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Shadow Monetary Policy Committee

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IEA's Shadow Monetary Policy Committee votes by seven to two to hold Bank Rate in August but states main problems are collapse in sustainable growth and excessive financial regulation

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 10th July, the Shadow Monetary Policy Committee (SMPC) decided by seven votes to two that Britain's Bank Rate should be held at ½% on Thursday 2nd August. Both dissenters wanted to raise Bank Rate by ½%. There was a range of views with respect to the efficacy, as well as the desirability, of the additional £50bn of quantitative easing (QE) announced on 5th July. Two shadow committee members supported this move, another pair thought that QE would work better if the range of assets was extended to include more private debt, one did not want to see the extra £50bn implemented, and four were reasonably agnostic on the issue, while advocating QE in a lender of last resort situation.

More generally, there was a widespread view on the SMPC that, under the current unusual circumstances, small changes to Bank Rate, had the power of a rifle, and QE was the equivalent of a large bomb, but financial regulation had a destructive potential akin to that of a tactical nuclear weapon. The committee argued that the policy inconsistency between over aggressive financial regulation and the need to stimulate money and credit creation – to get the real economy moving – was more than cancelling out the stimulatory effects of the ½% Bank Rate and £375bn of QE. There was also a strong consensus that the tax-and-spend policies pursued in the first decade of the 21st century – when combined with serious policy errors since the 2010 election, such as the VAT hike – meant that the sustainable growth rate of the UK economy was now little more than 1% per annum.

The SMPC is a group of economists who have met 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 similar exercises elsewhere. Because the committee casts exactly 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. As a consequence, the discussion and nine independent analyses should be regarded as more significant than the precise vote. The next two e-mail polls will be released on the Sundays of 2nd and 30th September, respectively. The next SMPC gathering will be held on Tuesday 16th October and its minutes will be published on Sunday 4th November.

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Minutes of the meeting of 10th July 2012

Attendance: Philip Booth (IEA-Observer), Tim Congdon, Andrew Lilico, Kent Matthews (Secretary), David B Smith (Chairman), Akos Valentinyi, Peter Warburton, Trevor Williams.

Apologies: Roger Bootle, Jamie Dannhauser, Anthony J Evans, Ruth Lea, Patrick Minford, David H Smith (*Sunday Times* observer).

Chairman's Comment

The rebased ONS national accounts

The Chairman, David B Smith, began the meeting by saying that the Office for National Statistics (ONS) had published a rebased set of national accounts with the volume figures expressed in chained 2009 prices, rather than the previous 2008 price basis, on 28th June. Unlike last year's catastrophic move to the new ESA-2010 definitions, this year's rebasing had proceeded more smoothly and long back runs of the new data were available on the ONS website without the six month delay that occurred in 2011. However, the data had been published originally with a number of errors that were not disclosed until well into July. Anyone who had downloaded the ONS data on its first release would be well advised to check that it remained accurate.

Implications of the new official figures

A cursory examination, which involved running the Beacon Economic Forecasting (BEF) model with scaled pseudo-2008 price figures, suggested that there had been some changes to the composition of the expenditure measure of national income. In particular, household consumption was now believed to be weaker and private investment stronger than had been reported previously. There had also been a marked upward revision to the growth rate of real general government consumption in the year to 2012 Q1 from 1.9% to 3%. These data changes slightly altered the terms of the current economic debate and also pulled the rug from under Labour's claims that vicious spending cuts were undermining the recovery. However, the figures for the growth of overall gross domestic product (GDP) remained pretty much the same. The updated data produced a forecast of average GDP growth in 2012 of 0.4% using the BEF model. This was a smidgen higher than the projection using the old official data set but the difference was not significant.

The LIBOR scandal

The chairman then added that he had been shocked and surprised by the London Inter-Bank Offered Rate (LIBOR) scandal because he had always naively considered this to be an accurately measured free-market rate throughout his long City career. However, corporate borrowers with rates linked to LIBOR had gained from the downwards suppression of the true rate, just as large wholesale depositors had lost out. Furthermore, it was not clear that high frequency gyrations in LIBOR, which largely self-cancelled over the term of a normal deposit or loan, had had major adverse consequences for anyone other than financial speculators who were caught out on the wrong side of derivatives transactions. None of this justified the appalling behaviour of the banks involved. There were likely to be further scandals yet to be revealed. Concern had recently been expressed about the broadly similar way in which the quoted price of oil was determined, for example. Another important issue was what the Bank of England was doing at the time either to permit, or to be unaware of, such misbehaviour. The Chairman then called upon Akos Valentinyi to give his assessment of the economic situation.

UK Economic Situation

Fall in inflation – too soon to say if permanent

Akos Valentinyi then produced a hand-out of reference charts and commenced his presentation with a discussion of inflation trends in the UK. While recent months have shown a downturn, even Consumer Price Index (CPI) inflation excluding energy had shown an upward trend on a longer term perspective. Therefore, it was too early to say that inflation was definitely on a downward trend. Goods price inflation had been highly volatile but services inflation had been less volatile and consistently above CPI inflation. Producer price inflation still indicated some upside risk as did the Bank of England inflation expectations survey.

Household indebtedness continues to act as drag on spending

Aggregate demand remained weak with both household consumption and investment dragging down growth. Spending on consumer durables had risen but, again, there was little to suggest a sustained positive trend. The investment figures continued to show weakness with only equipment investment showing signs of unusual activity, although the latter may result from the extension of wind farms. The rebalancing of household balance sheets was evident in the decline in the ratio of personal debt to income and, also, in the rise in the savings ratio.

Okun's Law prevails …growth of 2 per cent necessary to stop unemployment from rising

Growth was being driven by activity in the service sector but services growth remained anaemic. The decomposition of service sector growth showed weakness in all areas. Manufacturing productivity had risen as a result of the output drop not being as great as the contraction in employment. Britain's terms of trade had continued to decline. This deterioration could be interpreted as a negative productivity shock, which exacerbated the decline in real disposable income. Yet, the rate of unemployment remained below the peak of the early 1990s recession. A simple plot of the change in the rate of unemployment against the growth rate confirmed that Okun's Law still prevailed. The implication was that real GDP growth in the region of 2% was necessary to stop unemployment from rising.

Weak supply-side but inflation remains a risk

In summary, the demand side of the economy remained weak in the opinion of Akos Valentinyi. There might have been some good news with respect to durables spending but the supply-side was also debilitated. The balance between weak demand – but even weaker supply – suggested that the longer-term risks to inflation were on the upside.

Discussion

Introduction to discussion

The Chairman thanked Akos Valentinyi for his presentation before throwing open the meeting for discussion. David B Smith added that while the latest ONS figures showed that government consumption expenditure was up 3% year-on-year in the first quarter, general government fixed capital formation was down almost 33% year-on-year, and that both figures were now noticeably adrift – but in opposite directions – from the post-Budget projections of the Office for Budget Responsibility (OBR). The Chairman then asked for comments and questions from the committee.

QE has little power

Andrew Lilico asked whether the exclusion of monetary developments in the presentation was deliberate and how did Professor Valentinyi see quantitative easing (QE) working on the economy. Akos Valentinyi said that there had been no major

changes in the pattern of credit flows. Given the weakness of household demand and the rebuilding of balance sheets, QE would have had little force. He suggested that there might be a threshold effect before QE started to work so that only after a particular level has been breached, would QE begin to operate. He added that, in an open economy, QE could leak out in capital flows to the overseas sector and not have any direct effects on home demand.

Trend output growth is 1% a year and output gap is low

Tim Congdon said that he found the lack of discussion of monetary developments very disappointing. He also disagreed with Akos Valentinyi's pessimism on inflation. The recent collapse in oil and other energy prices implied a sharp fall in inflation measures later in 2012 and in early 2013. By the end of this year, all-items CPI inflation would be lower than CPI inflation excluding energy. Nevertheless, he doubted that output was substantially below its trend level, largely because the UK's trend growth rate of output was now only around 1%.

Euro crisis is a supply side shock

Kent Matthews said that no amount of QE would have any real effects if there was indeed as little spare capacity as Tim Congdon suggested. Peter Warburton added that the output gap should not be seen as a domestic constraint. Rather world inflation was related to a global output gap and its consequences for the UK were amplified or diminished according to the weakness or strength of sterling. Andrew Lilico said that the most recent tranche of QE had been driven by the Euro crisis. The function of QE was to push money into the economy. However, with low capacity growth, a low output gap and loss of inflation target policy credibility, the policy had lost its traction. The Euro crisis could be viewed as an adverse supply-side shock.

QE is second, third or even fourth best policy option…

Tim Congdon said that QE was indeed necessary at the outset of the crisis and that things would have been worse in its absence. David B Smith said that the official push towards ever greater financial regulation was so severely restrictive in its monetary and macroeconomic consequences that a great deal of QE was needed simply to offset its negative effects. The logical course was no regulatory overkill and no QE. It was crazy to try to offset the collateral damage done by one set of policy-induced distortions with another damaging set of interventions. This was reminiscent of the policy blunders of US President Carter and Britain's second Wilson administration in the 1970s, where distortions were piled upon distortions and the authorities ended up chasing their own tails. It took Ronald Reagan and Margaret Thatcher to cut through this Gordian knot the last time round. However, he saw little prospect of current politicians being up to the task required. Kent Matthews said that this argument was reminiscent of the Lipsey-Lancaster theory of the second-best, where an initial distortion caused by a market failure was corrected by a counter-balancing policy distortion. Peter Warburton said that QE was a third or fourth best option. He said that gilt purchases were only one type of QE intervention. Another type was to swap out existing QE for more risky assets, at fair value, held on commercial banks' balance sheets. The Bank of England needed to take more risk in order to break the deadlock. Tim Congdon said that the separation of activity between the Bank of England, Debt Management Office (DMO) and HM Treasury had created inconsistency in policy.

Counterproductive regulations

David B Smith concluded the discussion by suggesting that the stance of bank regulators can be best understood by applying public choice theory to regulatory bureacracies. Over-regulation made it less likely that there would be politically embarassing bank failures and a few big banks centred on London were easier to supervise than numerous small ones scattered across the country. In addition,

complex regulations allowed officials to maximise their bureaucratic empires and better enjoy the fruits of office. This was not an argument for zero regulation. Rather, he was suggesting that there was a tipping point beyond which regulation did more harm than good to society, and that we were now well past that point. Tim Congdon added that, as there was unanimous agreement on the SMPC that regulation was making things worse, a common statement on the implementation of Basle III and other regulation should be included in the policy recommendation. The Chairman then called on the committee to cast their votes and make their comments on monetary policy. These votes are listed in alphabetical order. The vote of Ruth Lea was cast in absentia on 17th July, because she had been unable to attend the SMPC gathering.

Comment by Philip Booth

(Institute of Economic Affairs)
Vote: Hold Bank Rate.
Bias: Do not implement the round of QE recently announced.

Supply side risks…monetary policy should not be dominated by Euro crisis

Philip Booth said that there were considerable supply side risks. The Eurozone crisis should not be allowed to dominate monetary policy. He said that falling inflation was resulting in less negative real interest rates and therefore there was no need to tighten and raise Bank Rate in the short term. He said that he was satisfied with the status quo and that latest round of £50bn QE should not be implemented.

Comment by Tim Congdon

(International Monetary Research)
Vote: Hold Bank Rate.
Bias: Continue with QE as announced.

QE remains correct policy response

Tim Congdon said that the funding for lending scheme announced in the Mansion House speech was potentially important. There could be higher growth of the quantity of money, due to both the third exercise in QE and the funding for lending scheme in late 2012 and early 2013. He said that interest rates should remain on hold for the time being and QE continue as planned. QE, which was currently organized solely by the Bank of England, should be replaced by a proper policy of debt management, coordinated between the Bank, the Treasury and the Debt Management Office. The main purpose of debt management policy should be to maintain stable growth of the quantity of money. However, another important consideration was to ensure that banks and other institutions active in the money market had an abundant stock of liquid assets (such as Treasury bills) to trade.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: No change in Bank Rate; continue with latest announced QE stimulus.

Weak growth and Euro crisis justified extra QE

The Bank's latest £50bn tranche of QE, announced at the July MPC meeting, was wholly unsurprising. Faced with a struggling economy, the recent downgrade by the International Monetary Fund (IMF) to its UK GDP growth forecasts was only to be expected; the Bank, rightly, continued to pursue its very stimulatory monetary policy. The damaging uncertainties created by the on-going Eurozone crisis show no signs of abating as the Eurozone's political leaders continue to avoid the painful and necessary

measures required to ‘solve’ the Euro’s intrinsic problems. The Euro crisis blew up in early 2010 and a permanent solution is almost as remote as it ever has been – even after the latest summit. Regulatory pressures on the banks continue to act in a counter-cyclical manner, restricting the banks’ ability to lend.

Inflation not a concern

Meanwhile there was no need to be concerned about inflation. June’s CPI inflation rate fell to 2.4%, better than expected, and earnings growth remains extraordinarily subdued. It is now quite possible that the Bank will meet the 2% inflation target by the end of the year, which vindicates its ‘wait and see’ policy and refusal to tighten monetary policy even though CPI inflation has been above target since 2010. As CPI inflation falls to target then the painful squeeze on real incomes should be eliminated, which in turn should support consumer expenditure.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no additional QE.
Bias: To raise rates.

Monetary policy should not be used to offset regulatory errors

Andrew Lilico said that it was not the job of monetary policy to offset regulatory errors. In the current situation, there was little monetary policy could do. An extreme monetary stimulus had been carried on for longer than necessary. Some normalisation of monetary policy should be aimed at. The rate of interest needed to revert to a Wicksellian norm – i.e. a real rate of something around 2% and there had to be a reconnection of the policy rate to market rates. A return to an equilibrium growth rate could not be obtained with Bank Rate so low. A rise was appropriate at this stage as a step towards the normalisation of monetary policy.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%; no additional QE.
Bias: To raise; QE to be used only in the event of another Euro crisis flare up.

Interest rates can always be lowered from a new higher position if there is a Euro crash

Kent Matthews said that he was impressed by Tim Congdon’s comments that there was little spare capacity in the economy and that capacity growth was in the order of 1% a year. If this was the case, then QE would be ineffective. He said that he was also optimistic about the funding for lending scheme and that it did have the potential to kick start bank lending to the growth sectors that will capacity build. His argument for raising the rate of interest was somewhat different to Andrew Lilico’s. While agreeing that monetary policy had to revert to some norm meant that rates had to rise, he felt that the Euro crisis might carry on for far longer than people currently suspect. Interest rates at the current position left no room for monetary policy in the event of another flare up of the Euro crisis. Currently, interest rates had nowhere to go in the event of a crisis. Interest rates would have to move closer towards a level where real interest rates were positive, so that in the event of a crisis the Bank could cut rates and deploy QE as a countermeasure. He said that interest rates should start to rise in small steps. While he felt that QE should be held in reserve for a bad day, to not implement the announced policy would only signal what some market participants fear – i.e., that the Bank does not know what it is doing.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate. No additional QE
Bias: To raise Bank Rate, once the Euro-zone situation clarifies.

Lower oil price should help boost activity in 2013

David B Smith said that policy should be geared towards boosting the long term rate of growth using deregulation, tax reform and other supply-side friendly measures immediately and a rolling back of the excessive size of the state as soon as that becomes practical. The massive increase in the governmental sector between 2000 and 2010 had led to the mother of all supply withdrawals where the UK was concerned. This was not a situation that could be corrected by injecting ever more nominal demand into the economy. Britain's small open economy meant that the main role of monetary policy was to differentiate UK inflation from world inflation via changes in the external value of sterling, which had been reasonably strong recently. The cut in the oil price from around $125 for a barrel of Brent crude to $100 – which now seems to be the new Saudi Arabian goal – will be dis-inflationary in the short term but also result in a positive surprise to global output in 2013.

Regulatory policy has been perverse and exacerbated the business cycle

Regulatory policy had been totally perverse and business cycle-exacerbating where money and credit creation were concerned. Monetary policy had attempted to offset the negative effects of regulation but without success. Higher capital and liquidity ratios should have been imposed in the boom not in the recession. QE was not a silver bullet. The only remaining argument for it now was to offset regulatory mistakes that should not have happened in the first place. Private-sector agents were not spending and investing because they faced hugely excessive regulatory uncertainty, tax unpredictability, and political risk. Politicians and bureaucrats needed to stop making matters worse and cease their confidence-sapping anti-business rhetoric. The economy required a predictable and stable banking system. Competition in the banking system could be brought in by employing anti-monopoly legislation to break-up the bigger banks, perhaps into their original constituents that existed before the clearing bank mergers of the late 1960s. This would reduce the 'too big to fail' problem without requiring the wholesale socialisation of the banking system that current policies were engendering.

Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)
Vote: Hold Bank Rate; no further QE.
Bias: To tighten.

Significant inflation risks

Akos Valentinyi repeated that it was too early to say that inflation was on a sustained downward path. There remained significant inflation risks and expectations of inflation on the Bank of England's own survey continued to point to an upward path. Low unemployment in the current stage of the recession could be interpreted as a positive inflation surprise. He said that there was no need for interest rates to rise immediately but his bias was for a rise in the near future. He said that QE should be put on hold for the moment.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Hold Bank Rate; diversify existing QE into non-gilt assets.
Bias: To raise Bank Rate.

Increase scope of QE

Peter Warburton noted that the basis of policy recommendation could be either principled or pragmatic. The principled action was to normalise monetary policy by raising Bank Rate and begin to rebalance tracker interest rates in favour of existing savers rather than borrowers. Further QE, in whatever form, should be held back as an emergency measure. The pragmatic policy approach was to keep rates on hold – to avoid the difficulty of presenting this policy in a positive light at a time of economic stagnation – and to switch some of the existing £325bn of QE into riskier 'available-for-sale' investments on the balance sheets of UK commercial banks, acquired at fair value. This would reduce the banks' requirement for regulatory capital and release balance sheet capacity for new lending.

Deeply expedient UK monetary policy

Current monetary policy had left the realm of first best or even second best solutions. In seeking to counteract the contractionary force of international regulatory pressures on the UK financial system, monetary policy was deep into the territory of pragmatism and expediency. He said that he had deeper concerns about further gilt purchases in relation to regulatory interventions designed to raise collateral requirements. In addition, he was not optimistic about the impact of 'funding for lending' because there was little to suggest that banks lacked short-term liquidity. Rather, their problem was that of regulatory overload which should, ideally, be reversed at source. He said rates should remain on hold and the power of existing QE be increased by switching from purchases of gilts from the market to purchases of riskier assets directly from the banks.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold.
Bias: Widen scope of QE.

Extend QE by a further £75bn

Trevor Williams said that the rate of interest had to remain on hold until the wider economic situation improved. Inflation would most certainly fall in the coming months. In the next twelve months, the beginning of the normalisation of interest rates could start to occur as real interest became less negative with the fall in price inflation, provided no adverse demand shocks arose from Europe. Regulation was having an adverse effect on credit supply. QE should be expanded to include a wider portfolio of collateral. QE should also be kept ready for use in the event of a wider Euro zone problem developing.

Policy response

1. On a vote of seven to two the IEA's shadow monetary committee recommended that the official rate of interest should remain on hold.

2. Several SMPC members indicated a bias to raise Bank Rate in the future, while accepting that this was not appropriate at the moment.

3. There was a mixed response to the announcement of further QE. One member said that the announced policy should not be implemented, while two agreed that the policy should be continued. Four members felt that there should be no further QE while two members said that the scope of QE should be widened to cover a wider range of assets. Two members said that further QE could be deployed in the event of fallout from the Euro crisis. One member felt that in the medium term QE should be replaced by a more appropriate debt management policy.

4. There was unanimous agreement that excessive bank regulation, including the early application of Basle III, was having perverse effects on the ability of banks to lend. It was felt that the timing of domestic and international regulatory policy was unhelpful in creating the conditions for recovery. Any further regulatory policy impositions should be delayed until a firm recovery was in sight.

Date of next SMPC meeting

Tuesday, 16th October 2012.

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 (University of Derby and Beacon Economic Forecasting). 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), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), 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 Wholesale 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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