

Shadow Monetary Policy Committee

April 2013

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IEA's Shadow Monetary Policy Committee votes by five to four to raise Bank Rate by 1/4% in April

In its most recent e-mail poll, which was finalised on 27th March, the Shadow Monetary Policy Committee (SMPC) decided by five votes to four that Bank Rate should be raised on Thursday 4th April. Two SMPC members wanted an immediate increase of ½%, while three wanted a rise of ½%, implying a rise of ½% on normal Bank of England (BoE) voting procedures. This represented the third consecutive month that a majority of shadow committee members had decided that a rate increase was justified on economic grounds, and the second month in a row that it was five to four in favour. Of the four that voted against a rise, none voted for more QE though it was held in reserve by one.

The verdict on the Budget was that it was neutral and so will do little to stimulate the economy. More broadly, some believed it was a missed opportunity: to go further in stimulating the economy via capital projects to kick start growth and more on the BoE's remit. On the latter, the worry was generally that the changes announced and Mark Carney's arrival suggests a period where monetary policy would be loose and could be seen to endorse inflation. Fears about the public sector's debt position were felt by some to have been vindicated in the Budget. With more debt, for longer in the future, with not enough effort in the view of some to rein it in, prospects for recovery were damaged. For one, lack of control of fiscal policy is as responsible for the lack of recovery as the supply side issue that the UK faces. For another, that the rating agencies were too slow to recognise the UK's debt problem, not too fast. One worried that the focus on both fiscal and monetary policy is wrong and self defeating, their failure actively contributing to the weakness of the economy. Structural reform is key to recovery.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (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. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 16th April and its minutes will be published on Sunday 5th May. The next two SMPC e-mail polls will be released on the Sundays of 2nd June and 30th June, respectively.

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Comment by Tim Congdon

(International Monetary Research Ltd)

Vote: Hold Bank Rate; no change in asset purchases.

Bias: To achieve low and stable growth of the quantity of money (broadly-defined).

The economy is weak and the Budget seems to have endorsed 'monetary activism' Disappointment about the UK economy's performance is widespread today. The government is under pressure 'to do something'. However, its macroeconomic options are limited. Some Keynesian critics say that the government should boost its own spending, in order to stimulate aggregate demand as a whole. But the large budget deficit and associated increases in public debt prohibit such so-called 'fiscal reflation', while experience over many decades shows that fiscal policy does not work in the manner discussed in the textbooks. The Budget documents therefore endorse 'monetary activism', with the Bank of England (BoE) reported to have been given new powers to influence the economy in a positive way.

I would say that the central problem in monetary policy at present, as over all of the last five years, is that banks cannot readily grow their balance sheets while they are struggling to meet officialdom's demands for more capital and liquidity relative to risk assets. Since equilibrium national income is a function of the quantity of money broadly-defined (i.e., of the total of bank deposits, more or less), officialdom's demands remain a powerful deflationary force. Monetary activism in the form of 'quantitative easing' (QE) (i.e., the creation of new bank deposits [money] by the state) has been tried and has been vital in mitigating the officially-imposed deflation. However, various initiatives 'to ease credit conditions' – such as the Funding for Lending Scheme (FLS) and the granting of powers to the BoE to purchase corporate bonds (i.e., to engage in the 'credit easing' advocated by Ben Bernanke) – are of little importance relative to the clamp on money growth implied by the official pressure for safer bank balance sheets.

But the main problem is that banks cannot freely expand balance sheets due to regulation The Budget announced that public sector net borrowing is expected to be about £120 billion in the coming 2013/14 fiscal year, much as it was in 2012/13. The Office for Budget Responsibility (OBR) has correctly said that Mr Osborne's campaign to reduce the budget deficit has 'stalled'. As a result, public debt will rise faster than national income this year and next. Even more worrying are the medium- and long-term prospects for the UK's public finances. In documents published with the Budget the OBR sets out a plan with assurances that, on present policies, the debt/GDP will peak in 2017. However, it had previously given assurances that the debt/GDP would peak two or three years earlier, and it was wrong. The remainder of this note discusses why the government has failed to bring the budget deficit down to lower and more sustainable levels.

Blame for the UK's poor performance has been put on the supply side

The economy's weaker-than-expected growth performance is often mentioned as the main cause of the disappointing fiscal arithmetic. Since the start of the Conservative-LibDem coalition government in 2010, growth of national output has been lower than envisaged. As tax revenues are a proportion of national output, they also have been lower than forecast. On this basis the blame for the above-target deficit outturns lies with the 'supply side' of the economy, which is understood as having less dynamism than in the 1980s and 1990s for all sorts of reasons that cannot be immediately remedied. Osborne has not yet been criticised because of unsatisfactory control of

public expenditure. Indeed, the standard badmouthing he receives from 'the left' in British politics is that he has been too austere (or even 'too austerian', to quote Paul Krugman's neologism in his 2011 book, End this Depression Now!). The left seems to think that Osborne has been dogmatic and uncaring in his commitment to lowering public expenditure. My argument here is that some important evidence does not support this view. On the contrary, Osborne has not reduced general government consumption at all.

In the last few quarters for which data are available (i.e., up to the third quarter of 2012), general government was rising fast As is well-known, Gordon Brown reacted to the Great Recession by so-called 'Keynesian fiscal reflation', so that government consumption continued to grow even as private spending and the government's tax revenues fell. That led to the sharp widening in the budget deficit recorded between 2007 and 2010. After the change of government in 2010, the first few quarters of data appeared to suggest a move to austerity. The annual change in general government consumption was negative in each of the four quarters to the second quarter of 2011. Meanwhile, the rebound in the economy in 2010 and early 2011 boosted tax revenues, causing the budget deficit to drop significantly from 11% of GDP in 2009/10 to 8% of GDP in 2011/12. Osborne's Plan A seemed to be in place and the UK retained its triple-A credit rating.

In the last few quarters for which data are available (i.e., up to the third quarter of 2012), general government consumption was rising faster than total expenditure in the economy. On this basis the claims of tight expenditure control under the coalition governments, and the polemics about an unjustified move to austerity, are invalid. Total expenditure in the economy is predominantly expenditure by the private sector. Whereas it has been barely growing since 2011, general government consumption has been increasing at about 2% - 3% a year.

It is therefore not true that the setbacks on the budget deficit are entirely to be attributed to weak tax revenues and the inability of the economy to expand because of supply-side constraints. The setbacks on the budget deficit are also to be explained by rising public expenditure. Osborne and his team have a more definite responsibility to control government consumption than the government's transfer payments, the levels of which are set partly by statute and the economy's performance (as with welfare benefits) and partly by conditions in the government debt market (as with debt interest). But an obvious link holds between control of government consumption expenditure and the budget deficit, and then between the budget deficit and the burden of debt interest. Further, the higher is the budget deficit, the greater is the increase in the national debt and – for any given average interest rate on the debt – in the debt interest that has to be paid on the debt.

So far Osborne's record in curbing the budget deficit has been at best mediocre

The analysis in this suggests that so far Osborne's record in curbing the budget deficit has been at best mediocre. In the last few quarters he has allowed government consumption to increase noticeably in real terms. That is one reason why the budget deficit will remain well above 5% of GDP when the present Conservative-LibDem coalition government comes to an end.

Comment by Anthony J Evans

(ESCP Europe Business School)

Vote: Raise Bank Rate by 1/4%. No change to QE.

Bias: Neutral but liquidity support available if Eurozone situation deteriorates.

OBR growth forecasts implausible

Several important things came out of the March 20th budget. One is the continued implausibility of the OBR's growth forecasts. Although the 0.6% growth forecast for 2013 is disappointing, the subsequent rates of 1.8% (for 2014), 2.3% (for 2015) and 2.7% (for 2016) are hard to believe. The OBR appear oblivious to the fact that there has been a negative supply shock, and even if potential GDP remains >2% there is little rationale for believing that the output gap will be closed. As I argued in a policy report for the Mercatus Center, the forecast reduction in government spending as a proportion of GDP can in large part be attributed to over optimistic growth forecasts. Attempting to stimulate aggregate demand in a world where potential GDP has fallen will lead to frustratingly sluggish growth and rising inflation expectations (having almost fallen to 3% in 2012, they are now approaching 4%) – exactly what we see today.

Monetary policy shouldn't facilitate a housing bubble

The Chancellor's attempts to reignite a UK boom in subprime lending appear to be a muddled attempt to kick life into the housing market. It is not clear whether it will help the intended target of those priced out of the housing market, as opposed to existing homeowners using public money to cash in on another housing bubble. However, the combination of low interest rates and reduced lending standards generates adverse selection (in terms of enticing people to take on debt that they cannot afford to service) and moral hazard (incentivising mortgage holders to take on more risk). Lending standards provide an important market test and "Help to Buy" backfires if it's help to buy an asset that you cannot ultimately afford. In a 2012 report the Financial Services Authority (FSA) pointed out that although sales of fixed-rate mortgages were increasing relative to variable rate ones, there has been a sizable shift of people already on mortgages from the former to the latter – 55% of new mortgages were fixed rate, but less than 30% of outstanding mortgages were fixed. Although it is incredibly difficult to use monetary policy to deflate specific asset bubbles, the BoE should not facilitate government efforts to maintain them. The release of data regarding the FLS should generate scepticism about the Chancellor's efforts to widen the scope. There's no doubt that such schemes can help at the margin but it is unlikely that they will drive banks' decisions to extend credit.

The Chancellor missed an opportunity to make a bold change to the MPC remit In terms of the monetary policy remit, the announcements were underwhelming. Moving towards forward guidance ties the hands a little of those who attempt to simulate the MPC's decisions, and inevitably turns attention away from speculating about policy decisions and towards the remit itself. Delaying the date in which the letter to the Chancellor is due constitutes an acknowledgement that inflation will continue to remain above target, without changing that target. Adding the objectives of "growth and employment" constitutes a slightly more flexible target, but is merely making a vague de facto remit, a vague de jure one. It formalises the discretion with which the MPC have already been utilising, but fails to offer a clear replacement. It is this leeway that is stymieing recovery, because it generates uncertainty. It would have been preferable to combine a nominal growth target with unambiguous expectations about its future path. Nominal GDP grew by 6.6% in Q3 2012 (relative to the previous quarter), but only 0.4% in Q4. Most would agree that going forward the optimal rate is

somewhere between the two, but the stability of expectations are more important than the actual rate. In a similar way, it is the permanence of QE that determines its impact, and uncertainty about how the stock of QE will be maintained over time has limited its potential impact. Forward guidance is a fairly meek way to manage expectations relative to the types of commitment central bankers should be making.

MPC should aim to get policy back to a neutral level as soon as possible Over the past few months, I have argued that the overriding goal of the MPC should be to get back to a neutral monetary policy, and I would still argue that rates are artificially low. Even though there is a danger of raising them too soon, the events in Cyprus also remind us that there's a limited window of opportunity. With such disappointing growth figures it would be dangerous to raise interest rates without also have a clear communication strategy to explain why, but for the purposes of debate I vote for a moderate rate rise even without this. If events in the Eurozone begin to pose a serious risk to the UK banking system, it would be unwise to wait until an MPC meeting to act. Therefore the BoE should be prepared to offer liquidity provisions as and when needed.

Comment by Graeme Leach

(Institute of Directors)

Vote: Hold Bank Rate and QE.

Bias: Neutral.

The Budget was fiscally neutral and will not change the short term economic outlook Monetary growth, the housing market and survey evidence point towards a muted recovery in 2013. The Budget was fiscally neutral and won't change the short-term economic outlook. Nor should it. Fiscal policy should concentrate on deficit reduction and long-term growth, by improving the incentives to work, save and invest. The underlying budget deficit is stuck. Over the 2011-12, 2012-13 and 2013-14 period the underlying deficit is flat at close to £120 billion. Yes, it is projected to fall thereafter, but these are forecasts and the error factors are huge - around 1 percentage point of GDP per annum for every year ahead i.e. £15 billion 1 year ahead, £30 billion 2 years, £45 billion 3 years etc. It wouldn't take much for the budget deficit to get stuck at £100 billion for as far as the eye can see.

A tough fiscal stance could see a loose monetary stance decade I differ with the consensus about the short (stronger) and long term (weaker) economic outlook. Basically, I think the short-term outlook, driven by the recent pick-up in broad money growth, could be a little stronger than expected. With regard to the long-term outlook, the potential growth rate of the UK economy is probably below 2 per cent. If so, and in the absence of radical supply-side reform, fiscal policy will be under pressure throughout the current decade and as a result monetary policy could remain loose for the entire period.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise rates ½% and no more QE.

Bias: To raise Bank Rate.

British policymaking is stuck in a rut

Rationale: British policymaking is stuck in a rut. The Fixed Term Parliaments Act has condemned us to no General Election until 2015, when in a healthy political system we might have had two General Elections by now, since 2010. Policymakers are therefore trapped by foolish promises they made in 2008 and 2009, or even earlier,

regarding their approach to fiscal and monetary control. That has meant that any concerted effort to raise the UK's sustainable growth rate by cutting government consumption spending early or seriously increasing the efficiency of government consumption spending has been impossible. The government, having in 2011 abandoned its target of eliminating the structural deficit over a Parliament, has in the latest Budget abandoned any attempt to cut the deficit at all, being content to allow the deficit to sit at £120bn in 2011/12, 2012/13 and 2013/14. With no deficit reduction scheduled in the deficit for three years, the government's economic policy can no longer even pretend to be a "deficit reduction programme".

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Having abandoned efforts to cut the deficit or raise the sustainable growth rate, and with events in Cyprus reminding us – if the experiences of Iceland, Ireland and Spain were not already lesson enough – that countries with as large banking sectors relative to GDP as the UK's cannot save their major banks without bankrupting the state, the government is now clearly switching to a policy of "financial repression" to make its obligations manageable. Public service spending, benefits, tax allowances, and the deficit are all to be held in nominal terms, then inflation encouraged to accelerate fiscal drag, devalue benefits, and ease the burden of debts, whilst easing the balance sheets of bust banks by eroding the real value of their liabilities to depositors. Understandable though such a policy is, the choice of such a route constitutes surrender to events.

In the Budget a change to the monetary policy remit was announced, with George Osborne effectively informing the BoE that from now on it was fine for inflation to be as far above target as the Bank likes, for as long as it likes. That such a change in the remit was greeted with a shrug and remarks along the lines of "But that's what policy has been for years anyway" just indicates how totally the BoE's credibility has been eviscerated in recent years.

The new Bank of England framework can best be described as "not avoiding inflation" The new BoE framework can best be described as "not avoiding inflation". Policymakers around the world, through the long and sad history of the monetary system of exchange, have found not avoiding inflation a tempting route. It often seems as if letting inflation go just a little higher would make everything just that little bit easier. But once inflation goes much above 5% it becomes volatile as well as difficult to keep down. The consequence will be that employers and workers will be forced to anticipate inflation in wage-setting. However, they will find it difficult always to predict inflation accurately. A number of consequences spring from this: some years employers may pay far too much, and either go bankrupt or cannot hire workers; in other years employees may be paid far too little, and therefore find themselves unable to service their own debts. High and volatile inflation thus causes unemployment and personal and corporate insolvency. Policymakers appear so set on attempting (but failing) not to repeat what they regard as the failures of the 1930s that they have forgotten the key lessons of the 1970s and 1980s and set aside the core insights of the macroeconomic theory of the past forty years.

We have a deep-seated structural problem that only structural solutions can address This is the most fundamental lesson of the past few decades of macroeconomic theory and practice: neither fiscal nor monetary policy can raise the medium-term growth rate of economies, but can lower it if pursued to excess. Debates about "fiscal stimulus" and "flexible inflation targeting" thus miss the point. We do not have a short-term problem susceptible to short-term solutions. We have a deep-seated structural problem that only structural solutions can address. Monetary and fiscal stimulus

measures have had their go, and achieved what they could. They have now passed the point at which they do good and reached the point at which they do harm, and the longer they are kept in place the more harm they will do.

Comment by Kent Matthews

(Cardiff Business School)

Vote: Raise Bank Rate by 1/4%; hold QE.

Bias: To raise rates further.

Euro crisis is far from over

In case anyone thought that the euro crisis looked to be coasting towards some sort of resolution based on the politician's hope that something 'good' will happen if we could just hold on, the whole thing flares up again. Indeed this crisis will run and run with periodic lulls until something 'good' really happens as the politicians hope or the whole experiment be declared a failure with the breakup of the single currency. Whatever happens in the future, the Bank needs to have enough ammunition in its arsenal to use against the fallout from a likely breakup and the inevitable contagion of the ensuing bank crisis. QE worked to arrest a fall in the financial markets from developing into a disastrous collapse. It can be used again if the euro crisis threatens to turn into a survival phase with all the negative implications for the UK.

This was not a great time for UK Budget, with a downgrade by Moody's and negative watch warning from Fitch With this backdrop it has certainly not been a good time for Cameron's fourth budget. Earlier, Moody had downgraded UK debt from its AAA rating and now Fitch has placed it on negative watch. The budget itself was unadventurous with only weak signals of a future supply side policy that might have positively influenced growth expectations and provided a boost to domestic investment spending. What is left of policy is a dependence on the continuation of a supposed loose monetary policy that has demonstrably failed to stimulate a moribund economy. More of the same does not sound like a good policy.

Despite this, the Bank should raise interest rates to allow market forces to work There are three reasons why the Bank should start the process of raising interest rates – two good ones, and one weak one. If the euro crisis reaches a terminal phase with the knock on effects for the UK economy, at near zero interest rates, monetary policy has no traction. A phased rise can be reversed sharply if needed to provide comfort to financial markets. The second good reason is that the current policy has led to the survival of zombie corporates (bank credit insiders) while companies that need to grow (bank credit outsiders) are faced with a credit famine and relatively high borrowing rates and tough conditions. The result is that the current policy of QE and low official bank rate has denied the economy of a Schumpeterian process of 'creative destruction'. The third reason is that the Bank, even belatedly can try and restore some credibility to its inflation target policy. It is a weak reason because the credibility of its anti-inflation policy may well have been irreparably damaged and any rise in interest rates may fail to influence inflation expectations. However, it is worth a try!

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind

QE.

After the Budget, will the credit channel remain blocked by regulation?

While there has been criticism of the Chancellor's decision to subsidise mortgages, for me this is a most significant step for monetary policy. As I have argued in previous SMPC submissions, excessively harsh regulation of the banks – and especially the heavy new capital requirements which are expensive to meet now when banks are unattractive to investors – have raised the costs of credit to SMEs and personal borrowers, the two sets of clients who have no effective alternative to banking. So the credit channel is blocked by regulation.

It remains to be seen how effective the mortgage subsidy is By subsidising mortgages which are widely used by both these client sets, the Treasury is directly offsetting this distortion. It remains to be seen how effective the subsidy is in practice; as so often with these bureaucratic interventions one cannot know until the detail is laid out of how it is all accessed, what side-conditions and so on. However, what is becoming clear is that the Treasury and the Bank may at last be taking action to relieve the effects of their other, regulative, actions on monetary conditions; the FLS is another one of this type that may be having a modest effect. QE, as I have argued and shown in the data, is not doing the job; it is merely reducing returns to savers; cheapening the cost of credit to government, and possibly preserving 'zombie' clients.

Commence normalisation of Bank Rate now It would be better to reverse the regulations and allow the market to work freely. But with the great and the good determined to regulate, as seen in the Parliamentary Committee and the Vickers Report, the only avenue left is this sort of offset. My view therefore is that this latest mortgage offset, together with the FLS, should be consolidated and strengthened as necessary to eradicate the distortion and get the cost of credit down to these two sets of clients. QE should be stopped and steadily reversed. Interest rates should be raised towards normal levels, starting with 0.5% this month, with a bias to continue upwards. The object should be to return general rates to normal, while eradicating the abnormal premium on SME/personal lending.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by 1/4%; diversify existing QE into non-gilt assets.

Bias: To raise Bank Rate.

Three concessions to monetary flexibility that are significant

As expected, the Treasury has revised the remit for the BoE's MPC to allow even greater flexibility in the interpretation of the inflation objective. Although the inflation target remains unchanged at 2% "at all times", there are three concessions to flexibility that are potentially significant in combination.

First, the MPC has been given permission "to deploy forward guidance including intermediate thresholds in order to influence expectations and thereby meet its objectives more effectively. The Government considers any use of intermediate thresholds to be a matter subject to the Committee's operational independence in setting policy, to be considered in exceptional circumstances. The Committee is

requested to provide an assessment of such approaches to setting policy alongside its August 2013 Inflation Report."

Second, in forming and communicating its judgments the Committee should promote understanding of "the trade-offs inherent in setting monetary policy to meet a forward-looking inflation target. It should set out in its communication ... the horizon over which the Committee judges it is appropriate to return inflation to the target."

Third, when actual inflation departs from the target, in conjunction with the publication of the MPC minutes, the Committee should "communicate its strategy towards returning inflation to the target after consideration of the trade-offs."

In essence, the Bank has been given carte blanche to disregard the inflation target over an indefinite horizon The disturbing aspect of these remit changes is the acquiescence of the Treasury to the Bank's judgment and economic model. The terms of the remit allow for two distinct circumstances in which departures of inflation from target will be tolerated. The first takes for granted that there is a clearly identified short-run, and perhaps medium-run, trade-off between inflation and real economic activity. The second concerns situations where "attempts to keep inflation at the inflation target could exacerbate the development of imbalances that the Financial Policy Committee may judge to represent a potential risk to financial stability."

Hence, the MPC is given the flexibility to "look through" inflation deviations when to tighten monetary policy would be judged to create additional output volatility and/or to jeopardise financial stability. In essence, the Bank has been given carte blanche to disregard the inflation target over an indefinite horizon.

There is an underlying premise in the Treasury document "Review of the monetary policy framework" that the sources of above-target inflation are temporary and irrelevant to the operation of monetary policy. However, since QE plays a well-documented role in driving up primary product prices, then energy and commodity price impulses cannot be considered exogenous or temporary. Similarly, the side-effects of fiscal tightening such as higher excise duties, VAT or air passenger duty, reflect the reality of ongoing fiscal normalisation. These are not exogenous or temporary, either.

It does not consider the alternative: that the UK inflation rate may be in transition to a new and higher equilibrium

The remit is crafted as if the inflation rate were drawn, as if by a gravitational force, back to 2% per annum. It does not consider the alternative: that the UK inflation rate may be in transition to a new and higher equilibrium. Our decomposition of the Retail Price Index into semi-exogenous factors (e.g., administered prices, excise duties, oil and commodity prices) and prices mainly determined in the domestic private sector is revealing. The series for private sector inflation has a clear upward drift in its inflation rate that has been in place since 2005. The Treasury makes no attempt to explain the persistence of this trend, nor its implications for the task of anchoring inflation expectations. This upward drift in private sector inflation, mirrored in consumers' inflation expectations, is unlikely to be arrested by the adoption of a more flexible inflation mandate.

Finally, the revised remit rules out the replacement of inflation targeting with nominal GDP targeting, but holds open the door for the level of nominal GDP to play a role as an intermediate threshold, should Mark Carney wish to exercise this freedom. For further illumination on this issue we must wait until August.

Mark Carney's most pressing task as incoming Bank governor is to unblock the credit transmission channels However, neither the scope for larger and longer inflation departures from target nor the freedom to adopt US-style forward guidance on the level of Bank Rate addresses the fundamental blockage in the credit system. Until the Bank of England relaxes the overbearing capital and liquidity requirements on UK banks and considers the purchase of private sector assets within its asset purchase programme, then the effective growth-inflation trade-offs will remain hostile. Mark Carney's most pressing task as incoming Bank governor is to unblock the credit transmission not to construct an elaborate set of conditions under which Bank Rate may one day be raised. Indeed, if there is a role for 'forward guidance', it is to reassure markets of the Bank's determination to take rates back to the region of 2% to $2\frac{1}{2}$ % over the next two years. An immediate move to $\frac{3}{4}$ % is my preference.

Comment by Mike Wickens

(University of York and Cardiff Business School) Vote: Hold interest rate and no increase in QE.

Bias: Hold interest rate for now.

The question that is being asked after the UK Budget increasingly is whether the UK is positioning itself to inflate away its debt? After a broadly neutral budget that allows the debt-GDP ratio to rise to levels not seen for fifty years, the weakening of the inflation remit of the BoE, the appointment of Mark Carney and the negative-watch warning from the credit rating agency Fitch, the question that is being asked increasingly is whether the UK is positioning itself to partly inflate away its debt. Although this would be officially denied, it is becoming increasingly likely and may even shortly come to be seen by many as the only politically acceptable solution. I think that this would be the wrong way out of our debt and growth problems.

There is no convincing evidence to show that increasing government expenditure would raise private consumption expenditures, even in the short term, as assumed in Keynesian economics. If it did so in the long run, this would imply, most implausibly, that the larger the government sector, the better off would people be. Increased government investment expenditures, if well targeted, would lead to an increase in GDP and consumption. It was probably a mistake by the government to cut these, but increasing them now would only bring longer term benefits to growth. I would have preferred a budget that put more money into the hands of those most likely to spend it immediately and paid for this by cutting further wasteful government expenditures.

The changes to the Bank of England's remit are still vague but strongly suggest allowing more inflation in order to increase growth, especially over the cycle

The changes to the BoE's remit are still vague but strongly suggest allowing more inflation in order to increase growth, especially over the cycle. This makes sense if higher inflation is due to a negative supply shock, but not if it is due to a positive demand shock. In fact, the BoE has already adopted this policy but, perhaps due to its remit, has not formally admitted it. It is clear, however, that such a change in its responsibilities are unlikely to have made much difference to the conduct of monetary policy in the current recession, or to have increased the ability of monetary policy via interest rates to affect the real economy. The zero lower bound to interest rates has caused this. Only outright money financing of the deficit might raise GDP in the short term. Even QE and bailing out the banks is fiscal policy. In short, whatever the , monetary policy is much less effective in dealing with a recession caused by a negative supply shock as now.

The news in Moody's and Fitch's down-ratings is that they are too late

In my own recent research on the UK's credit rating (CEPR Discussion Paper 9378, March 2013) I found that the UK's credit rating should rather have been downgraded

in the second quarter of 2008. From 2010, when the government came to power, the UK's credit rating would have started to rise, and at the present time it is even healthier. In other words, the credit rating agencies appear to have got their timing of the UK's credit rating completely wrong. The news in Moody's and Fitch's downratings is that they are too late.

Do not adopt policies for the short term that worsen things later. It was short-termism that got us into this mess in the first place In my view the Chancellor is correct to say that one of the main reasons why the UK economy has not performed better is its export performance to the Eurozone. I would add to this the rise in the UK's saving rate as households and banks tried to rebuild their balance sheets. Although higher inflation would probably lead to a further depreciation of sterling – as well as reduce the real value of debt – I do not recommend this as the right solution for the UK because UK imports are not that price sensitive and exports to non-euro markets are already competitive, are growing and are higher than those to the euro area. The main problem with higher inflation that lasts too long or is too high, even temporarily, is that it risks raising longer-term inflation expectations. In short, I think that we just need to stick to plan A, be patient and not adopt policies for the short term that worsen things later. It was short-termism that got us into this mess in the first place.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking)

Vote: Hold Bank Rate and hold QE in reserve.

Bias: Neutral.

The Budget was fiscally neutral but debt will be higher for longer

As the UK Chancellor said in the opening of his Budget speech, 'this is a fiscally neutral Budget'. So it proved, with spending increases offset by spending cuts and tax increases in future years. However, as the starting point in 2013/14 was worse than forecast in the Autumn Statement in December - a PSNB of £86.5bn rather than the £80bn expected then, some £6bn higher. The cumulative effect of higher deficits in coming years means that net debt peaks at 85.6% of GDP in 2016/17 rather than the earlier 79.9% in 2015/16. That represents an increase of roughly £100bn more at the end of the five-year projection period. Gross debt peaks at 100% of GDP.

We are in for a prolonged period of tight fiscal, loose monetary policy from the authorities, with the latter hamstrung by deleveraging It would have been worse but for an under-spend by government departments in this financial year that has been carried forward and used to increase spending in some areas. In addition, economic growth has been revised lower by the OBR for 2013, to 0.6% from 1.2%, and next year to 1.8% from 2.0% previously. Unemployment is expected to peak at 8% by the OBR and stay there for at least two years, and CPI inflation has been raised modestly higher for this year and next. The result of these revisions is lower tax revenues relative to the previous projection in the December 2012 Autumn Statement. But these figures did not surprise financial markets and so have had little impact. Gilt yields have actually fallen back somewhat and the currency has barely moved (though likely partly down to events in Cyprus). Essentially, fiscal austerity has been maintained in the medium term with little increased borrowing in the short term.

As for the monetary policy stance, once again there was actually little change in practice. The remit has been maintained, and a study of the UK's monetary policy framework published by the Treasury concluded that the mandate should continue to focus on the primacy of price stability and the inflation target. But the BoE has been asked to look at how it could refine its operational activities - by perhaps providing

conditional forward guidance and by explaining in more detail the trade offs between greater inflation flexibility and the impact on growth. Although clearly influenced by the Federal Reserve's current practise, the changes announced were close to the bare minimum that markets expected.

More supply side incentives are needed to kick-start recovery

The main announcements from a corporate perspective were to boost infrastructure investment, to cut the main rate of corporation tax to 20% by 2015/16, and to boost housing market activity through various measures. All in all, this was a business-like Budget that enshrined the government's tight fiscal policy stance and the loose monetary stance of that has been in place over the last few years.

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 David B Smith (Beacon Economic Forecasting and University of Derby). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), 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). 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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