempt to get inflation to the level the Chancellor sets. What they are supposed to be doing is very hard to guess, but the UK's monetary policy framework has clearly been largely unbridled discretion for some years. Discretion is not necessarily a bad monetary policy framework for an economy as large as the UK's. But if, at some point in the future, the government or Bank did want to introduce some binding (or at least constraining) monetary policy rule, it is difficult to imagine that it would have any credibility. Since 2007, the monetary policy credibility so sorely won in the 1980s and 1990s has been casually tossed away, as if it were nothing, as if all that "monetary policy credibility" meant was that market participants have about the same forecast for future inflation as the Bank's target. But maybe that was right. Maybe the UK will not need credibility again in the sense of credibility where that means "sticking to your promises even when such sticking is unattractive to do when it comes to it".

Harming savers by keeping interest at zero without an emergency rationale is probably immoral

Treating the UK's monetary policy framework as pure discretion, there is little basis for believing 0% inflation a good reason in itself for keeping interest rates at effectively zero, at the same time retarding monetary growth through excessive prudential requirements, when the economy is growing well and unemployment is down. It is also most unclear how it is morally defensible to keep the returns to savers and pensioners so artificially low without an emergency rationale.

Having failed to raise rates when we ought to have, rate rises now, without something changing, would harm agents relative to their reasonable expectations

But this is a moral battle that advocates of monetary policy normalisation lost long ago. It has been at least four years since there was really any good reason for keeping rates at 0%. In my view, having come this far, we must play the game out to the end. Nothing has made the normalisation argument any stronger for raising rates for more than a year. The economy is adapting to lower interest rates in the reasonable expectation that, unless something changes that would justify a rate rise, there will not be one. Raising rates in this environment would arguably harm economic agents that have made decisions (e.g. taking out mortgages) based upon such reasonable expectations of stability. Accordingly, it is now my view that rates should stay on hold until rising inflation (by which I mean comfortably above-"target" inflation) or, at least, accelerating broad money growth, forces us to raise rates.

Vote and Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate; ½%;
Bias: To raise and QE to be reversed.

The inflation target worked well after 1992

The inflation target for monetary policy was new in 1992, when introduced here soon after our ejection from Europe's Exchange Rate Mechanism on Black Wednesday. New Zealand had been the first to use one a few years before. The new target has been an undoubted success here in that we have had little inflation ever since its introduction; it has also been highly credible, as evidenced by little drift away from 2% in measures of inflation expectations. Its credibility and its success in keeping inflation stable and low are just two sides of the same coin, since the credibility has stopped any group from making wage settlements or setting price increases at all far away from what 2% would imply.

Inflation targeting has not worked well in the presence of asset price or oil price booms and busts

But, as so often when we make strides in economic policy, a further problem has been revealed about the conduct of monetary policy according to this inflation target. We have seen poor control of credit booms and busts, as illustrated by the boom of the 2000s and the bust of 2007-9. The original idea was that monetary policy would be spurred to control the boom by surging inflation and the bust by sharply falling inflation. Neither really happened. During the boom inflation stayed moderate; it actually rose during the bust as oil and commodity surged, but this inflationary surge came after the bust and so gave the wrong signal.

What lessons can we learn for periods of oil-price-driven deflation?

What we have seen here is an illustration of how if you change the policy regime behaviour changes; in this case the key behaviour that changed was the response of inflation to boom and bust. The new policy regime assumed inflation would continue to respond strongly to these but in the event it did not, for the reason we have given that people built the new regime into their behaviour and so moderated their inflation responses. So the question today is how we should repair our monetary policy target regime and how within it we should respond to an inflation rate temporarily zero and maybe briefly negative?

Inflation signals are not enough by themselves, but we should take account of monetary signals, also

Take the first question of target first. It seems that what is missing from the previous regime was the old-fashioned response of monetary conditions to the business cycle: what a Fed Governor once famously called 'taking the punch bowl away as the party gets too merry'. This element could be supplied by varying the supply of money, as in Quantitative Easing (QE), to some degree independently of inflation and interest rates. The supply of money is supposed to affect credit and interest rates charged by banks and others like them.

Another approach would be to target levels, not changes

Another idea is to stiffen the response of Bank Rate itself by replacing an inflation target by a target for 'Nominal GDP', or for one element of Nominal GDP, the Price Level. Nominal GDP is defined as the economy's Output times the Price Level. Suppose one wants prices to grow at 2% (target inflation) and output to grow at 3% (target growth). Add the two together to make 5% and record the cumulative growth of both from some initial date, say 2012. Adjust Bank Rate up or down if the cumulative total exceeds or falls short of the cumulative target. The idea is that booms typically generate several years of excessive growth and so the accumulated overshoot would trigger a progressively stronger response from Bank Rate; and vice versa with busts which typically deliver several years of below par growth and inflation. Much the same argument applies if you only did this for the Price level and excluded output from the calculation. Some experiments with these ideas on models of the economy suggest they would work quite well to restore the old party-pooping responses into monetary policy, while also maintaining the control of inflation that now exists. One could combine a QE rule with such a beefed-up Bank Rate rule.

A key lesson: oil-price-driven deflation should not deter us from normalising policy rates

Against this background we can consider next how to respond to current 'deflation' combined with strong growth in output and employment. Latest figures suggest that the economy is cumulatively not too far below a reasonable target level, and may even be moving above it, while the huge rise in QE has pushed asset prices up and encouraged peer-to-peer lending on a large scale. Yet Bank Rate is still glued to the floor and QE remains at £375 billion, a huge holding of government bonds by the Bank of England. In my view it is time to move both back slowly towards normal.

Comment by David B Smith

(Beacon Economic Forecasting)
Vote: Hold Bank Rate until after the election; hold QE.
Bias: To raise Bank Rate by two ¼% increments in the late-summer/autumn.
1 Year View: Depends on election outcome; on no-policy change assumption, raise Bank Rate to 1½% by mid-2016 and then re-consider.

Political uncertainties now dominate but the UK's economic trilemma is also worsening

With Parliament dissolved on 30th March and the general election due on 7th May, UK monetary policy is almost certainly on hold until the late summer at least. The next official rate announcement will occur as normal on 9th April. However, the Bank of England announced some time ago that the May MPC decision will be delayed until Monday 11th May in order to avoid a rate decision being announced on election-day. With the opinion polls suggesting the strong likelihood of a hung Parliament, in which the tacit support of several parties may be required to pass legislation, the May rate announcement might well occur before a new government is in place. Looking beyond the election, there is likely to be a strong 'relief' rally in private investment and recruitment if the Coalition is renewed in office – current polls suggest that a Conservative government with a clear majority is unlikely – leading to 'overheating' concerns for 2016. In contrast, a Miliband administration (or a potential left-wing 'coalition from hell') could lead to major markdowns in sterling and the domestic financial markets, weaker activity and a tendency towards stagflation, confronting the monetary authority with an unpleasant trade-off between activity and inflation. Meanwhile, the recent economic indicators suggest that the three-way tension between reasonably buoyant home demand, a disappointing and worryingly weak supply-side response, and the dis-inflationary consequences of the much reduced oil price has grown worse in recent months.

Deflation fears are overblown and a mild disinflation is a tonic

In theory, the reduced price of oil and other commodities represents a relative price shock, which has had a temporary negative impact on inflation and a transitory positive one on output but contains no long-term consequences for the levels of either variable. This may be too simplistic if the supplies of money and credit respond endogenously to transitory shocks to prices and activity. However, it is probably right for the monetary authorities to look through the current undershooting of the 2% inflation target, while keeping a weather-eye open for any subsequent second-round effects. More generally, mildly negative inflation has two distinct and competing effects on activity. When nominal incomes are 'sticky', slightly negative inflation raises living standards and boosts consumption. This seems to have been an important reason why the British economy escaped so lightly compared with other leading countries from the Great Depression of the 1930s, for example. A potential negative, and offsetting, effect from falling prices is that people who are rich enough not to spend all their income immediately may delay discretionary purchases if they think goods and services will be cheaper in future. In addition, there is the impact of a falling price level on the real rate of interest paid by debtors. Nevertheless, with nominal rates as low as they are at present, the resulting real rate need not be out of line with the pre-2008 historic norm, for example. On balance an annual disinflation of less than, perhaps, 2% would probably be mildly stimulatory overall. However, if the price decline exceeded, say, 5% then there should be aggressive measures to boost the money supply, Technically, this would be easy to implement given the continuing large size of the UK budget deficit, which could simply be monetised for a period.

Resolving the trilemma

The appropriate response to the other two parts of the three-way tension, the combination of recovering demand with a weak supply-side response, would be to raise interest rates while undertaking tax cutting measures and regulatory reforms to make it more worthwhile for private agents to create wealth. The fiscal-stabilisation literature implies that this is what the Coalition should have done immediately it took office in 2010. In particular, this stabilisation literature distinguishes between 'type 1' fiscal retrenchments, which are led by reductions in government current spending, marginal tax rates are cut, and government infrastructure investment is not reduced, and 'type 2' fiscal retrenchments in which tax increases are front-end loaded, government consumption is allowed to grow and public capital formation is cut. Numerous international studies suggest that type 1 fiscal adjustments are followed by a marked recovery in national output and improved public finances, while type 2 adjustments see a poor (or negative) output response and a deterioration in the public finances. A current illustration is provided by the recoveries being observed in those Euro-zone countries, such as Ireland and Spain, that accepted the type 1 medicine required for Germany's support compared to Greece, which so dramatically rejected it.

Mr Osborne's 'timorous' type 2 fiscal retrenchment

Unfortunately, Mr Osborne has only implemented a 'timorous' type 2 fiscal adjustment during his period as Chancellor, with the predictable result that economic growth has averaged something under 2% throughout the life of the now-dissolved Parliament, while the public finances have improved far more slowly than the Chancellor expected. More generally, there appear to have been three main causes of the pressure on voters' living standards since the 2010 election. The first is that any economy that suffers from a high and capricious tax burden and excessive regulation will only grow slowly, if it all. This is because of the limited incentives for private agents to undertake capital investment or accept the business risk associated with new projects. These tax and regulatory induced disincentives to wealth creation are crucial because living standards cannot grow faster than the underlying economy for long, and real GDP per head in 2014 Q4 was still 1.2% below its pre-downturn peak in 2008 Q1. The second cause of the so-called 'cost of living crisis' was Mr Osborne's decision in 2010 to raise the VAT rate from the 15% he inherited to the present 20%. Returning the VAT to its pre-Crisis 17½% may have been defensible in 2010. Nevertheless, the extra increase of 2½ percentage points hit living standards directly, exacerbated and lengthened the recession, and gave a perverse signal to the private sector that, if in doubt, the government would always try to tax its way out. The final major reason for the adverse pressure on the electorate's living standards was the attempt to re-balance the economy through the previous cheap pound policy, which was probably as much a mistake on the Bank of England's part as the Chancellor's. Such a policy will work if the price elasticity of demand for UK exports and imports is high and the feed through from the external value of sterling to domestic prices is weak. However, the evidence – even before this policy was implemented – suggested that the facts were to the contrary. This seems to have been confirmed by subsequent developments.

Post-Budget ONS data revisions have partly invalidated OBR projections

Following the 18th March Budget, the Office for National Statistics (ONS) published a major set of revisions to the national accounts on 31st March, which inter alia revised last year's average growth rate up from 2.6% to 2.8% and 'through-the-year' growth from 2.7% to 3%. This is the second consecutive occasion on which the official forecasts have been rendered obsolescent within a few weeks of publication by ONS revisions – the same thing happened after last year's Autumn Statement – and one can only presume that the forecasters at the Office for Budget Responsibility (OBR) are spitting tin tacks with rage. The 31st March ONS data have been run through the Beacon Economic Forecasting (BEF) macroeconomic model in addition to the Budget measures. When running the BEF model, the official projections for the volume of general government investment were kept but it was assumed that the volume of general government current expenditure grew at a steady 1% each year, since the official OBR forecasts were not considered realistic. Even so, our forecasts should be regarded as representing a 'no-policy-change' assumption, which incorporated a realistic degree of spending slippage, rather than as a simulation of the very different policies that might follow a change of government.

The new macroeconomic outlook

Some of the main results of this exercise are as follows. Firstly, the BEF projections show that economic growth is expected to accelerate from last year's revised 2.8% to average 2.9% this year, before slowing to 2.3% in 2016 and then fluctuating around 1¾% up to 2020 (when the OBR forecast horizon ends). In the short term, this is actually faster than the 2.5% OBR growth forecast for this year, and matches the 2.3% projected by the OBR for 2016. However, our longer-term projections are weaker than the official ones, which show growth of 2.3% in 2018 and 2.4% in 2019. This is probably because the medium-term OBR growth forecasts are set 'off model' through a series of (arguably, over-optimistic) assumptions about potential supply, whereas the sustainable growth rate is both endogenous and heavily influenced by supply side factors in the BEF framework. Second, CPI inflation is expected to end this year at minus 0.3% (OBR prediction plus 0.6%), before rising to 0.9% in 2016 Q4 (OBR 1.4%) and 1.3% (OBR 1.8%) in 2017 Q4. Longer-term, CPI inflation is expected to pick up from an annual average of 1.5% in 2018 to 1.9% in 2020. This is similar to the OBR forecasts, which show a gentle rise from 1.7% CPI inflation in 2017 to 2% from early 2019 onwards. The BEF predictions assume that the price of a barrel of Brent crude averages US$57½ this year, before rising to US$60 next year and going up by US$1.5 in each subsequent year. The modest turn-around from negative inflation in the second half of this year to positive in 2016 reflects the fact that the 2015 oil price falls becomes part of the base for the annual inflation calculation next year.

The UK's stubborn twin deficits problem

Third, while the outlooks for growth and inflation look reasonable, the prospects for Britain's twin deficits look anything but, even on the assumption that present policies survive the May election. Where the first twin deficit is concerned, the 31st March ONS data show that the current account balance of payments deficit was a mighty £97.9bn last year, compared with £76.7bn in 2013. The latest BEF projections indicate that the current account payments deficit will ease temporarily, to £76.1bn in this year, but deteriorate to £80.7bn in 2016, £85.1bn in 2017, £94.2bn in 2018 and £103.9bn in 2019. This contrasts with the situation in the OBR projections, where the current account deficit is predicted to fall from £79.8bn this year to £49.6bn in 2019. However, when making these projections the OBR have assumed a massive turnaround in the UK's investment income balance from a deficit of £30.2bn this year to a surplus of £4.6bn in 2019, which seems optimistic. With respect to the other twin deficit, the latest BEF projections show underlying Public Sector Net Borrowing (PSNB) of £90.0bn in 2014-15, being followed by deficits of £77.9bn in 2015-16, £67.6bn in 2016-17, £62.4bn in 2017-18, £56.9bn in 2018-19 and £51.0bn in 2019-20. This is noticeably slower progress than Mr Osborne predicted in his March Budget statement, where the PSNB was forecast to fall from £89.9bn in 2014-15 to £75bn in 2015-16, £39bn in 2016-17 and £13bn in 2017-18 before showing surpluses of £5bn in 2018-19 and £7bn in 2019-20. However, Mr Osborne has significant form where overshooting budget deficits are concerned by now.

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. A more thorough analysis would require running several distinct scenarios, which would not be easy given the nebulous nature of many of the political parties' tax and spending commitments. Our no-policy change projections suggest that the sterling index could remain in the high 80s and low 90s (January 2005=100) over the next few years and that Bank Rate might end 2015 at 1%, if historic relationships re-asserted themselves. This might be nearly as far as the hikes go over the next few years, with the negative real rates overseas limiting the upside risks. The return to power of the Conservatives, or a renewal of the present Coalition, might be accompanied by a, possibly short-lived, relief rally in sterling, equities and the gilt-edged market, before it was back to business as normal. Alternative and not unlikely, political scenarios might well imply the opposite, of course. However, for this month and next a tactical hold seems the most appropriate Bank Rate decision for political reasons. This is despite the fact that the 31st March ONS data suggest that the UK economy is stronger than was previously believed and also living beyond its means where the twin deficits are concerned.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ¼%. QE restructure by £50 billion.
Bias: To raise rates to 1½% over 12 months.

22 countries have cut interest rates since January 2015

In view of the extraordinary speech from Andrew Haldane (Drag and drop, 19 March), in which he attempted to redraw the landscape for the Bank Rate decision, it is necessary to revisit my objections to the decision to hold Bank Rate at 0.5% for 6 years and, a fortiori, to rule out any temptation to cut Bank Rate. Many countries – 22 at the last count – have reduced their policy interest rates since the beginning of the year. The majority of these are emerging market nations seeking to counteract disinflationary pressures. In the case of resource-rich Canada and Australia, the motivation is additionally to seek currency depreciation.

There Is no reasons to believe the UK might benefit from further rate cuts

The UK does not fall into either of these camps. Domestic economic growth is quite robust, with household nominal incomes rising 5.3% and nominal GDP at market prices rising 4.3% in the year to 2014Q4. The drop in the CPI inflation rate to zero in February is insufficient in itself to change the polarity of interest rate change. There is no perceptible threat of income deflation in the UK and most recently wages have accelerated. The reluctance to raise Bank Rate demonstrates a failure to think internationally and far-sightedly about the inflation outlook.

Rate rises now would provide a buffer allowing cuts later if there are new shocks

While it is possible that breaking the taboo of 0.5% Bank Rate could provoke irrational fears and damage consumer confidence, we will never know unless we try. My conviction is that the initial stages of rate normalisation would have very mild effects on activity and employment. The first argument in favour of a rate increase is to build a buffer in time for the next economic shock: to have scope to ease conventionally in 2016-17 should the need arise.

Borrowers risk being complacent about the risk of rate rises

A second argument is to guard against borrower complacency concerning extraordinarily low debt service costs. It would be wise of the Bank to conduct a real-life stress test of mortgage and corporate borrowers' ability to withstand slightly higher interest rates.

Risks of property market leverage

A third argument is the risk of financial instability emanating from the excessive use of leverage in overheated property markets.

Interbank lending cannot recover without rate rises

Another by-product of 0.5% Bank Rate has been the demise of the London Interbank market. At such low interest rates, commercial banks see no attraction in lending out their surplus liquidity to their competitors. The hoarding of liquidity has become an entrenched behaviour, partly as a protection against an unexpectedly large drawdown of unused credit facilities by bank customers. The normalisation of interest rates is a pre-condition for the restoration of health to the interbank market.

Long-term fiscal risks of excessively low rates

Another unseen cost of the low Bank Rate is the future burden of government support for savers whose capital has perished in some reckless attempt to secure higher yields on their wealth. Low interest rates poses longer–term fiscal risk.

Arguments a low rate is needed are unconvincing

The arguments frequently presented to defend Bank Rate passivity concern the economy's alleged abundance of spare capacity, low real earnings growth, low inflation, stable inflation expectations, high household debt burdens, the strength of Sterling and weak money supply growth. None of these offer a robust argument against keeping rates at historical lows, much less to reduce them further.

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 of 0.25%.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold base rate. Hold QE.
Bias: Neutral

It ain't broke, so don't fix it

UK growth remains healthy. Notwithstanding concerns about falling prices, the UK should see some modest bounce-back in inflation later in the year as the oil price rise starts to fall out of the index. But with wage inflation currently subdued and price inflation likely to fall into negative territory before rising, the current level of interest is appropriate.

Policy response

1. On a vote of seven to two the committee agreed to hold Bank Rate.
2. Two members voted for rise.

Date of next meeting

21 April 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 and IEA). Other members of the Committee include: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Graeme Leach (Legatum Institute), Patrick Minford (Cardiff Business School, Cardiff University), Gordon Pepper (Cass Business School), 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 Corporate Markets). 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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